Australian Government

Corporations and Markets Advisory Committee

LONG–TAIL LIABILITIES

The treatment of unascertained future personal injury claims

Discussion Paper

June 2007

Corporations and Markets **Advisory Committee**

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Contents

1 Introduction

*This chapter outlines the issue under review, provides background and identifies key concepts, draws some comparisons with the separate **Sons of Gwalia** reference, and provides information for those who may wish to make submissions.*

1.1 The issue under review

The current review follows controversy and public concern about the adequacy of arrangements for payment by a company of compensation to people suffering from asbestos-related diseases.

The Advisory Committee has been asked to consider measures to improve the position of potential personal injury claimants against a company in circumstances where:

- the company has acted in a manner that may give rise to enforceable claims against it (say through the manufacture of faulty or dangerous products)
- individuals have suffered or are likely to suffer consequential personal injury, but
- evidence of the injury, necessary to give those persons a completed claim against the company, has not yet emerged and indeed may not emerge for a long time due to the latency period of the injury (a latency period that may differ between individuals).

A company faced with claims or the prospect of claims of this kind – so-called long-tail liabilities – may be on notice that future claims will emerge, though how many claimants there will be, and when each of those claims will arise, as well as the quantum of those claims, remain uncertain.

While the circumstances in which a company is faced with future unascertained personal injury claims of this kind may not be common, where they do arise, they can pose considerable difficulties for management and risks to fairness for claimants.

Given that the continuing financial well-being of a company cannot be taken for granted – a company can run into financial problems as a result of mismanagement or changed market or other factors – the issue for consideration is whether and to what extent special provision should be made to protect the position of unascertained future claimants in the event of the company getting into financial difficulty.

In considering any special protection for unascertained future claimants, a range of factors needs to be taken into account:

- *bearing the cost:* where possible, the company responsible for the personal injuries in question should bear the cost of compensating victims, rather than leaving this to the broader community through the provision of publicly funded health and social services

- *inherent uncertainty:* it is difficult to devise a regime that seeks to impose current duties or obligations in relation to uncertain factors, such as the number of future victims, the total size of their claims and the timing of those claims

- *materiality:* claims that may pose material future costs for one company, and have a significant potential impact on its financial position, may have a lesser effect on another company that is in a stronger financial position

- *balance:* the desire to protect the position of unascertained personal injury claimants needs to be weighed against the effect on the ongoing functioning of solvent companies; undue procedural burdens or restrictions on the current governance of a company may undermine its continuing ability to meet claims as they arise over time

- *clarity:* uncertainty or subjective judgment in the application of any new requirements may serve to constrain the operation of responsible companies, while not affecting more recalcitrant companies

- *equity:* any new procedure should seek to ensure, as far as reasonably possible, that individuals who suffer the same type of injury have a similar opportunity to recover compensation, regardless of when their injuries become apparent

- *workability:* any new requirements should be capable of being implemented in an efficient, effective and expeditious manner; where a company goes into external administration, trade and other current creditors have an interest in early recoupment of their claims from any available corporate funds.

It is noted that taxation issues may arise in relation to any provision for long-tail liabilities, including in relation to the tax treatment of any corporate assets set aside for the purpose of funding these liabilities. Taxation matters are not addressed further in this paper.

It should be noted too that, for the purposes of the reference given to the Advisory Committee, long-tail liabilities do not include claims for damages other than for personal injury.

1.2 Background to the review

1.2.1 Public concerns

The *Report of the Special Commission of Inquiry into the Medical Research and Compensation Foundation* (September 2004) (known as the James Hardie Inquiry)[1] observed that:

> current laws do not make adequate provisions for commercial insolvency where there are substantial long-tail liabilities.[2]

The report also noted that:

> unless some general reform is enacted that permits external administration to deal with long tail liabilities, future cases will arise that will have to be the subject of ad hoc legislative solution, if serious injustice is to be avoided.[3]

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1 **www.lawlink.nsw.gov.au/Lawlink/Corporate/ll_corporate.nsf/pages/MRCF_index**
The Special Commission was established by the New South Wales Government following public disquiet about the adequacy of arrangements made by James Hardie Industries Limited for compensating those who had suffered from exposure to asbestos as a result of the company's activities, which included the manufacture and distribution of asbestos products.
Legal proceedings in relation to James Hardie are still under way and are not addressed in this paper.

2 para 30.67.

3 para 30.78.

1.2.2 Referral of proposal by Government

In October 2005, the Parliamentary Secretary to the Treasurer, the Hon. Chris Pearce, MP, requested the Advisory Committee to review a proposal to extend existing statutory creditor protections to unidentified future personal injury claimants against companies where a mass future claim is afoot. The Parliamentary Secretary noted that:

> The *Report of the Special Commission of Inquiry into the Medical Research and Compensation Foundation* (the James Hardie Inquiry), released on 21 September 2004, highlighted the issue of the adequacy of arrangements under the law for the protection of personal injury claimants.
>
> In particular, the James Hardie Inquiry found that the current external administration mechanisms do not give adequate recognition to the existence of long-tail liabilities arising in the case of unascertained future creditors. Such claimants may include persons who have suffered injury through exposure to products, where the injury does not manifest itself until after the time of the external administration.
>
> Due to the uncertain nature of personal injury claims, reform in the area of corporate liability for personal injury claims needs to balance competing policy objectives.
>
> On one hand, there is a need to strengthen protections for personal injury claimants particularly where there is a long latency period for an injury, which hinders the claimant taking any action to protect their rights.
>
> On the other hand, it is recognised that in the normal course of business, companies will have little information about the likelihood or magnitude of future claims that may arise from their conduct. It would introduce significant business uncertainty if all companies were required to make provision for possible future personal injury claims. However, the situation may be different where a mass future claim is afoot. In this situation, the strong likelihood of future claims means that the distinction between present creditors and unascertained future personal injury claimants whose injuries are not manifest is less clear.

The letter from the Parliamentary Secretary set out a proposal for the treatment of long-tail liabilities for solvent companies and companies in external administration and sought advice on:

- whether the proposal would protect the interests of future, unascertained creditors without compromising unduly current corporate law and insolvency principles

- whether any alterations to the proposal might assist in striking an appropriate balance between the competing policy considerations.

In this paper, the proposal is referred to as the Referred Proposal, and is fully set out in Chapter 3.

1.3 Key concepts

1.3.1 Long-tail liabilities

Long-tail liabilities, as dealt with in this paper, will typically arise where the conduct of a company results in individuals suffering a personal injury that will only become manifest at some indefinite future time, due to its latency period. The injury may arise, for instance, from a faulty or dangerous product manufactured by the company. The concept does not extend to damages unrelated to personal injury.

Long-tail liabilities may arise even if the injury will only be suffered after a future intervening event, provided the precipitating conduct of the company has already occurred. For instance, individuals may not yet have been exposed to the faulty or dangerous corporate product.

Long-tail liabilities can be contrasted with claims such as occupational health and safety claims, which may arise against a company in the future, that is, where the precipitating corporate conduct, not just the injury, is yet to occur.

The long-tail liabilities in respect of which additional legal measures are canvassed in this paper are therefore confined to the liabilities of a company for personal injuries where:

- an act or omission that will give rise to a claim against the company has occurred

- the persons who in due course will have a claim against the company do not yet have a completed cause of action, either

because their injury has not yet become manifest[4] or because an intervening event that will give them a completed cause of action has yet to occur.[5]

Long-tail liabilities do not include:

- claims arising from corporate conduct that results in immediate discernible injury and therefore gives rise to a completed cause of action
- claims by persons whose indications of injury have become sufficiently manifest after a latency period to give them a completed cause of action.[6]

In either case, the injured party is entitled to claim immediately against the company and therefore has creditor rights, similar to any other person with present claims against the company, which are already recognised in the Corporations Act.

1.3.2 UFCs

This paper uses the term UFCs to refer to the unascertained future personal injury claimants, whose claims will arise over time from a company's long-tail liabilities.

1.3.3 Mass future claim

In addition to the elements identified above in defining UFCs, the Referred Proposal envisages that UFCs will only have the proposed protections that are discussed in Chapter 5 onwards when they are sufficiently numerous that their claims against the company

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4 For instance, 'persons injured through exposure to asbestos … do not have a completed cause of action until damage is suffered and that usually involves manifestation of the disease': *Edwards v Attorney General* [2004] NSWCA 272 at [58], 22 ACLC 1,177, 50 ACSR 122.

5 In the context of asbestos claims, the court in *Edwards v Attorney General* stated at [58]:

> Indeed, some of the future claimants could be in the more extreme category where the people concerned have not yet been exposed to the asbestos such as home renovators doing future renovations or may even be people not yet born who might be involved in demolishing an asbestos ridden building somewhere in 2030.

6 In some cases, proof of all the elements necessary to establish a claim can involve complex litigation: see, for instance, *Ellis, Executor of the Estate of Cotton (Dec) v South Australia* [2006] WASC 270.

constitute a 'mass future claim'. Chapter 4 discusses the case for that additional threshold test.

1.4 Purpose of the discussion paper

At the outset of its review, the Advisory Committee published the Referred Proposal and invited public submissions on the various initiatives suggested in it. Several submissions were received[7] and are available on the Advisory Committee's website. The Committee has closely considered these submissions and has been assisted by them. The Committee has decided to issue a discussion paper at this stage and invite further submissions, given:

- various new policy options under consideration in this paper, and
- further perspectives on issues relevant to long-tail liabilities in consequence of the High Court decision in *Sons of Gwalia Ltd v Margaretic* [2007] HCA 1 (*Sons of Gwalia*).

The Advisory Committee would welcome further submissions from the initial respondents as well as submissions from other interested parties.

1.5 Comparison with the *Sons of Gwalia* reference

The Advisory Committee has received a reference related to the *Sons of Gwalia* decision.[8]

The *Sons of Gwalia* and long-tail liabilities references both raise the general question of whether the interests of particular groups who traditionally have not been regarded as having rights in a voluntary

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7 Submissions were received from:
- Australian Conservation Foundation
- Chartered Secretaries Australia
- Institute of Actuaries of Australia
- Business Council of Australia
- Insolvency Practitioners Association of Australia
- Australian Lawyers Alliance
- Institute of Chartered Accountants in Australia
- Insurance Council of Australia
- Australian Institute of Company Directors.

8 The terms of reference can be found at **www.camac.gov.au**

administration should be included in those procedures, and if so in what manner. These references also raise the question of how these groups should be treated in a liquidation.

1.5.1 Current position

The current legal position in Australia (as summarised in Chapter 2) appears to be that UFCs are not treated as unsecured creditors until they have a completed cause of action, including proof of damage (for instance, through the development of symptoms of personal injury). Where injury is latent, this may not occur for many years after the relevant conduct by the company. During the latency period, UFCs appear to have no rights or role in a voluntary administration or liquidation. The Referred Proposal involves recognition of UFC rights in any such external administration.

On the other hand, the current position as determined by the High Court in *Sons of Gwalia* is that shareholders can prove in a voluntary administration or liquidation as unsecured creditors for the damages they have suffered as a result of misleading conduct by the company that induced them to buy its shares. This places them on the same level as 'conventional unsecured creditors' (including lenders and trade creditors).[9]

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[9] Sons of Gwalia Ltd was a gold mining company listed on the Australian Stock Exchange (ASX). The plaintiff shareholder purchased shares in the company on the ASX. Shortly thereafter, the company went into voluntary administration and the value of the shares held by the shareholder (and all other shareholders) was reduced to nil.
The shareholder commenced an action against the company, claiming that at the time of his share purchase the company was in breach of the ASX continuous disclosure listing rules in that the company had failed to notify the ASX that its gold reserves were insufficient to meet its gold delivery contracts and therefore it could not continue as a going concern. The shareholder claimed that, in consequence of the non-disclosure, he was a victim of misleading and deceptive conduct by the company, involving breaches of s 52 of the *Trade Practices Act 1974*, s 1041H of the Corporations Act and s 12DA of the *Australian Securities and Investments Commission Act 2001*.
Pursuant to the voluntary administration, the company entered into a deed of company arrangement (DOCA) that provided for distributions from the company's assets to take place in the same order of priority as would apply if the company were being wound up. The High Court ruled that the shareholder could be admitted as an unsecured creditor under the DOCA, on the assumption that he had been induced to buy shares of the company as a result of misleading conduct by the company prior to its insolvency. The shareholder's claim was not of the type that was postponed behind those of unsecured creditors under s 563A.

1.5.2 Points of similarity

The two references have some overlapping or common policy issues:

- the effect on various groups in an external administration (in this context being a voluntary administration or liquidation)
- the effect on the conduct of an external administration.

The beneficiaries

The groups that benefit from a widening of the traditional category of unsecured creditors are:

- *currently*: shareholders with particular shareholder claims against the company (under *Sons of Gwalia*)
- *potentially*: UFCs (if the law is amended).

Disadvantaged groups

The corollary of giving shareholders and UFCs greater rights in external administrations is that, unless there are sufficient corporate assets to pay out all debts, the rights of conventional unsecured creditors (including the payment they receive) would be adversely affected.

Groups not affected

Neither reference affects the rights of secured creditors, or other priority creditors such as employees, in an external administration.

Conduct of external administrations

Another issue common to both references is whether external administrations are or would be made more complex by having to take into account additional categories of claims, being some claims by shareholders (*Sons of Gwalia* reference) or the interests of UFCs (long-tail liabilities reference) and, if so, how these complexities could be mitigated.

1.5.3 Points of difference

Application to solvent companies

The long-tail liabilities reference has significance for solvent ongoing companies, as well as those in external administration. By contrast, the issues in the *Sons of Gwalia* reference only apply to

insolvent companies, given that there has never been any impediment to shareholders recovering damages from solvent companies in relation to claims arising from their shareholding.

Nature of the wider class of claimants

UFCs, having suffered personal injury in consequence of corporate conduct, may be seen as particularly vulnerable and deserving involuntary victims whose interests should be protected, or taken into account, in some manner in a voluntary administration or liquidation of the company.

There is more room for debate on whether shareholders should enjoy the rights of general unsecured creditors in relation to various shareholder claims arising from financial loss.

Awareness of loss allocation issue

Public debate on the position of UFCs arising from the James Hardie matter focused primarily on how best to ensure that solvent companies (within a corporate group) make appropriate provision for UFCs. There has been less focus on the consequences for conventional unsecured creditors if UFC claims are given greater recognition.

On the other hand, there has been considerable debate on whether the risk transfer arising from *Sons of Gwalia* is appropriate or should be reversed by statutory amendment. The Parliamentary Secretary to the Treasurer, in his referral letter to the Advisory Committee, noted that the High Court decision creates a transfer of risk from shareholders to unsecured creditors and commented that:

> This raises an initial question about which party is best able to manage the risk of misleading statements by a company prior to an insolvency. Some have argued that creditors are in a better place to protect themselves against these types of risks, by monitoring borrowers or taking security. Others argue that shareholders enjoy the profits of the business, and as such should bear the risk of its failure.

1.6 Request for submissions

The Advisory Committee invites submissions on any aspect of the matters covered in this paper, including the Referred Proposal and other possible procedures outlined in this paper. The Advisory

Committee has developed these other procedures for further discussion and has not endorsed any of them at this stage.

Issues relating to *Sons of Gwalia* will be dealt with in a separate discussion paper.

Please send your submission, in Word format, to:

john.kluver@camac.gov.au

If you have any queries, you could call (02) 9911 2950.

Please forward your submissions by **Friday 5 October 2007**.

All submissions, unless marked confidential, will be available at **www.camac.gov.au**.

1.7 The Advisory Committee

The Advisory Committee is constituted under Part 9 of the *Australian Securities and Investments Commission Act 2001*. Its functions under s 148 of that Act include, on its own initiative or when requested by the Treasurer or the Parliamentary Secretary to the Treasurer, to provide advice to the Minister about corporations and financial services law and practice.

The members of the Advisory Committee are selected by the Minister, following consultation with the States and Territories, in their personal capacity on the basis of their knowledge of, or experience in, business, the administration of companies, financial markets, financial products and financial services, law, economics or accounting.

The current members of the Advisory Committee are:

- Richard St John (Convenor)—Special Counsel, Johnson Winter & Slattery, Melbourne
- Zelinda Bafile—General Counsel and Company Secretary, Home Building Society Ltd, Perth
- Barbara Bradshaw—Chief Executive Officer, Law Society Northern Territory, Darwin

- Jeremy Cooper—Deputy Chairman of the Australian Securities and Investments Commission
- Alice McCleary—Company Director, Adelaide
- Marian Micalizzi—Chartered Accountant, Brisbane
- Ian Ramsay—Professor of Law, University of Melbourne
- Robert Seidler—Partner, Blake Dawson Waldron, Sydney
- Greg Vickery AM—Chairman and Partner, Deacons, Brisbane
- Nerolie Withnall—Company Director, Brisbane.

The function of the Legal Committee is to provide expert legal analysis, assessment and advice to the Advisory Committee in relation to such matters as are referred to it by the Advisory Committee.

The members of the Legal Committee are selected by the Minister, following consultation with the States and Territories, in their personal capacity on the basis of their expertise in corporate law.

The current members of the Legal Committee are:

- Nerolie Withnall (Convenor)—Company Director, Brisbane
- Lyn Bennett—Partner, Hunt & Hunt, Darwin
- Elizabeth Boros—Professor of Law, Monash University, Melbourne
- Damian Egan—Partner, Murdoch Clarke, Hobart
- Jennifer Hill—Professor of Law, University of Sydney
- James Marshall—Partner, Blake Dawson Waldron, Sydney
- David Proudman—Partner, Johnson Winter Slattery, Adelaide
- Laurie Shervington—Partner, Minter Ellison, Perth
- Simon Stretton—South Australian Crown Solicitor, Adelaide

- Gabrielle Upton—Legal Counsel, Australian Institute of Company Directors, Sydney.

The Executive comprises:

- John Kluver—Executive Director
- Vincent Jewell—Deputy Director
- Liam Burgess—Legal Consultant (until October 2006)
- Anne Durie—Legal Consultant (from February 2007)
- Thaumani Parrino—Office Manager.

2 Current position

This chapter considers whether UFCs have rights, or are otherwise recognised, under the Corporations Act and whether companies must disclose information about their potential claims. While it appears that UFCs do not have the general rights of creditors under the Act, the courts may recognise and protect their interests in some contexts. Also, the relevant accounting standard may require the disclosure of potential liabilities to UFCs.

2.1 Overview

The first consideration in determining what, if any, provision needs to be made for UFCs is whether, and the extent to which, the position of those persons is already recognised in corporate law and, if so, in what manner. This raises various questions:

- are UFCs creditors
- are their interests otherwise recognised
- must companies disclose information about them?

2.2 Whether UFCs are creditors

2.2.1 Rights of creditors

The Corporations Act makes provision for the creditors of solvent companies and companies under external administration. In some circumstances, such as a share capital reduction or a share buy-back, a company may not carry out a transaction if to do so would materially prejudice its ability to pay its creditors. Creditors also have various rights to participate in an external administration and their claims rank above various claims by shareholders.[10] Creditors have various remedies where their rights have been breached.[11] In

[10] s 563A, as interpreted in *Sons of Gwalia*.
[11] See, for instance, ss 1324, 1325.

addition, amounts due and payable to creditors are taken into account in assessing corporate solvency.[12]

2.2.2 Meaning of 'creditor'

The concept of 'creditor' of a company is not defined in the Corporations Act. There is a question whether UFCs are creditors of a company and therefore currently have the rights and powers of creditors under the Act.

It has been suggested that UFCs could be creditors, at least in the context of a return of share capital under s 256B, which is prohibited if it would 'materially prejudice the company's ability to pay its creditors'.[13] Also, there is case law to the effect that UFCs could be

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12 s 95A.

13 Legal advice given to James Hardie suggested that unknown future tort claimants could be considered creditors, at least in the context of a reduction of share capital under s 256B, which is prohibited if it would 'materially prejudice the company's ability to pay its creditors': *Special Commission of Inquiry into the Medical Research and Compensation Foundation – Final Report* (Sydney, 2004) at [27.41-27.45].

According to one opinion cited in that report (para 27.44), the range of persons who would be creditors in this capital reduction context include:

> a class of people having the potential right to claim under circumstances which have already arisen giving them such a right and whose claims are predictable and reasonably certain to occur in the future. The strongest example in the context of people exposed to asbestos are those who currently manifest symptoms of an asbestos induced disease but who are yet to make a claim. It is quite possible that people exposed to asbestos who have not yet manifested any symptoms are also creditors for these purposes, provided such claims are predictable and reasonably certain to occur in the future. Including such people as creditors is certainly a prudent approach to adopt.

Another opinion cited in that report (para 27.45) also considered it likely that the definition of 'creditors' in s 256B would be construed in a broad rather than a narrow fashion. The opinion commented that, in this context:

> Clearly, it may be very difficult to identify the individual persons who would constitute such 'creditors'. However, statistics may assist in establishing the likely number of claimants and the likely nature of their alleged injuries, as would (no doubt) reference to information as to the period of time within which symptoms of asbestos related diseases would manifest themselves. Assessment of the strength and likely success of such claims will of course be difficult but actuarial and like analysis will probably be capable of yielding some measure of quantification that will assist the Board in this respect. The matter should, in my view, be approached in a commercial and realistic way. This is consonant with a view that claims that are predictable and reasonably likely to emerge (but which have not yet emerged) ought to be taken into account in the way that an insurer does.

creditors in a scheme of arrangement under UK legislation.[14]

However, the more likely view under Australian law is that UFCs do not have the rights of creditors and cannot be bound as such. The Corporations Act uses the term 'creditor' but does not define it. However, the notions of debts or claims that are admissible to proof in a winding up under s 553 throw light on the meaning of 'creditor'. The courts have also applied this approach to the meaning of 'creditor' in other contexts, such as in a voluntary administration or a scheme of arrangement.[15]

Under s 553(1):

> all debts payable by, and all claims against, the company (present or future, certain or contingent, ascertained or sounding only in damages), being debts or claims the circumstances giving rise to which occurred before the relevant date, are admissible to proof against the company.[16]

Some elements in this provision, namely:

- 'present'
- 'certain', and
- 'ascertained'

are clearly inapplicable to the position of UFCs.

Other elements, namely:

- 'future', and
- 'contingent'

may also be inapplicable to UFCs, for the following reasons.

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14 *Re T&N Ltd* [2006] 2 BCLC 374, [2005] EWHC 2870 (Ch), *In the Matter of Cape Plc* [2006] EWHC 1316 (Ch), *In the Matter of T&N Limited* [2006] EWHC 1447 (Ch). These cases are further discussed in Section 7.1.3 under the heading *Creditor schemes involving UFCs*.

15 *Brash Holdings Ltd v Katile Pty Ltd* (1994) 13 ACSR 504 at 514-515 (voluntary administration); *Re Glendale Land Development Ltd (in liq)* [1982] 2 NSWLR 563 at 566, 7 ACLR 171 at 175-176 (scheme of arrangement); *Re RL Child & Co Pty Ltd* (1986) 5 NSWLR 693 at 694-695, 10 ACLR 673 at 674 (scheme of arrangement).

16 'Relevant date' is defined in s 9.

Future claims

In relation to future claims, it has been held that:

> A future claim is distinguishable from a contingent claim in that, while both are founded on an obligation existing as at the commencement of the winding up or the deed of company arrangement, a future claim will arise at some time thereafter while a contingent claim may arise.[17]

Arguably, the future claims test cannot include UFCs. At the specific time in an external administration that this test is to be applied, it is not possible to identify the particular persons who in the future will satisfy the UFC test (as outlined in Section 1.3).

Contingent claims

A person with a contingent claim is a contingent creditor, being:

> a person towards whom, under an existing obligation, the company may or will become subject to a present liability upon the happening of some future event or at some future date.[18]

There is Australian authority that a UFC is not a contingent creditor. In *Edwards v Attorney-General (NSW)* (2004), the New South Wales Court of Appeal held that:

> On current authority, persons injured through exposure to asbestos … do not have a completed cause of action until damage is suffered and that usually involves manifestation of the disease: *Orica Ltd v CGU Insurance Ltd* [2003] NSWCA 331, 13 ANZ Insurances Cases 61-596. Indeed, some of the future claimants could be in the more extreme category where the people concerned have not yet been exposed to the asbestos such as home renovators doing future renovations or may even be people not yet born who might be involved in demolishing an asbestos ridden building somewhere in 2030. No-one can currently know the identity of the future claimant.
>
> This type of liability must be distinguished from the case of a contingent creditor. A contingent creditor is a person to whom a corporation owes an existing obligation out of

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17 *Expile Pty Limited v Jabb's Excavations Pty Ltd* [2004] NSWSC 284 at para 37.

18 *Community Development Pty Ltd v Engwirda Construction Co* (1969) 120 CLR 455 at 459, *Re William Hockley Limited* [1962] 1 WLR 555 at 558, *Re International Harvester Australia* (1983) 1 ACLC 700 at 703.

> which a liability on its part to pay a sum of money will arise in a future event, whether that event be one which must happen or only an event which may happen: *Community Development Pty Ltd v Engwirda Construction Co* (1969) 120 CLR 455, *Re International Harvester Australia* (1983) 1 ACLC 700 at 703. Again, the liabilities in this case must be distinguished from the case of a prospective creditor, a prospective creditor being one who is owed a sum of money not immediately payable but which will certainly become due in the future either on some date which has already been determined, or on some date determinable by reference to future events: *Stonegate Securities Ltd v Gregory* [1980] Ch 576, *Commissioner of Taxation v Simionato Holdings Pty Ltd* (1997) 15 ACLC 477.
>
> The distinction is vital because whilst contingent or prospective creditors are taken into account in assessing solvency, possible future claims that might crystallise are not.[19]

A contrasting approach was taken in a UK decision, which held that future asbestos claimants are contingent creditors under English law for the purposes of the scheme of arrangement provisions, though they did not have provable debts in a liquidation.[20] Following that decision, the UK Insolvency Rules were amended to provide that future tort claims are provable debts in a liquidation or administration.[21] In particular, the interpretation of debt was extended:

> to include claims founded in tort where all of the elements required to bring an action against the company exist at the time the company goes into liquidation or enters administration, except that the claimant has not yet suffered any damage and does not therefore, at that time, have a cause of action against the company.[22]

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19 [2004] NSWCA 272, 22 ACLC 1,177, 50 ACSR 122, at paras [58]-[60].

20 *Re T&N Ltd* [2006] 2 BCLC 374, [2005] EWHC 2870 (Ch). The decision of the New South Wales Court of Appeal was not cited in argument in that decision. However, in a subsequent case, *In the Matter of T&N Limited* [2006] EWHC 1447 (Ch) at paras 61-63, the same UK judge, while acknowledging the decision in *Edwards*, maintained his view of the English law. These UK decisions, and the related case of *In the Matter of Cape Plc* [2006] EWHC 1316 (Ch), are further discussed in Section 7.1.3 under the heading *Creditor schemes involving UFCs*.

21 Statutory Instrument 2006 No. 1272, which came into force on 1 June 2006. This Statutory Instrument replaced Rule 13.12.

22 Explanatory Note to the Rules.

2.3 UFCs recognised in a facilitative context

The courts may take into account the interests of UFCs in some contexts in the exercise of their discretionary powers. However, any such recognition by the court does not amount to giving UFCs enforceable creditor rights.

In *In the matter of Stork ICM Australia Pty Ltd* [2006] FCA 1849, the Federal Court approved a s 411 scheme of arrangement that included the transfer of UFC asbestos liabilities from one company to another related company in circumstances where the court was satisfied that the interests of these potential asbestos claimants were adequately protected in the transfer. The Court held, at [87]-[92], that a company's potential liabilities to asbestos victims fell within the definition of 'liabilities' under s 413(4), thereby permitting them to be included in the scheme:

> That the word 'liabilities' in s 413 should also receive an expansive interpretation is indicated by the purpose of the section of facilitating the transfer of undertakings. (at [91])

2.4 Disclosure of future UFC liabilities

Australian Accounting Standard AASB 137, *Provisions, Contingent Liabilities and Contingent Assets*, deals with the disclosure of future probable or possible corporate liabilities. It applies to the annual financial reports of all reporting entities.[23] It specifies the criteria for:

- recognising a 'provision' on the balance sheet, or
- disclosing 'contingent liabilities' in the financial statements.

Under this accounting standard, reporting entities should provide some information on their potential liability to UFCs.[24]

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[23] AASB 137 applies to each entity that is required to prepare financial reports in accordance with Part 2M.3 of the Corporations Act and is a reporting entity as defined in Statement of Accounting Concepts SAC 1 *Definition of the Reporting Entity*.

[24] The International Accounting Standards Board (IASB) issued an Exposure Draft of Proposed Amendments to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* in June 2005. The IASB is currently considering the content of the Exposure Draft. A standard is expected in the first half of 2008, but is not expected to reduce the reporting requirements found in AASB 137.

2.4.1 Provision on the balance sheet

A company has to include a provision on its balance sheet where it is probable that the company will have a liability and the amount of that liability can be reliably estimated.[25] This may include liabilities flowing from corporate acts that have already occurred and which are expected to give rise to future successful claims against the company.

Under the accounting standard, a provision is a liability of uncertain timing or amount.[26]

A provision must be recognised on the balance sheet when:

(a) an entity has a present obligation (legal or constructive) as a result of a past event;

(b) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and

(c) a reliable estimate can be made of the amount of the obligation.[27]

A company must disclose the amount of the provision, as well as other specified matters.[28]

Present obligation

Obligation. The standard refers to an obligating event, being 'an event that creates a legal or constructive obligation that results in an entity having no realistic alternative to settling that obligation'.[29]

The standard states that:

> It is only those obligations arising from past events existing independently of an entity's future actions (that is, the future conduct of its business) that are recognised as provisions.[30]

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25 AASB 137 para 14.
26 AASB 137 para 10.
27 AASB 137 para 14.
28 AASB 137 paras 84 & 85.
29 AASB 137 para 10.
30 AASB 137 para 19.

This element is satisfied in the case of UFCs (as defined in Section 1.3), as the relevant corporate conduct that will give rise to future personal injury claims against the company has already occurred.

An obligation necessarily involves another party to whom the obligation is owed. However, it is not necessary to know the identity of the party to whom the obligation is owed.[31] This means that it is not necessary to identify the potential UFCs.

Legal obligation. This is an obligation that derives from:

(a) a contract (through its explicit or implicit terms);

(b) legislation; or

(c) other operation of law.[32]

Constructive obligation. This is an obligation that derives from an entity's actions where:

(a) by an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept certain responsibilities; and

(b) as a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities.[33]

Reliable estimate

To come within element (c) of the definition of 'provision', a reliable estimate must be able to be made of the amount of the obligation.

On one view, it may not be possible for a company to make a reliable estimate of its potential UFC liability where the number of future claimants, the total size of their claims and the timing of those claims are uncertain. However, the accounting standard points out that the use of estimates is an essential part of the preparation of

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31 AASB 137 para 20.
32 AASB 137 para 10.
33 AASB 137 para 10.

financial reports. It states that this is especially true in the case of provisions, which by their nature are more uncertain than most other balance sheet items. The standard also states that, except in extremely rare cases, an entity will be able to determine a range of possible outcomes and can therefore make an estimate of the obligation that is sufficiently reliable for use in recognising a provision.[34]

While it may be difficult for companies to make a reliable estimate of their potential liability to UFCs, it should be borne in mind that any insurer will need to measure and recognise the same potential liability as part of running its insurance business.[35]

Application

An example of provision being made in corporate accounts for UFCs is found in *In the matter of Stork ICM Australia Pty Ltd* [2006] FCA 1849 at [22]. In that case, the company recorded on its balance sheet a monetary amount concerning the possible future incidence and value of asbestos-related disease claims against the company (referred to as the 'Directors' central estimate'). A note to the balance sheet observed that:

> Estimates of asbestos related disease claims are subject to considerable uncertainty and actual liabilities for such claims could vary, perhaps materially, from the Directors' central estimate … The Company will use the Directors' central estimate, based on independent actuarial expert advice and calculated in accordance with Australian Actuarial Standards, as a benchmark for the ongoing monitoring of the liability.

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34 AASB 137 para 25.

35 Uncertainty in liability estimates is well-recognised in the insurance industry. APRA Prudential Standard GPS 210 *Liability Valuation for General Insurers*, AASB1023 *General Insurance Contracts* and the exposure draft of IAS37 *Provisions, Contingent Liabilities and Contingent Assets* require a provision comprising a present value estimate of the expected value of the liability faced by an insurance company, plus a margin reflecting the uncertainty around this estimate. Also, the Institute of Actuaries of Australia *Professional Standard 300* relating to actuarial reports and advice on general insurance technical liabilities provides further guidance on the calculation and presentation of the assessment of outstanding claims liabilities.

2.4.2 Contingent liability disclosure

If it turns out that liabilities to UFCs do not have to be recognised as a provision (as discussed in Section 2.4.1), a question may still arise whether those liabilities should be treated as contingent liabilities for accounting purposes.

A reporting entity does not have to 'recognise' (make provision on the balance sheet for) a contingent liability, but generally has to disclose information about that liability in the financial statements.[36]

A contingent liability is:

(a) a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or

(b) a present obligation that arises from past events but is not recognised because:

  (i) it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or

  (ii) the amount of the obligation cannot be measured with sufficient reliability.[37]

Except where the possibility of an outflow of corporate resources is remote, an entity is required to disclose certain information concerning a contingent liability, namely a brief description of its nature and, where practicable:

(a) an estimate of its financial effect

(b) an indication of the uncertainties relating to the amount or timing of any outflow; and

(c) the possibility of any reimbursement.[38]

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36 AASB 137 paras 27, 28.
37 AASB 137 para 10.
38 AASB 137 para 86.

A company that may be subject to claims by UFCs may find it difficult to determine some of this information. For instance, determining an estimate of the financial effect of UFC liability (under paragraph (a)) may not be possible where the number of future claimants, the total size of their claims and the timing of those claims are uncertain. On the other hand, these factors can be referred to in the indication of the uncertainties relating to the amount or timing of any future payments to UFCs (under paragraph (b)).

2.5 Request for submissions

The Advisory Committee invites you to forward submissions on any aspect of the matters raised in Sections 2.2 and 2.3 on whether UFCs have rights as creditors.

The Advisory Committee also invites you to forward submissions on any aspect of the matters raised in Section 2.4 on whether companies with UFCs have disclosure obligations under the accounting standards, including:

- whether AASB 137 has the effect that UFC liabilities are provisions or, alternatively, contingent liabilities
- whether AASB 137 needs to be clarified in relation to these matters
- whether, in principle, UFC liabilities should be treated as provisions or contingent liabilities
- the practical implications for companies, and others, if UFC liabilities were provisions or contingent liabilities
- if, in principle, UFC liabilities should not be treated as provisions or contingent liabilities, whether there should be some other disclosure requirement.

3 The Referred Proposal

This chapter sets out the proposal as referred to the Advisory Committee by the Parliamentary Secretary to the Treasurer and summarises the initial submissions on that proposal.

3.1 Overview

The Referred Proposal states:

> It is proposed that the existing creditor protections should be extended to future unascertained creditors, where a mass future claim is afoot. Specifically, provisions could provide that if a company is subject to a mass future claim:
>
> - existing creditor protections will apply to any future unascertained personal injury claimants;
>
> - conduct intended to avoid or reduce payments to personal injury claimants will be prohibited (that is, a new provision modelled on Part 5.8A of the Corporations Act); and
>
> - if the company is put into external administration, the external administrators will be required to admit and make provision for future unascertained personal injury creditors.

3.2 The concept of 'mass future claim'

The Referred Proposal states:

> The proposed new protections would be targeted, such that they would only apply where an exceptional number of personal injury claims have arisen out of a company's action or product, and more claims of that nature are expected (i.e. where a mass future claim is afoot). Specifically, the protections would only apply where:
>
> - either:
>
> - the company has been subject to an unusually high number of claims for payment arising from

particular acts or omissions leading to personal injury; or

- more than one company of a similar industry, or other companies with similar business operations to the company in question, have been subject to such claims;

and

- there is a strong likelihood of numerous future claims of this type.

Where such a mass future claim is afoot, the new provisions could extend a range of existing creditor protections to facilitate recovery of amounts that will be owed to future unascertained personal injury claimants.

The proposed protections would have the effect of prohibiting certain transactions unless the interests of future personal injury claimants are sufficiently provided for. It would be unreasonable to impose such restrictions if it is not reasonably possible to identify the nature of the future claims or the extent of the company's financial exposure to those claims. Accordingly, the new protections will not apply if it can be shown that it is not reasonably possible to either:

- identify the circumstances giving rise to the future personal injury claims and the class of persons who will bring the claims; or

- reasonably estimate the extent of the company's liability under such claims.

3.3 Solvent companies

The Referred Proposal states:

A number of provisions in the Corporations Act require persons involved in corporate decision-making to consider the impact of certain transactions on the ability of the company to pay its creditors. The provisions apply to those transactions that are most likely to reduce the pool of assets (or share capital) available for the creditor to recover against any liability. The protections seek to maintain an appropriate allocation of risk between creditors and shareholders. That is, creditors are entitled to rely on the capital of the company

remaining undiminished by any expenditure outside the limits of the company's objects.

Where a mass future claim is afoot, these existing creditor protections could be extended to future unascertained creditors. Specifically, this would:

- restrict company transactions which adversely affect share capital, including reductions of share capital (s 256B) and share buy-backs (s 257A); and

- defer payment of membership-type debts owed by the company to its members in their capacity as members when the company goes into liquidation until the future personal injury claimants are paid in full (i.e. extending existing section 563A).

3.4 Prohibition on intentional avoidance

The Referred Proposal states:

> The second proposal to strengthen creditor protections for future unascertained personal injury claimants is the introduction of a new offence provision and related compensation provisions, modelled on Part 5.8A of the Corporations Act in relation to the protection of employee entitlements. This would send a clear message that deliberate avoidance of payment to personal injury claimants is unacceptable.
>
> Specifically, where there is a mass future claim afoot and the company has a threshold level of information about the nature of expected claims, then the new provisions would provide that a person must not enter into a relevant agreement or a transaction with the intention of, or with intentions that include the intention of, preventing the recovery of amounts owing (or a significant part of amounts owing) in respect of the unascertained future personal injury claimants.
>
> Successful prosecution of the proposed offence would result in a penalty of up to ten years imprisonment and fines of up to $110,000. Any person knowingly involved in such a contravention would be in breach of the prohibition, not just directors.
>
> Where an intention to avoid payment to personal injury claimants is shown, the provisions would provide means to secure compensation not just from directors or other

companies in a group, but from any person who is party to the transaction or arrangement. Such actions need only be brought to the civil standard of proof, whether or not an offence is proven, and need only prove that the proscribed intent was included in the person's intent (in contrast to dominant or sole intent tests).

When considering the details of this proposal, due regard must be had to the priority afforded by the Corporations Act to employee entitlements in a liquidation vis a vis the classification of amounts owing to successful personal injury claimants as ordinary unsecured creditors.

There may be merit in considering a special priority for amounts awarded as compensation under the new provision. This way, it is assured that the personal injury claimants who suffered damage from the conduct and are the subject of a claim under the new provision receive the maximum benefit possible from the action.

Such a priority would only come into play if an action for compensation under the new provision was successful, and be limited to the actual amount awarded under the new compensation provisions. Such a priority should not compromise the priority afforded to employee entitlements and should therefore rank below employee entitlements.

3.5 External administration

The Referred Proposal states:

> The third proposal to strengthen creditor protections for unascertained personal injury claimants is the introduction of a requirement for external administrators to admit and make provision for mass future claims for personal injury. This proposal adopts features of the United States reorganisation procedure within the Bankruptcy Code.
>
> Where a court determines that the liquidator is required to admit and make provision for mass future claims for personal injury, an external administrator would be required to inform known creditors at the earliest opportunity and provide for the payment of such claims in the future. There would be scope for the appointment of a person to represent the class of personal injury claimants in any proceedings.
>
> Provision for mass future personal injury claims would be calculated on the basis of estimates of the number of acts or omissions that may give rise to liability under the relevant

head of damage; industry analyses; academic studies; independent actuarial analyses; the level of damages awarded for similar claims in courts or administrative review bodies of Australia or other common law jurisdictions; or such other matters as the external administrator thinks relevant.

Over time, future creditors would be able to make claims against funds set aside for future claimants. If such claims are uncertain, their amount could be determined in accordance with a process similar to that provided for by section 554A of the Corporations Act (determination of value of debts and claims of uncertain value).

In the case of a liquidation, asset distributions to creditors known at the time of external administration would take place as normal except a proportion of the assets could be set aside for future creditors. If there are insufficient assets to fully fund the provision for unascertained future creditors and repay existing creditors, assets could be divided proportionately.

In the case of a deed of company arrangement, there would be some flexibility about the amount of money set aside immediately and the amount to be contributed in future as the company continues to trade. In the event that funds remain after all claims have been met, there may be a further distribution to ordinary creditors.

Courts could be empowered to appoint a representative for the class of personal injury claimants, to convene meetings with claimants and to require the preparation of an independent expert's report on the impact of the proposed compromise or arrangement on the class of personal injury claimants. The representative for the class of personal injury claimants would have standing to make submissions to the court before it approves the proposed compromise or arrangement.

Similar provisions would apply in the case of schemes of arrangement and voluntary administrations.

3.6 Initial submissions on the Referred Proposal

3.6.1 Support for the Proposal

Some submissions[39] supported the general thrust of the Proposal, though in some cases[40] that support was subject to reservations about its effect on shareholders and creditors (see *Effect on shareholders* and *Effect on liquidation* in Section 3.6.2). Another respondent said that the process needs to be such that it can be completed in a reasonable time (so that current creditors are not unduly prejudiced by substantial delays) and in a cost-effective manner.[41]

One of those submissions[42] considered that the preliminary test for a 'mass future claim' was adequate to avoid the overwhelming burden on business that may arise if the threshold were merely the possibility of a mass future claim. That respondent considered that any proposals:

> should clearly not apply where there is only a chance of future claims or where claims only become apparent with hindsight and could not have been reasonably foreseen at the time.

Otherwise:

> companies, and their directors and officers, would be obliged to act conservatively and assign considerable funds as a provision against these possible claims. Such an outcome would be commercially burdensome and economically inefficient.

One respondent[43] (in its submission to the Advisory Committee's corporate social responsibility review[44]) recommended a system for

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39 Chartered Secretaries Australia, Business Council of Australia, Institute of Chartered Accountants in Australia, Institute of Actuaries of Australia, Australian Lawyers Alliance.

40 Chartered Secretaries Australia, Business Council of Australia, Institute of Chartered Accountants in Australia (which pointed to 'the challenges in estimating at any one point in time, the likely commercial exposure for payment of future mass claims').

41 IPAA.

42 Business Council of Australia.

43 Australian Conservation Foundation.

44 The Advisory Committee published its report *The social responsibility of corporations* in December 2006. It is available at: **http://www.camac.gov.au/camac/camac.nsf/byHeadline/PDFFinal+Reports+2006/$file/CSR_Report.pdf**

dealing with UFCs that is similar to the Proposal (including the appointment of a representative for possible future claimants).

3.6.2 Reservations about the Proposal

Partial solution to general problem

One submission[45] said that the Proposal deals only with personal injury claimants, whereas the treatment of long-tail liabilities in an insolvency is a more generic problem that covers, for instance, long-tail environmental liabilities that do not necessarily result in personal injury claims but involve very large remediation costs borne by public authorities and/or private landholders. The proposed reforms should encompass all long-tail liabilities, including environmental liabilities, not just personal injury claims.

Effect on shareholders

Another submission[46] said that the current rights of shareholders should not be further delayed or compromised in a liquidation. Possible disadvantages of the Proposal included:

- delays in payments to shareholders for many years, pending the resolution of class actions
- difficulties in locating 'lost' shareholders or their estates after many years
- the impediment to shareholders claiming a tax loss on their shares, given that external administrators could not issue a certificate under the *Income Tax Assessment Act* stating that there are reasonable grounds to believe there will be no further distribution in the winding up of the company.

Effect on liquidation

Some submissions expressed concern about the effect of the Proposal on unsecured creditors who are not UFCs.[47] For instance:

> the inclusion of such creditors within [a liquidation] will potentially involve a very significant (and difficult to quantify) cost to the other creditors in terms of increased

45 Australian Conservation Foundation.
46 Chartered Secretaries Australia.
47 Chartered Secretaries Australia, Business Council of Australia, AICD.

> costs of administration, delay in distribution and decreased dividends.[48]

One submission,[49] while approving the establishment of a contingency fund where there is a strong likelihood of a mass future claim, argued that, in the context of a liquidation:

- *inadequate funding:* there is always a risk that the contingency funding required will be underestimated. However, it is not practicable or desirable for the legislation to regulate such a risk. Moreover, this risk is balanced by the certainty granted to unsecured creditors who are not mass future claimants and shareholders that they need not wait many years for payment

- *surplus:* the distribution of any surplus from the contingency fund after UFCs have been paid should also be left to the determination of the fund administrator at the appropriate time

- *class actions:* the judge dealing with a class action involving mass personal injury claims should be granted the power to take into account the amount to be set aside in a contingency fund, which could be administered by the court or by a court-approved body, such as an insurance company or an external fund administrator, long after the winding up is completed

- *delays in winding up:* any reform to introduce a contingency fund should ensure that it does not create any undue delay in the winding up of the company, which would disadvantage creditors and shareholders, for instance, by interfering with the liquidator's decision about how to deal with assets.[50]

Effect on corporate management

One submission[51] argued that:

- it is in the best interests of future personal injury claimants that the regulatory environment should not unduly discourage companies with potential exposure to UFCs from continuing to trade and thereby having the resources to meet claims as they develop

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48 AICD.
49 Chartered Secretaries Australia.
50 The Business Council of Australia also made this point.
51 AICD.

- any regulation should not have an inappropriate impact on the ability of these companies reasonably and responsibly to manage their capital consistently with modern capital management and market expectations

- the legislation should provide these companies and their boards with clear and certain guidelines for managing their affairs. The lack of certainty in the Proposal may add to the difficulties for directors and officers in determining whether a company is trading while solvent, which in turn strengthens the case for extending the business judgement rule in s 180(2) to the insolvency provisions applying to directors and officers

- any long-tail liability legislation should operate cohesively with the relevant accounting standards (for instance, AASB 137). In this context, it is not generally possible to provide a 'true' estimate of the likely quantum of such claims, but only a 'best estimate' subject to appropriate assumptions and qualifications.

3.6.3 Comments on specific matters in the Referred Proposal

Further views in submissions on various elements of the Proposal are set out at:

- Sections 4.3 and 4.4: definition of 'mass future claim'
- Section 5.3 solvent companies
- Section 8.3: companies in liquidation
- Section 9.5: anti-avoidance provisions.

4 Threshold test of 'mass future claim'

Under the Referred Proposal, the additional protections for UFCs (discussed in Chapter 5 onwards) are applicable only where the company in question is exposed to a mass future claim. This Chapter considers the case for any such limitation and its possible form.

4.1 The role of this threshold test

The Referred Proposal contains a 'mass future claim' test, as outlined in Section 4.2. This threshold test would limit the protections for UFCs that are discussed in Chapters 5 to 9 of this paper to situations where claims by those UFCs are sufficiently numerous to satisfy this threshold test.

This raises the questions:

- should a test of this nature be adopted
- if so, what form should it take?

4.1.1 Arguments for this test

The intended purpose of a 'mass future claim' threshold test, however defined, is to limit the regulatory burden on companies by confining any protections for UFCs to those companies that are faced with a multitude of claims.

This threshold test also aims to avoid possible over-regulation, which might otherwise occur if companies, or external administrators, were made subject to long-tail liability provisions simply because one or more personal injury claims may arise in the future from past corporate conduct.

4.1.2 Arguments against this test

Arguments against the inclusion of any 'mass future claim' threshold test, however defined, include:

- *arbitrary benefit:* whether particular UFCs will receive the protection of the long-tail liability provisions will depend in part

on whether there are sufficient other victims of the particular corporate conduct to satisfy the test. Individual victims may regard this outcome as arbitrary

- *uncertainty of application:* it may be difficult for a company's directors or external administrators to determine whether the company is subject to a 'mass future claim', to the extent that any definition relies on statistical or trend assessments, industry experience, or future projections. A test may be of limited utility if different interpretations of how it applies in particular circumstances are reasonably open

- *reputation risk:* a company may be reluctant to acknowledge that it is subject to a 'mass future claim' under whatever threshold test is applied, through concern about the possible adverse reputational impact of such a conclusion and the legal constraints that flow from it. This may act as a motivation for a company to read down the test to avoid this stigma, even where it does not anticipate that compliance with the long-tail liability provisions would be burdensome

- *over-regulation concern:* omitting the threshold test may not increase the regulatory burden on companies in practice. For instance, solvent companies with a relatively small potential UFC liability may not find that this significantly impairs their ability to operate, even in light of the proposals requiring solvent companies to accommodate the interests of these claimants in particular circumstances (see Chapter 5).

4.2 Referred Proposal

The Referred Proposal contains the following definition of a 'mass future claim':

- either

  - the company has been subject to an unusually high number of claims for payment arising from particular acts or omissions leading to personal injury; or

  - more than one company of a similar industry, or other companies with similar business operations to the company in question, have been subject to such claims;

and

- there is a strong likelihood of numerous future claims of this type

unless it is not reasonably possible to:

- identify the circumstances giving rise to the future personal injury claims and the class of persons who will bring the claims; or
- reasonably estimate the extent of the company's liability under such claims.

4.3 Submissions on the Referred Proposal test

4.3.1 General comments

One submission[52] said that the limitations and qualifications in the Referred Proposal test seriously limit its application. For instance, it applies only to personal injury and not, say, long-term economic or environmental harm.

Another submission[53] considered that various phrases in the Referred Proposal test, including 'unusually high number', 'strong likelihood' and 'similar industry', need to be very clearly defined to avoid ambiguity about when the provisions will apply.

Another respondent[54] argued that the Referred Proposal test is too uncertain, complicated and onerous, potentially requiring a company to make extensive inquiries to determine whether the test has been satisfied. Various key concepts involve the determination of a number of differently described opinions (for instance, 'unusually high', 'similar', 'strong likelihood'), which could be the subject of different views and potential dispute, rather than easily determinable objective criteria.

4.3.2 Unusually high number of claims

This criterion in the Referred Proposal test was intended to ensure that the Proposal would have only a minimal effect on business. However, some respondents questioned whether it is workable.

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52 Australian Conservation Foundation.
53 IPAA.
54 AICD.

One respondent[55] argued that this criterion is too narrow and that it would be unjust and perverse to deny compensation to a small class of UFCs merely because the corporation's misconduct does not injure a larger group of individuals.

Concerns have also been raised that this criterion:

- is too vague and overlaid with value judgments to be a legislative test and could, if enacted, result in fruitless litigation
- may result in an industry with a very high level of personal injury claims setting an unreasonably high benchmark to satisfy this element.

4.3.3 Similar industry or other companies subject to similar claims

In relation to this criterion in the Referred Proposal test, some respondents pointed out that:

- the administrator may not have access to relevant information regarding other companies in a similar industry[56]
- existing powers of examination of third parties (for instance, s 596B) may not be wide enough to give the external administrator access to such information[57]
- in any event, the external administrator may simply not be put on notice of the possibility that other companies may have information regarding claims against them which could suggest the existence of a mass future claim against the company under external administration[58]
- one solution might be to apply the provisions only to companies that have sold or produced a specific product or operated in a specific industry that is prescribed by regulation.[59]

One submission[60] was concerned that the criterion was too restrictive, as knowledge of the risk caused by the product or

55 Australian Conservation Foundation.
56 IPAA, AICD.
57 IPAA.
58 IPAA.
59 IPAA.

conduct, and indeed the existence of injuries caused by the product, pre-date claims at law by many years.

4.3.4 Strong likelihood of numerous future claims

One submission[61] supported the notion of limiting the Referred Proposal test to circumstances where it is very clear that substantial future claims are highly likely, to prevent significant interference in the day-to-day operation of companies that are ultimately unlikely to be subject to substantial successful claims.

4.3.5 Definition not to apply if not reasonably possible to identify circumstances and class of persons

One respondent, while agreeing that this criterion in the Referred Proposal test identifies a situation in which a company should not be subject to long-tail liability provisions, considered that this qualification, as well as the criterion of 'not reasonably possible to reasonably estimate the extent of liability' (see Section 4.3.6):

- illustrates the inefficiency of the principal key concepts suggested for the threshold determination
- involves further matters of opinion
- does not reduce the inquiries that would be required to be made in an attempt to determine whether the preliminary test might apply in any particular case.[62]

Another submission[63] regarded this criterion as a fundamental factor in precluding some claims from being admitted as long-tail liabilities, as:

- there needs to be certainty about the appropriate legal responsibilities of the company, in particular, its ability to meet legitimate future claims and to determine, at any given time, whether the company is solvent

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60 Australian Lawyers Alliance.
61 Business Council of Australia.
62 AICD.
63 Business Council of Australia.

- relevant factors, such as the number of claimants and the level of damages they are awarded will vary depending, for example, on the ways in which future damage or harm to claimants manifests, while advances in medical technology and expertise could increase liability (where improved diagnostics allow greater certainty about the causes of harm) or could reduce liability (where improved treatment reduces the impact of harm)[64]

- any actuarial estimate is inherently uncertain, and may be shown to be incorrect over time, particularly as circumstances connected with a mass claim change.

4.3.6 Definition not to apply if not reasonably possible to reasonably estimate the extent of liability

One submission[65] argued that this aspect of the Referred Proposal test may exclude some future claims that are almost certain to arise. Where estimates of the extent of possible claims vary widely, all claims would be excluded, even where it is possible to say with some certainty what the lower end of the range would be.

Another submission[66] said that this criterion is unnecessary and may be counterproductive by allowing undue challenges to the long-tail liability procedure. The fact that the liability estimate will change over time does not necessarily mean that the estimate is not reasonably quantifiable:

- under current Australian accounting concepts, 'reliable' estimation is a fairly forgiving requirement: an uncertain estimate is 'reliable' if its uncertainty can be adequately conveyed, so that users do not place undue reliance on it[67]

- 'reasonable' is presumably a weaker test than 'reliable': if it is clear that there is a liability to UFCs, it should always be possible to place a reasonable, albeit uncertain, estimate on its

64 cf Institute of Actuaries of Australia paras 14-23.
65 Australian Conservation Foundation.
66 Institute of Actuaries of Australia, para 35.
67 para 36.

value. If a liability exists and its value is material, a genuine attempt to protect claimants' interests should be made.[68]

4.4 Alternative approaches suggested in submissions

Various other approaches to a possible threshold test of 'mass future claim' were suggested in submissions.

4.4.1 Definition by regulation

This approach would involve prescribing in the Corporations Regulations industries or products that have become publicly identified with the risk of UFC claims (including asbestos products) and which would trigger the application of the long-tail liabilities provisions to any affected company.[69]

4.4.2 Application of accounting standards

Another approach[70] would be to adopt a 'mass future claim' test consistent with the definition of 'contingent liability' in the accounting standards, namely:

> a possible obligation [from personal injury] that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more future events not wholly within the control of the entity (AASB 137 cl 10).

4.5 Possible alternative test of 'mass future claim'

The Advisory Committee puts forward for consideration a possible alternative lower threshold test of 'mass future claim', if such a threshold test is retained before providing additional protections for UFCs, as follows:

- at least one personal injury claim against the company or against another company in a similar industry has

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68 para 37. The Institute of Chartered Accountants in Australia specifically agreed with this point.

69 IPAA, AICD.

70 AICD. This respondent considered this a 'second-best option' to identifying products or industries by regulation.

> successfully been made (including by way of settlement, with or without a confidentiality agreement) 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 that claim, and
>
> - there is a reasonable likelihood [a balance of probabilities test] that numerous future claims against the company would arise from that exposure.

Under this test, the provisions for UFCs could be activated as soon as at least one personal injury claim is made in circumstances where many more such claims can be expected in the future, rather than having to wait until 'an unusually high number of claims', against either the company or other similar companies, has arisen.

This test does not include the carve-outs in the Referred Proposal, namely that the Referred Proposal would not apply if:

> it is not reasonably possible to:
>
> - identify the circumstances giving rise to the future personal injury claims and the class of persons who will bring the claims; or
>
> - reasonably estimate the extent of the company's liability under such claims.

On one view, the second carve-out suggests that a company could avoid being subject to the long-tail liability provisions in circumstances where there are numerous future personal injury claimants but it is difficult to estimate the extent of the actual liability to them.

4.6 Request for submissions

The Advisory Committee invites you to forward submissions on any aspect of the matters raised in this chapter, including:

- whether it is appropriate to have a 'mass future claim' threshold test for the application of the additional protections for UFCs (Section 4.1)

- if so, whether, and for what reasons, you prefer the approach in the Referred Proposal (Section 4.2), or any of the alternative possible approaches, to the definition of 'mass future claim' (Sections 4.4 and 4.5), or

- whether some other approach should be adopted.

5 Solvent companies

This chapter reviews the suggested requirement in the Referred Proposal that solvent companies subject to claims by UFCs take into account the interests of these claimants in various corporate transactions that return capital to shareholders.

The chapter also raises for consideration a possible new procedure available to solvent companies that face possible future insolvency as claims by UFCs crystallise.

5.1 Areas of concern

Directors of solvent companies are subject to various fiduciary duties in their corporate decision-making. Beyond that, it is not possible, or appropriate, to seek through legislative means to regulate companies in their general day-to-day activities in a manner that will guarantee their commercial success and that all creditor claims, including future claims by UFCs, will be met as and when they fall due or crystallise.

Some corporate transactions, however, may be particularly significant both for current creditors and for UFCs. Companies may seek, for legitimate business reasons in the course of their capital management, to return capital to shareholders. These transactions will also reduce the pool of assets available to creditors to cover their claims. The interests of current creditors are already recognised in the statutory provisions regulating such reductions of capital. The issue is whether, and if so by what means, the interests of UFCs should also be taken into account.

5.2 Outline of the Referred Proposal

Under the current law, a company may reduce its share capital in a way not otherwise authorised by law if 'the reduction does not materially prejudice the company's ability to pay its creditors'.[71] Likewise, a company may buy back its own shares if 'the buy-back

[71] s 256B(1)(b).

does not materially prejudice the company's ability to pay its creditors'.[72]

The Referred Proposal is that, for companies that have UFCs and also satisfy the mass future claim threshold test, the creditor protection elements in these share capital and share buy-back provisions should be amended specifically to cover these claimants.

5.3 Submissions on the Referred Proposal

One submission supported the proposed creditor protections.[73]

Another submission said that a complete prohibition on capital management for companies with UFC claims would severely affect them and is not appropriate.[74] However, the respondent said that 'some recognition of a provision required by the relevant accounting standards may be appropriate in the consideration by a company of its capital management'.

5.4 Analysis of the Referred Proposal

One rationale for the proposed additional restrictions on share capital reductions and buy-backs for companies subject to claims by UFCs is that current shareholders should not be entitled to a return of capital at the expense of the company's ability to meet these claims in due course.

However, the proposed restrictions would not necessarily have the effect of precluding a company subject to this provision from managing its capital. For instance, directors could legitimately say, in some circumstances, that buy-backs or capital reductions, undertaken as part of their continuing capital management program, would strengthen the company over time and therefore likely increase, rather than reduce, the funds available to cover claims by UFCs as they arise.

At the same time, it is also necessary to consider whether the restrictions might have perverse consequences, for instance, companies with excess liquidity being reluctant to reduce capital because of their potential UFC liability and instead using surplus

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72 s 257A(1)(a).
73 Australian Lawyers Alliance.
74 AICD.

funds to go into less productive or unnecessary re-investment or new business ventures that they would not otherwise have entered into.

A protective provision for UFCs could be introduced in various ways. For instance, the sections could be amended so that directors may only undertake a capital reduction or buy-back if they are satisfied it will not materially prejudice the company's ability to pay its current creditors and UFCs.

5.5 Extension to financial assistance transactions

The Referred Proposal concerning solvent companies does not include companies providing financial assistance for the acquisition of their own shares.[75]

On one view, any proposals to protect UFCs in relation to reductions of capital and share buy-backs should also apply to these financial assistance transactions. All three areas involve some direct or indirect transfer of corporate funds to current or anticipated shareholders.

One significant difference between financial assistance and the other two procedures is that, whereas companies may not enter into a capital reduction or buy-back if creditors would be materially prejudiced, they may nevertheless provide financial assistance that has this effect, provided it is approved by shareholders.[76] It is not suggested that this element be changed. However, directors are not relieved of their duties simply because the financial assistance transaction has been approved by shareholder resolution.[77]

5.6 Alternative to the Referred Proposal: disclosure only

A possible alternative approach would be to require solvent companies (whether or not facing a mass future claim) to disclose the existence of UFCs and otherwise rely on general principles of directors' duties to guide boards on how to take UFCs into account in their corporate decision-making, including in relation to capital

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75 The financial assistance procedures are set out in ss 260A ff.
76 s 260A(1)(b).
77 s 260E.

reductions, buy-backs and financial assistance transactions. There would be no extension of the current creditor protection provisions, as envisaged in the Referred Proposal.

The disclosure required of solvent companies could apply:

- in their financial reports, and/or
- through specific disclosures prior to a capital reduction, buy-back or financial assistance transaction.

This obligation would be independent of any requirement, in particular circumstances, to disclose information relevant to UFCs under the continuous disclosure provisions.

On one view, any additional disclosure requirement is unnecessary given the reporting requirements in AASB 137 (see Section 2.4).

An argument for having an additional disclosure requirement, say before a capital reduction, buy-back or financial assistance transaction, is that it may assist directors in carrying out their corporate decision-making duties by drawing this information to their attention. However, disclosure alone would not impose any duty on directors to take UFCs into account in share capital reductions, buy-backs or financial assistance transactions.

5.7 Dividends

The Referred Proposal as it applies to solvent companies does not extend to dividends.

Some arguments for a possible extension of UFC protective provisions to dividends include:

- payment of dividends reduces corporate funds and thereby could disadvantage UFCs just as much as a reduction of capital, share buy-back or financial assistance transaction
- the various forms of payments to shareholders, including dividends, have historically been subject to maintenance of capital rules.

While there may be in-principle arguments for including dividends, any extension of this nature might be seen as unduly impeding the

regular ongoing management of companies and could affect their operations in various ways:

- share buy-backs, capital reductions and financial assistance transactions are discretionary, whereas it is commonplace for companies to declare dividends and there is a strong market expectation that they will do so
- requiring a company to take UFCs into account before declaring a dividend could add a significant element of uncertainty for the company, or unduly restrain it from declaring dividends
- restraints on declaring dividends could adversely affect the market value of a company's shares, and hence its ability to raise capital, which could also affect its ability to meet the cost of claims by UFCs.

5.8 Insolvent trading

The Referred Proposal does not extend to insolvent trading (s 588G). Arguably, to require a company to take into account the position of UFCs for the purpose of determining solvency in day-to-day trading could:

- render an otherwise ostensibly solvent company technically insolvent and hence unable to continue trading
- adversely affect the ability of a company to generate sufficient wealth over time to pay future claims as they arise.

5.9 Section 1324

Persons whose interests have been, are or would be adversely affected by particular corporate conduct, including in relation to capital reductions, buy-backs and financial assistance transactions, may seek injunctive and other relief from the court.

The current provision may already be available to UFCs. In any event, UFCs would be able to seek relief under this provision if the share buy-back, share capital reduction and financial assistance provisions were amended to take their interests into account.

5.10 Directors' duties

Directors of solvent companies may choose to make provision for UFCs. Under the current law, as explained in Chapter 3 of the CAMAC report *The social responsibility of corporations* (December 2006):

- directors can take the interests of various classes of stakeholders, not just shareholders, into account if this will benefit the company
- directors are not confined to short-term considerations in their decision-making.

Given this, it does not appear necessary to introduce a provision permitting directors of a solvent company to set aside a portion of the company's assets in trust to meet anticipated claims by UFCs. Directors may already so act, provided their actions are in good faith and are at least in the longer-term interests of the company.

Also, introducing a permissive provision of this nature could have unintended consequences. It could be interpreted as a duty to so act or alternatively as setting out the only proper manner in which to deal with UFCs.

5.11 Possible procedure for companies anticipating insolvency

A question arises whether, in addition to matters in the Referred Proposal, it would be useful to have a provision that could be utilised by companies that anticipate the likelihood of becoming insolvent in the future, as UFC claims crystallise through the development of injury-related symptoms.

The procedure draws on an approach in the US Bankruptcy Code that was developed for companies in this situation. Details of the US approach are set out in the Appendix.

This possible procedure is set out for the purpose of consideration, and should not be seen as having been endorsed by the Advisory Committee.

Another precedent for this approach in the form of a scheme of arrangement between companies and an identifiable class of UFCs is found in recent UK case law, as discussed in Section 7.1.3 *Creditor schemes involving UFCs*.

5.11.1 Purpose of the procedure

This voluntary procedure would apply to a company that still satisfies the solvency test in s 95A (that is, it is 'able to pay all [its] debts, as and when they become due and payable'), but anticipates that at some stage in the future, as the number of crystallised claims by UFCs increases, it will be unable to meet all claims in full. A company in those circumstances could apply to the court for an order enabling its affairs to be conducted pursuant to a plan, as described below.

The principal purpose of the proposed procedure would be to achieve a level of equity between UFCs. It would overcome the problem of UFCs whose claims crystallise earlier receiving a full return, with remaining UFCs receiving a lesser return, or no return at all, if and when the company becomes insolvent. The proposed procedure could be applied to companies well short of insolvency, as well as those close to liquidation.

The procedure may also have the effect of assisting a company subject to claims by UFCs to continue in existence for an extended period or indefinitely, rather than being forced into liquidation as claims by UFCs crystallise.

Under current law, a company in the situation described above may choose to go into a voluntary administration or a scheme of arrangement. However, neither procedure can bind UFCs or lock in a certain return rate for them to reduce the likelihood of a company being pushed into insolvency as claims by UFCs crystallise.

5.11.2 Outline of the procedure

The possible procedure is based on US provisions arising out of the Johns-Manville case. Unlike a voluntary administration, the procedure envisages a fairly high level of initial court involvement.

Under the procedure, directors would be able to apply to a court for orders confirming a plan under which:

- the company will issue new voting shares to a trust set up to meet UFC claims
- those new voting shares held by the trust will constitute a majority voting interest in the company and in any relevant related companies
- those shares will have dividend rights (and therefore be linked to the company's future earnings), based either on their proportion of the issued shares or on some other formula approved by the court
- the funds in the trust, comprising any corporate assets that the company agrees to transfer to the trust, the dividends received from the voting shares issued to the trust and any further assets generated from those funds, will be used to fund damages payments to UFCs as their claims crystallise
- all the rights of UFCs to claim for damages will be confined to the trust funds
- the damages payable to UFCs will, from the outset, be at a uniform rate of return stipulated under the plan.

The court would have power to approve the plan with or without such amendments as the court considers necessary if satisfied that:

- the company would be likely to become insolvent at some future time as claims by UFCs crystallise if it were not granted the order sought
- unsecured creditors have been notified and approve the plan, by a majority in number and value, either before or after the court hearing
- the plan achieves a proper balance between the interests of current unsecured creditors and UFCs. To achieve this, the court may choose to appoint a representative of the UFCs and also require the company to transfer more corporate assets to the trust.

Shareholders would have no voting rights or other role in regard to the proposed plan, which, if approved, would reduce considerably the powers and benefits attaching to their shares.

Where a court approves a plan, it would also have power, at some later time, to:

- vary the rate of return to UFCs as their claims crystallise. This is designed to counter the problem that the initial rate of return under the terms of the trust deed approved by the court may be based on estimates, which later prove to be materially inaccurate, of the assets of the trust (given the company's subsequent performance) or the size of the UFC liabilities

- extinguish some or all of the shares issued to the trustee (as the number of UFCs decreases).

5.11.3 Possible benefits

The possible benefits of this proposed procedure include:

- *quarantined liability:* the rights of UFCs would be limited to the funds held by the trust, thereby giving a company some opportunity to avoid being forced into liquidation by long-tail liabilities. This may:

  - help protect employees and other unsecured creditors from the prospect of corporate insolvency

  - separate the task of administering claims by UFCs (the role of the trust) from the role of directors in conducting the ongoing business of the company

- *unsecured creditors protected:* the usual priority of creditors' interests over shareholders' interests[78] is preserved: the principal loss is borne by shareholders (through diluted equity in consequence of the trust being issued the majority of voting shares) rather than by unsecured creditors (through diluted returns in an insolvent liquidation)

- *flexibility:* there is no obligation on the company to set aside a lump sum in advance for UFCs (though the company may agree to transfer some corporate assets to the trust or the court may require this as a condition of approval of the plan)

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[78] As now understood in consequence of the High Court decision in *Sons of Gwalia*.

- *aligned interests:* the trust, through its majority of voting shares, has a major stake in the company, so the interests of the trust and UFCs (maximum payouts) would be better aligned with the interests of the directors and general unsecured creditors (long-term viability).

5.11.4 Possible detriments

The possible drawbacks of this model include:

- *rate of return:* the procedure requires the court initially to set a rate of return for UFCs. In some circumstances, this may be less than 100% of the damages for injuries incurred. In consequence, UFCs may be locked into a rate of return under the terms of the trust deed that may later prove to be less than the company could afford, based on its subsequent performance. The trustee could apply to the court to vary that rate, but it would add a further level of complexity to extend this benefit to claimants who had already been paid out

- *novelty:* this procedure is designed for companies that anticipate future financial difficulties, but has features that are materially different from voluntary administration, which is also designed for companies in financial difficulties. However, a precedent for this approach, in some limited instances, in the form of a scheme of arrangement between companies and UFCs is found in recent UK case law, as discussed in Section 7.1.3 *Creditor schemes involving UFCs*

- *shareholder cost:* a transfer of voting control by the issue of new voting shares to the trustee would very significantly diminish the value of the already issued shares, including their voting power and dividend rights

- *takeovers:* use of this procedure may prevent takeover offers that might benefit the minority shareholders, unless the offeror obtains the consent of the trustee as the majority voting shareholder.

5.11.5 Possible variations

Some possible variations to the above procedure could be to give the trustee:

- less than the majority of voting shares, or
- dividend rights only.

Either option would reduce the impact of the procedure on other shareholders, though there would not necessarily be the same level of alignment of interests between the trust, the directors and general unsecured creditors that is a central rationale of the US approach.

5.12 Request for submissions

The Advisory Committee invites you to forward submissions on any aspect of the matters raised in this chapter, including:

- the possible amendments to the share capital reduction, share buy-back, and financial assistance provisions (discussed in Sections 5.2 to 5.5)
- the possible disclosure only approach (discussed in Section 5.6)
- the discussion of dividends, insolvent trading, s 1324 and directors' duties (Sections 5.7 to 5.10)
- the possible new procedure for companies that anticipate future insolvency as claims by UFCs mature (discussed in Section 5.11).

6 Voluntary administration

This chapter considers whether some provision for UFCs should be made in the voluntary administration provisions and its possible form, taking into account the implications for current unsecured creditors.

6.1 Affected voluntary administrations

The policy options discussed in this chapter would apply to all voluntary administrations except those that are limited to a moratorium on the making of claims by unsecured creditors. Any temporary freeze cannot detrimentally affect the interests of UFCs.

6.2 Current procedure

Voluntary administration is a process, regulated under Part 5.3A of the Corporations Act, which allows a company to be placed under the control of an external administrator with a view either to its financial rehabilitation or to its liquidation where corporate recovery is not possible. Various steps in a voluntary administration relevant to the current review are set out below. Further details are found in previous Advisory Committee reports.[79]

6.2.1 Objectives

The voluntary administration provisions provide for the business, property and affairs of an insolvent company to be administered in a way that:

- maximises the chances of the company, or as much as possible of its business, continuing in existence; or

[79] *Corporate voluntary administration* (June 1998), *Rehabilitating large and complex enterprises in financial difficulties* (October 2004). Various recommendations in these reports are reflected in the Corporations Amendment (Insolvency) Bill 2007.

- if that is not possible - results in a better return for the company's creditors and members than would result from an immediate winding up of the company.[80]

6.2.2 Appointment of an administrator

The procedure allows for the appointment of an administrator to take control of, investigate and make recommendations for dealing with, the property and affairs of insolvent or near-insolvent companies. An administrator can be appointed by the company itself,[81] a liquidator or provisional liquidator[82] or a chargee over all or substantially all the property of a company, where the charge is enforceable.[83]

While a company is under administration, the administrator has control of the company's business, property and affairs and acts as the company's agent.[84] During that period, its officers (other than the administrator) cannot exercise any function, except with the administrator's written approval.[85]

6.2.3 Who are creditors

As indicated in Section 2.2, creditors in a voluntary administration are persons with debts or claims that are admissible to proof in a winding up. UFCs do not appear to satisfy this test and therefore have no role or rights of creditors in a voluntary administration.

6.2.4 Notifying creditors

Administrators are required to give every creditor (whether appearing on the company's books or not) notice of creditors' meetings.[86] UFCs do not appear to be creditors and therefore are not entitled to be notified of meetings of creditors or to participate in those meetings.

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80 s 435A.
81 s 436A.
82 s 436B.
83 s 436C.
84 ss 437A, 437B.
85 s 437C.
86 Corporations Regulations reg 5.6.12.

6.2.5 Meetings of creditors

First meeting

The administrator must hold a first meeting of creditors within 5 business days of appointment.[87] At this meeting, creditors decide whether to appoint a committee of creditors.[88] They also have the opportunity to replace the administrator with their own appointee.[89]

Major meeting

The administrator, after investigating the affairs of the company, calls a further meeting of the company's creditors to decide the company's future. That meeting must normally be convened within 21 days of the appointment of the administrator (the convening period)[90] and must be held no later than five business days after the end of the convening period.[91] The court has an express power to extend the convening period[92] and may also do so under its general powers.[93]

At that meeting, the creditors may resolve:

- that the company execute a deed of company arrangement, or
- that the administration should end, or
- that the company be wound up.[94]

When calling the meeting, the administrator must give creditors a report giving his or her opinion, with reasons, about each of these options, the state of the company's business, property, affairs and financial circumstances and, if a deed of company arrangement is proposed, a statement setting out details of the proposed deed.[95]

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87 s 436E.
88 s 436E(1).
89 s 436E(4).
90 s 439A(1), (5). The Corporations Amendment (Insolvency) Bill 2007 contains incremental changes to this and other time limits.
91 s 439A(2).
92 s 439A(6).
93 ss 447A, 1322(4)(d).
94 s 439C.
95 s 439A(4).

6.2.6 Voting by creditors

There are no voting provisions exclusively for Part 5.3A. The provisions for voting under Part 5.3A are generally the same as for liquidations,[96] including that:

- a resolution at a creditors' meeting is carried if:
  - a majority by number of the creditors voting (whether in person, by attorney or by proxy) (*majority by number*) vote in favour of the resolution, and
  - a majority by value of the creditors voting (*majority by value*) (that is, creditors the value of whose debts is more than half the total debts owed to all the creditors voting, whether in person, by proxy or by attorney) vote in favour of the resolution[97]
- a resolution at a creditors' meeting is not carried if:
  - a majority by number of creditors voting vote against the resolution, and
  - a majority by value of creditors voting vote against the resolution.[98]

If a meeting does not reach a result under the previous two steps (given that for a resolution to be either carried or not carried requires a vote for or against the resolution, respectively, by both majorities), the administrator may exercise a casting vote.[99] Where a resolution is passed or defeated on the casting vote of the administrator, a person who has voted the opposite way in some capacity (or on whose behalf someone else has voted the opposite way) can apply to the court to vary or set aside the resolution.[100]

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96 Corp Reg 5.6.11(2) applies Corp Regs 5.6.12 to 5.6.36A to the convening and conduct of, and voting at, meetings held under Part 5.3A.
97 Corp Reg 5.6.21(2).
98 Corp Reg 5.6.21(3).
99 Corp Reg 5.6.21(4).
100 ss 600B, 600C.

6.2.7 Parties bound by a deed

A deed of company arrangement (DOCA) is executed by the company in voluntary administration[101] and binds various parties, including the company,[102] ascertained unsecured creditors[103] (ascertained creditors), and any secured creditors who consent to being bound.[104]

In determining who are ascertained creditors, s 444D(1) provides that:

> A deed of company arrangement binds all creditors of the company, so far as concerns claims arising on or before the day specified in the deed under paragraph 444A(4)(i).

The day specified in s 444A(4)(i) is:

> the day (not later than the day when the administration began) on or before which claims must have arisen if they are to be admissible under the deed.

UFCs, not being ascertained creditors, cannot be bound by a DOCA. Equally, however, they have no right to be considered when a company enters into a DOCA with its ascertained creditors.

Creditors bound by a deed may not take action against the company or its property without the leave of the court or make or proceed with an application for a winding up order.[105] Creditors may vary or terminate a deed of company arrangement.[106]

6.2.8 Role of the court

Court approval is not required to conduct a voluntary administration. Instead, the court has general supervisory powers in relation to

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101 ss 444A, 444B.
102 s 444G(a).
103 s 444D(1).
104 s 444D(1), (2). Strictly, a secured creditor who has voted against a deed is still 'bound by' it, as s 444D(1) provides that the deed binds 'all creditors'. There are restrictions on the rights of these persons to take court proceedings: s 444E, *J & B Records Ltd v Brashs Pty Ltd* (1995) 16 ACSR 285, 13 ACLC 458, *Roder Zelt-und Hallenkonstruktionen GmbH v Rosedown Park Pty Ltd* (1995) 17 ACSR 153, 13 ACLC 776. However, subject to these restrictions, a secured creditor who has voted against a deed may nevertheless realise or otherwise deal with its security: s 444D(2).
105 s 444E.
106 ss 445A, 445C(b), 445E, 445F.

voluntary administrations, for instance, to determine points of law, to remove an administrator or to terminate a deed of company arrangement.[107]

6.3 Option 1—Referred Proposal: monetary provision for UFCs in a DOCA

6.3.1 Monetary provision, with further recourse for UFCs

The Referred Proposal is to require that the administrator admit and make provision in a voluntary administration for UFCs where the mass future claim test is satisfied.

The DOCA would include some financial provision for UFCs (for instance, some corporate funds being set aside in a trust for UFCs). The Proposal also contemplates the appointment of a representative for the UFCs and the preparation of an independent expert's report on the impact of the proposed DOCA on the UFCs. The representative would have standing to challenge the proposed DOCA in court.

The purpose of the Proposal is to provide some level of equitable financial treatment between ascertained creditors and UFCs. The Referred Proposal envisages some flexibility in the DOCA about the amount of money to be set aside immediately and to be contributed in future if the company is to continue to trade. In the event that funds remain after all UFC claims have been met, there may be a further distribution to ascertained creditors.

The Referred Proposal does not appear to require that UFC rights be confined to those funds.

The Referred Proposal gives rise to various procedural questions for the conduct of a voluntary administration, including:

- would the representative for the UFCs be appointed by the administrator or the court

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107 ss 445B, 445C(a), 445D, 445G, Division 13.

- would the representative have some role or rights in the process of voting on the DOCA? This could raise some very complex issues[108]

- what factors would be relevant in determining the appropriate division of available corporate funds between ascertained creditors and UFCs

- what impact would the process of preparing an independent expert's report have on the timing, and cost, of a voluntary administration?

In addition to these procedural questions, there are some more general incentive and market reaction issues in adopting this proposal:

- would it reduce the incentive for companies in financial difficulty to use voluntary administration? Some corporate assets would have to be set aside for UFCs, rather than be used to reduce the debt to ascertained creditors. Companies and their ascertained creditors may prefer to enter into 'informal workouts' involving private contractual arrangements to avoid having to make provision for UFCs

- would ascertained creditors have less incentive to agree to a DOCA that gives them only a partial repayment of their debts if the repayment rate is considerably reduced by having to set aside funds for UFCs

- would providers of unsecured debt finance or other potential unsecured creditors demand higher premiums from companies subject to UFCs, given the additional risk to them if those companies go into voluntary administration?

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[108] There would be questions about how to determine the voting rights of a representative that, while very difficult to resolve, would be crucial. For instance, providing for only nominal voting rights may provide no real protection to UFCs, while giving a legal representative substantive voting rights commensurate with the best estimate of the potential liability to UFCs may result in that person being able to determine, or strongly influence, the outcome of a vote on whether to adopt a DOCA. There is no simple method to balance ascertained current interests against future speculative interests in a manner that would be seen by all interested parties as fair and equitable.

6.3.2 Monetary provision, without further recourse for UFCs

One possible variation of the proposal in Section 6.3.1 would be that any financial provision for UFCs in a voluntary administration constitutes the full amount of corporate funds available to them in the future.

Adoption of this approach might create a considerable incentive for companies with UFCs to use the voluntary administration procedure if, by making some ongoing provision for UFCs in a DOCA, they could at that point settle their full liability to UFCs and thereafter trade free of claims by those persons. However, this would require a series of strong procedural safeguards to ensure that the interests of UFCs were not unduly prejudiced as may occur, for instance, if a DOCA locked in a rate of return to UFCs less than 100%, and that rate of return later proved to be too low in light of the company's profitable performance after it ceased to be subject to the DOCA. The inclusion of an ongoing power for the court to revise a return rate may help alleviate this possibility, but it may also undermine the incentive for companies to employ this procedure to achieve certainty.

6.4 Option 2—No provision for UFCs in a voluntary administration

Another option is to retain the current law, which makes no provision for UFCs in voluntary administrations, but equally does not bind UFCs to any consequent DOCA. Any provision to accommodate the interests of UFCs would be confined to liquidation proceedings, as discussed in Chapter 8.

An argument for this option is that ascertained creditors may be more inclined to agree to a partial repayment DOCA that provides some hope of corporate recovery if the proportionate return that the company can provide to them under the DOCA is materially higher than if the company had to make provision for UFCs. Arguably, in some instances at least, the interests of UFCs could be enhanced if companies can use the voluntary administration procedure to

continue to trade, and do so profitably, over time.[109] Conversely, any obligation on companies to make provision for UFCs in a partial repayment DOCA may increase the possibility of ascertained creditors rejecting the DOCA as giving them no benefit greater than they would receive if the company immediately went into liquidation.

An argument against this option is that UFCs would have little or no protection, as:

- a company may enter into a DOCA that provides ascertained creditors with a level of partial repayment well in excess of what they would receive if the company was immediately placed in liquidation and the available residual assets were apportioned between ascertained creditors and the UFCs (under the proposed liquidation procedure in Chapter 8). Companies, and their ascertained creditors, may therefore have a strong motivation to use voluntary administration in this manner, even if it constitutes only a temporary respite before the company goes into liquidation

- it may be very difficult to apply the proposed anti-avoidance provisions (Chapter 9) in these circumstances, given that one of the purposes of a voluntary administration, set out in s 435A, is to provide an opportunity for financially stressed companies to see if it is possible to continue in business. It may be difficult to argue that moving from a partial repayment voluntary administration to a later liquidation, with little or no remaining funds for ascertained creditors and UFCs, is, of itself, evidence of an intent on the part of directors or others to prevent recovery by UFCs.

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[109] The IPAA submission argued that consideration should be given to whether it is appropriate to apply the UFC provisions in an administration or a DOCA where the purpose is to facilitate the company's continuation in existence in a more viable financial state. In such a case, the purpose of the deed, if achieved, should mean that if and when the future claims arise, there will remain a solvent entity available to meet them, whereas having to make provision for such claims as part of the DOCA may mean that a rescue is impossible to achieve.

6.5 Option 3—Certificate by directors

Another option would be to permit a vote by ascertained creditors on a partial repayment DOCA only if the directors have provided a certificate stating that:

- the company has no UFCs, or
- the DOCA would not prejudice the interests of UFCs, applying a similar provision for determining prejudice as in capital reductions, buy-backs and financial assistance (discussed in Chapter 5, above), for instance, that the DOCA does not materially prejudice the company's ability to pay its creditors or its UFCs.

Directors would be liable if they provided this certificate without reasonable grounds for their belief.

This option would avoid many of the procedural issues that would arise with some of the other options discussed in this chapter, including any apportionment of funds under the DOCA between ascertained creditors and UFCs.

Arguments against this certification option include that:

- directors of companies in financial difficulties may decline to initiate a voluntary administration, given the possible personal liability for providing the certificate
- directors in these circumstances may prefer to enter into 'informal workouts' with various ascertained creditors, involving some provision for partial repayment.

If either practice becomes common, it could undermine the role of voluntary administration and any benefits to UFCs in that process.

6.6 Option 4—Right of legal representative of UFCs to challenge a DOCA

This option would require the administrator to appoint a legal representative for UFCs before a vote on any partial repayment DOCA. That representative would have no voting or veto rights in relation to the DOCA, but would have standing to apply to the court

to challenge it. The legal representative might also be given rights to attend and speak at the meeting of ascertained creditors, to assist in determining whether a court challenge to the DOCA might be appropriate.

The circumstances in which the court currently may make an order terminating a DOCA are set out in s 445D. The section could be amended to allow the court to take into account the interests of UFCs.

The legal representative of those claimants could be added as one of the parties who could apply for an order.

Principles drawn from the case law on s 445D, which might be adapted by the courts in the context of UFCs, include:

- the onus would be on the legal representative to establish the criteria for terminating a DOCA[110]
- a DOCA may discriminate between creditors or classes of creditors, but it ought nevertheless deal fairly with the interests of creditors of an insolvent company[111]
- a DOCA could be held to be oppressive in the light of facts emerging after the creditors' meeting.[112]

Under this option, an application by the legal representative for the UFCs may require the court to compare what might happen under the DOCA with the probable result in a liquidation. The courts have demonstrated a capacity to do this on the basis of expert evidence about a company's financial affairs.[113]

6.7 Request for submissions

The Advisory Committee invites you to forward submissions on any aspect of the matters raised in this chapter concerning various possible ways to take into account the interests of UFCs in a

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110 cf *JA Pty Ltd v Jonco Holdings Pty Ltd* (2000) 33 ACSR 691 at [90] per Santow J.

111 cf Davies AJA in *Khoury v Zambena Pty Ltd* [1999] NSWCA 402 (unreported, SC (NSW), Full Court, CA 40253/97, 28 October 1999, BC9906991) at [105].

112 *Bathurst City Council v Event Management Specialist Pty Ltd (admin apptd)* (2001) 36 ACSR 732.

113 See *JA Pty Ltd v Jonco Holdings Pty Ltd* (2000) 33 ACSR 691 per Santow J at [90]-[101].

voluntary administration that involves some level of return of funds to ascertained creditors, including:

- Option 1: the alternative possibilities under the Referred Proposal (monetary provision with or without further recourse for UFCs) (discussed in Section 6.3)
- Option 2: no provision for UFCs (discussed in Section 6.4)
- Option 3: a certificate by directors (discussed in Section 6.5)
- Option 4: allowing a representative for UFCs to challenge a DOCA in court (discussed in Section 6.6).

7 Schemes of arrangement

This chapter outlines the current protections for UFCs under schemes of arrangement and sets out various policy options for dealing with their interests.

7.1 Current procedure

7.1.1 Types of schemes

A compromise or arrangement under Part 5.1 of the Corporations Act can take the form of a members' scheme, a creditors' scheme, or a combined member/creditor scheme. Schemes are valid only if approved by the requisite majority of shareholders and/or creditors (depending on the nature of the scheme) and by the court.[114] Approved schemes bind all shareholders or creditors in those classes that voted to approve the scheme, including dissenters within a class.[115]

7.1.2 Members' schemes

Members' schemes involve mergers or other forms of corporate reconstruction or amalgamation, implemented through various means including the transfer or cancellation of shares and/or the transfer of corporate assets and/or liabilities between related companies.[116] Only shareholders (or the affected class of shareholders) have rights to vote on whether to approve these schemes.

The implications of a members' scheme for a company's creditors and UFCs can be considered by the court in exercising its discretion whether to approve the scheme.[117] For instance, in *In the matter of*

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114 ss 411-413. The court's powers to approve a scheme, with or without such alterations or conditions as the court thinks fit, are set out in s 411(4)(b), (6).

115 s 411(4).

116 *In the matter of Stork ICM Australia Pty Ltd* [2006] FCA 1849 at paras [68]-[69], and cases cited therein. See also paras [71]-[78] on the distinction between a reconstruction and an amalgamation, as those terms are used in s 413. Various forms of corporate group merger and asset and liability transfers utilising Part 5.1 of the Corporations Act are described in Chapter 5 of the Advisory Committee report *Corporate Groups* (May 2000), available at **www.camac.gov.au**

117 *Stork* at [69].

Stork ICM Australia Pty Ltd [2006] FCA 1849, the Federal Court approved a reconstruction scheme involving the transfer of assets and liabilities, including rights of insurance indemnity, from one company with asbestos-related potential liabilities to a related company, on being satisfied that the potential claimants would be protected, in the sense of being no worse off under the scheme than under the previous arrangement.

7.1.3 Creditors' and combined schemes

Creditors' schemes, or combined member/creditor schemes, may take various forms, including partial payments to unsecured creditors in satisfaction of the corporate debt or a moratorium on creditor claims.

Who are creditors

To be bound as 'creditors' by a creditors' scheme or a combined scheme, persons must be 'creditors' within the meaning of the scheme provisions.

The relevant Australian case law indicates that the term 'creditors' in the Part 5.1 scheme of arrangement provisions has the same meaning as in the winding up provisions:

> 'creditors' in s [411] should be understood as embracing all persons with claims which would be entitled to be admitted to proof if the company were wound up. This formulation was not intended to limit the scope of the expression, but rather to indicate that persons with unliquidated, prospective or contingent claims were not excluded, notwithstanding difficulties of assessment of value in such cases.[118]

Recent case law indicates that UFCs do not have prospective or contingent claims and therefore cannot be involved as creditors in a scheme of arrangement.[119]

A different approach has been taken in the UK, where a court has recently held, in a series of related cases, that UFCs are creditors

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118 *Re R L Child & Co Pty Ltd* (1986) 5 NSWLR 693 at 694.
119 *Edwards v Attorney-General* (2004), as analysed in Section 2.2.

under the UK scheme of arrangement provisions and can be parties to a scheme.[120]

The UK court held that the term 'creditor' in the UK scheme of arrangement provisions should have as wide a meaning as possible, given that one of the purposes of these provisions is to encourage arrangements with creditors that avoid liquidation and facilitate the financial rehabilitation of the company. The term should include persons who in the future will have claims against a company for personal injury if and when, as a result of a past breach by the company of its common law duty of care, they develop a disease or condition recognised in law as actionable damage.[121]

Creditor schemes not involving UFCs

Schemes of arrangement involving conventional unsecured creditors have not been common since the introduction of the voluntary administration provisions. However, where they are proposed, the affected creditors must be informed of various matters concerning a proposed scheme,[122] which is binding on them only if approved by a majority in number and by 75% by value of those creditors voting on the scheme,[123] as well as by the court.

UFCs cannot be bound by schemes to which they are not parties. Equally, however, they have no voting or other rights in relation to the terms of those schemes. Likewise, there is no obligation to make any provision for UFCs in these schemes. However, as with members' schemes, the court has a general discretion, in approving a scheme, to take into account any implications for affected groups, which could include UFCs where appropriate.

As with voluntary administrations, the only relevant schemes of this nature for the purpose of considering whether any changes should be made to accommodate the interests of UFCs are those that involve some level of return of funds to ascertained creditors. Schemes that simply postpone the rights of unsecured creditors to claim or enforce a corporate debt cannot disadvantage UFCs.

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120 The principal cases involved in settling this scheme include *Re T&N Ltd (No 2)* [2005] EWHC 2870 (Ch), *In the Matter of Cape Plc* [2006] EWHC 1316 (Ch) and *In the Matter of T&N Limited* [2006] EWHC 1447 (Ch).

121 *Re T&N Ltd (No 2)* [2005] EWHC 2870 (Ch).

122 s 412.

123 s 411(4).

Creditor schemes involving UFCs

It appears that, under Australian law, UFCs cannot be parties to a scheme of arrangement.

By contrast, UFCs can be parties to a scheme of arrangement under the UK provisions.[124] A UK court approved a proposed scheme of arrangement between various group companies and all the current and former employees of those companies who have, or may in the future have, claims for damages against the companies for personal injuries arising out of their exposure to asbestos.

For many years those companies had been involved in the manufacture, distribution and installation of asbestos-containing products. Even though the companies were solvent, the uncertainty as to future asbestos-related claims raised a real risk that at some future time they may become insolvent. The group's ability to meet future claims depended on the successful continuation of its businesses.

The proposed scheme was developed:

> with a view to protecting the group's businesses from asbestos claims, so as to maximise the opportunities for their successful development, while at the same time directing a proportion of its earnings to the payment of asbestos claims.[125]

Under the scheme, a trust (funded from current and future group corporate assets) would be established to pay present and future employee asbestos claimants according to a distribution procedure, which included a 'payment percentage' formula for all claimants. The rights of those claimants would also be protected by issuing a class of shares in the parent company to an independent party (the scheme shareholder), who through the voting entitlement attached to the shares could limit the dividends payable to other shareholders.

The arrangement, if approved, would bind all present and future employee claimants, who would be precluded from enforcing their claims other than against a particular entity funded by the trust.

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124 *Re T&N Ltd (No 2)* [2005] EWHC 2870 (Ch).
125 *In the Matter of Cape Plc* [2006] EWHC 1316 (Ch) at [7].

The court approved the calling of meetings of all present and former employees to vote on the scheme (given that this group would include all the claimants to be bound by the scheme) holding that:

- all these employees constituted one class for the purpose of voting on the scheme, given that all claimants from within that class, whether present or future, would receive the same payment percentage of their claims

- satisfactory steps had been taken to enable all these employees to be notified in advance of the meetings

- the court could sanction a scheme that contained provisions for its subsequent amendment without further approval of employees or the court, including in relation to the payment percentage, given the likelihood of material changes (including in relation to medical knowledge) that may occur over the long period of the scheme and which may affect the scheme's operation.[126]

The scheme was workable because of its limited nature:

- it involved only the group companies and an identifiable class of current claimants and UFCs. It did not include, or seek to bind, any UFC asbestos claimants who were not present or former employees

- the scheme did not involve, or affect the rights of, the conventional unsecured creditors of those companies or provide for any return of funds to them.

It would not be possible to use the scheme of arrangement provisions where all the possible members of the class of UFCs cannot be clearly identified and therefore be given the right to vote on the proposed scheme.

7.2 Referred Proposal

The Referred Proposal is that the scheme of arrangement provisions for UFCs where there is a mass future claim would be similar to those for UFCs under a voluntary administration. In this context,

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[126] *In the Matter of Cape Plc* [2006] EWHC 1316 (Ch), *In the Matter of T&N Limited* [2006] EWHC 1447 (Ch).

courts could be empowered to appoint a representative for the UFCs, to convene meetings with claimants and to require the preparation of an independent expert's report on the impact of the proposed compromise or arrangement on the UFCs. The representative for the UFCs would have standing to make submissions to the court before it approves the proposed compromise or arrangement.

Various disincentive issues and procedural questions arise in applying the Referred Proposal to relevant schemes. For instance:

- as with voluntary administrations (Section 6.3), there may be a disincentive for companies to go into a creditors' scheme if the directors anticipate that a fund will have to be established out of the company's assets to cover long-tail liabilities

- questions arise about appropriate voting rights if a scheme is to involve, and bind, UFCs as well as conventional unsecured creditors. If the legal representative for UFCs were to be given voting rights in a scheme, then, arguably, that person would, consistently with the general structure of Part 5.1, have the right to vote as a separate class from conventional unsecured creditors, thereby in effect having veto rights over any scheme. Alternatively, if provision were made for the representative to vote with general unsecured creditors, what monetary figure would be attributed to the representative vote for the purpose of satisfying the 75% by value requirement for a binding scheme?

7.3 Other policy options

One policy option is to extend the scheme provisions to permit schemes between companies and UFCs.

In regard to schemes involving some level of return of funds to ascertained creditors, similar policy options to those discussed for voluntary administration could be considered, namely:

- no provision for UFCs in these schemes (compare Section 6.4). Given that the courts are always involved in schemes, which cannot be entered into without their consent (in contrast to voluntary administrations), UFCs would have the protection of the court's general discretion to consider their interests in determining whether to approve the scheme

- a requirement that before any such scheme can be approved, directors must provide a certificate stating that either there are no UFCs or the scheme would not prejudice their interests. The same disincentive issues may arise here as with voluntary administrations (see Section 6.5)

- a right of the legal representative of UFCs to challenge such a scheme in the court. This option raises some procedural questions similar to those for voluntary administrations, such as who would appoint the representative and whether that person should have rights to attend and speak at a creditors' meeting (see Section 6.6). However, one possible benefit of this option is that it may assist the court in exercising its general discretion to approve a scheme, which can include considering its implications for UFCs.

7.4 Request for submissions

The Advisory Committee invites you to forward submissions on any aspect of the matters raised in this chapter concerning how to take into account the interests of UFCs in schemes of arrangement, including:

- whether the scheme provisions should be extended to permit schemes between companies and all possible members of a class of UFCs (discussed in Section 7.1)

- the Referred Proposal (discussed in Section 7.2)

- any of the other policy options (discussed in Section 7.3).

8 Liquidation

This chapter considers a possible procedure to implement the part of the Referred Proposal that deals with liquidation, including that the interests of UFCs be included in the liquidation process and that provision be made for UFC claims, alongside those of unsecured creditors.

8.1 Current position of UFCs

8.1.1 Overview

As indicated below, a court may take a company's potential liabilities to UFCs into account in deciding whether to exercise its discretionary powers to wind up a company. Beyond that, UFCs have no role or rights in a liquidation.

8.1.2 Determining insolvency

Companies may go into liquidation for various reasons, including that they are insolvent. Under the general Corporations Act test of insolvency, a company is insolvent if it is unable to pay all its debts as and when they become due and payable.[127] In this context, UFC claims would be taken into account only when they become sufficiently crystallised to be classified as debts or claims that are provable in a winding up under s 553 (see Chapter 2).

There is, however, another, extended, test of insolvency, found in s 459D(1), which may be significant for companies subject to UFCs, namely, that:

> in determining for the purposes of an application [to wind up a company on the grounds of insolvency] whether or not the company is solvent, the Court may take into account a contingent or prospective liability of the company.

The term 'contingent liability' is not defined in the Corporations Act. However, as explained in Section 2.4, Accounting Standard AASB 137 *Provisions, Contingent Liabilities and Contingent Assets*,

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[127] s 95A.

which deals with what information about these liabilities and assets should be included in a company's financial statements, has two tests of contingent liabilities, the one more relevant to UFCs being:

> a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity.[128]

The extended insolvency test in s 459D(1) may give courts a discretion to take into account the company's contingent liabilities arising from the presence of UFCs for the limited purpose of considering applications to wind up a company on the grounds of insolvency. However, the provision does not otherwise require a contingent liability to be treated as a debt or give UFCs a claim in a winding up.

8.1.3 Creditors

As indicated in Section 2.2, creditors in a liquidation are persons with debts or claims that are admissible to proof in the winding up. UFCs do not satisfy this test and therefore have none of the rights of creditors in a liquidation.

In contrast, the UK Insolvency Rules treat UFCs as creditors in a winding up, by providing that future tort claims are provable debts in a liquidation.[129] In particular, the interpretation of 'debt' is extended:

> to include claims founded in tort where all of the elements required to bring an action against the company exist at the time the company goes into liquidation or enters administration, except that the claimant has not yet suffered any damage and does not therefore, at that time, have a cause of action against the company.[130]

8.2 Referred Proposal

The proposal is that:

> Where a court determines that the liquidator is required to admit and make provision for mass future claims for

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128 AASB 137 para 10.

129 Statutory Instrument 2006 No. 1272, which came into force on 1 June 2006. This Statutory Instrument replaced Rule 13.12.

130 Explanatory Note to the Rules.

personal injury, an external administrator would be required to inform known creditors at the earliest opportunity and provide for the payment of such claims in the future. There would be scope for the appointment of a person to represent the class of personal injury claimants in any proceedings.

Provision for mass future personal injury claims would be calculated on the basis of estimates of the number of acts or omissions that may give rise to liability under the relevant head of damage; industry analyses; academic studies; independent actuarial analyses; the level of damages awarded for similar claims in courts or administrative review bodies of Australia or other common law jurisdictions; or such other matters as the external administrator thinks relevant.

Over time, future creditors would be able to make claims against funds set aside for future claimants. If such claims are uncertain, their amount could be determined in accordance with a process similar to that provided for by section 554A of the Corporations Act (determination of value of debts and claims of uncertain value).

In the case of a liquidation, asset distributions to creditors known at the time of external administration would take place as normal except a proportion of the assets could be set aside for future creditors. If there are insufficient assets to fully fund the provision for unascertained future creditors and repay existing creditors, assets could be divided proportionately.

8.3 Submissions on the Referred Proposal

8.3.1 General

The Australian Lawyers Alliance generally supported the Referred Proposal. It approved the proposals for marshalling assets, notifying claimants and representation.

The AICD gave support in principle to recognising the rights of UFCs in a liquidation, given that they would otherwise receive nothing, with the company's funds being distributed and the company dissolved before many of the claims may mature. However, that respondent considered that:

- the inclusion of UFCs within a liquidation involves a very significant (and difficult to quantify) cost to the other creditors in terms of increased costs of administration, delay in

distribution of available funds and decreased distributions (given any provision for UFCs)

- there should be suitable mechanisms to allow the early crystallisation and assessment of such claims, to permit a liquidation to be completed within a reasonable time.

8.3.2 Asset distributions—liquidation

The proposal states that:

> asset distributions to creditors known at the time of external administration would take place as normal except a proportion of the assets could be set aside for future creditors.

One submission[131] said that:

- this statement over-simplifies the difficulty of reconciling the interests of UFCs with those of other claimants known at the time of liquidation, given the high degree of uncertainty about the actual level of future claims
- if a proportion of the assets needs to be available to meet all actual successful claims, payments to other unsecured creditors will be delayed until all future claims are known and settled
- the only feasible alternative is:
  - at the time of winding up, a reasonable estimate of future claims is made 'independently' and the validity of the estimate 'certified' by a court
  - assets are assigned to meet this estimate
  - the remaining assets are distributed to the other claimants (employees, ascertained creditors, etc)
  - the company's directors, officers and administrator are protected from any future action if the assets assigned based on that reasonable estimate prove inadequate to meet actual future successful claims.

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131 Business Council of Australia.

8.3.3 Estimation of claims

There was a general recognition in submissions that the estimation of the fund to be set aside can be a very costly process requiring much expert evidence. One respondent pointed out that the US experience seems to suggest that estimates are often insufficient.[132]

The Institute of Actuaries of Australia[133] and the Insurance Council of Australia[134] pointed out that the estimation of liabilities of the type in the proposal is a core actuarial skill and is required when insurance companies make provision for outstanding claims.

Similarly, the submission from the Institute of Chartered Accountants in Australia argues that:

- it is essential that actuarial advice (which should take into account expert advice specific to the nature of the liabilities, where available) be sought regarding the evaluation of the liabilities, because of the considerable expertise that actuaries have in relation to the financial dynamics of personal injury risk and claim experience

- the estimate should be subject to regular, preferably annual, actuarial review, at least while the liabilities remain significant

- the quantification of these liabilities involves assumptions regarding the size of the group exposed to injury or disease, the proportion of those exposed who will suffer such an injury or contract such a disease, the proportion of those affected who will seek compensation, and the amounts those people will receive.

More specifically, the Insurance Council of Australia said that the assessment of outstanding liabilities involves a careful examination of a number of key factors:

- the nature and extent of the level of exposure, for instance, how many products were sold that might give rise to an injury or the

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132 The IPAA referred to *The Conclusion in re Federal-Mogul Global Inc 2005; The Official Committee of Asbestos Claimants and Eric D Green, as the legal representative for future asbestos claimants v Asbestos Property Damage Committee* (Civil Action No 05-59).

133 paras 24-30.

134 This submission endorsed the submission of the Institute of Actuaries of Australia in relation to the assessment of potential future claims liabilities, in particular, the uncertain events that can have an impact on this assessment.

volume of wages that might need to be paid in a workers compensation case

- a system of measuring the number of injuries arising out of the use of the product (the availability and quality of statistics are variable). This may be based, for instance, on a measure of 'claim frequency'

- extrapolation of the trends in exposure, injuries, claims and claim frequency, to project the number of claims that are likely to be made in the future. This process requires a number of subjective judgments and assumptions regarding the likely continuance of observed trends in claims and can be subject to considerable uncertainty, particularly if past trends do not prove to be an accurate indicator of future experience. The trend in claims may involve looking at overseas as well as Australian cases

- the average cost of claims, based on measuring known claims costs as accurately as possible, and then extrapolating trends in claims payments according to the number, nature and timing of expected future claims. The level of compensation awarded over time can vary. Actuaries must take account of any known or likely legal developments relating to the assessment of damages when calculating the likely cost of claims. These developments can affect the reliability of the estimate.

The Institute of Actuaries of Australia pointed out[135] that the estimate of the company's liability for personal injury claims will change over time for various reasons including (but not limited to) the following:

- while the company's liability for personal injury claims arises from past actions, the quantum will depend on future events, such as claimants' propensity to claim, changes in judicial and societal attitudes, changes in economic conditions, and technological (particularly medical) advances

- estimates are based on imperfect data and other information, corrected, replaced and updated over time to produce more reliable estimates

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[135] para 31.

- the models used to determine the liability estimates involve approximations and assumptions. Regular analysis of the variation between the projected experience and the actual outcome is used to improve the predictive power of the model.

The submission said that:

- there can at any time be a range (sometimes wide) of reasonable estimates of liability[136]

- while a single estimate is chosen for the purpose of preparing financial statements, the implications of the range of estimates need to be considered in decision-making for corporate administration.[137]

8.3.4 Role of the court

The IPAA said that the scope for court involvement in the process needs to be clearly articulated, including:

- whether the existing ability of external administrators to seek directions is sufficient

- whether court approval should be required for arrangements regarding UFCs or for decisions to make no provision for such claims

- if so, who, if anyone, should be required to be joined to any application as a contradictor.

8.3.5 Insurance implications

The Institute of Actuaries of Australia queried whether recoveries for the company's liability for personal injury claims that were covered, to some extent, before liquidation by existing commercial insurance arrangements should benefit all creditors or only personal injury creditors. It said[138] that:

- this may depend on the wording of the insurance contract and the likely extent of the recoveries

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136 paras 33.
137 paras 34.
138 paras 65-67.

- where the claims are expected to be almost totally covered by existing commercial arrangements, it may be appropriate to 'ring fence' the liabilities and the potential insurance recovery asset for the sole benefit of UFCs

- the existence of insurance policies does not guarantee payment, particularly over the very long term, in relation to claims of this type: contract conditions may not be able to be maintained and the possibility of insurer failure needs to be considered.

In a similar vein, this respondent said that the questions about who are the beneficiaries of any amounts recovered may also arise where the company has a right of recovery against a third party in respect of the relevant personal injury claims.[139]

The submission from the Australian Lawyers Alliance considered that:

- all relevant insurance coverage against the risk that will manifest should be identified and resolved at the earliest possible time, long before claims start in abundance, to avoid withdrawal of coverage on the basis that the insured corporation has failed properly to inform the insurer of the potential risk

- insurance coverage for UFCs should then be secured, by requiring payment forthwith, entering a secured scheme which provides for payment over time and/or increasing the prudential reserve requirements for insurers at risk

- funds obtained from insurers should be preserved solely for the UFCs.

8.3.6 Practical problems

Management of claims

The Institute of Actuaries of Australia [140] argued that:

- personal injury claims can be very complex and require specialist claim management skills

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139 para 67.
140 paras 49-51.

- how the claims are managed can materially affect the ultimate cost of those claims
- the infrastructure to manage a winding up is unlikely to be the most appropriate for claims management, particularly in the long term
- there may therefore be a need for an alternative claim management framework to handle the claims efficiently and effectively. Possible alternatives are:
  - establishing a trust with a separate company as trustee to manage the claims and the fund
  - outsourcing management to a third party provider, either directly or through a trust arrangement
  - establishing a statutory body to manage all liabilities of this type for companies in liquidation.

Dealing with movements in liability estimates

The Institute of Actuaries of Australia pointed to the need for measures to ensure that, as far as practicable, personal injury claimants who have claims on the fund at different times are treated equitably.[141] For instance, if a fund for UFCs is established based on an estimated liability and a liquidation distribution of 70 cents in the dollar, but after five years the liability estimate is increased, which of the following should occur:

- the 70 cents in the dollar payable to claimants is reduced for claims lodged after the date of the estimate adjustment
- the payout proportion remains at 70 cents in the dollar, with claims settled at that level until the funds are exhausted
- all personal injury claimants receive an 'interim distribution' based on a worst case scenario, until such time as the liability is reasonably certain, with a final distribution then paid to all claimants if the funds permit?

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[141] paras 52-54. The IPAA made a similar point.

Conversely, consideration needs to be given to how the payments from the fund would be affected where the fund's performance is better than expected and there are surplus funds after settlement of all claims.

Limiting the size of the liability

The Institute of Actuaries of Australia raised the question[142] whether there is a need for restrictions on the quantum to be paid to personal injury claimants, for instance, through benefit thresholds or deductibles (both of which could eliminate trivial claims) or caps. Such measures may help achieve a balance between generosity and affordability of compensation. They may also reduce uncertainty.[143]

The submission recognised the sensitivity of restrictions and said that applying further thresholds and/or caps may be considered unduly harsh, given that most Australian jurisdictions already apply thresholds and/or caps for personal injury compensation. The submission recommended that any restrictions on quantum be accompanied by significant protections to ensure that the approach was taken only as a last resort.

Potential for risk transfer

The Institute of Actuaries of Australia suggested[144] that a practical solution to the problems of uncertainty and timeliness of the liquidation is to transfer some or all of the liabilities to a specialist claim manager (such as an insurance company). The advantage for the liquidation is that the uncertain liability is replaced by a certain insurance premium. The disadvantage is the additional cost, being the loading in the premium for the insurer to take on that uncertainty.

Mechanisms to 'top up' the fund

The Institute of Actuaries of Australia raised the possibility of a mechanism for government to 'top up' the fund by providing the difference between the ultimate cost of claims and the fund established through the liquidation.[145] The cost of doing so could be limited by applying caps or thresholds, as discussed under *Limiting*

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142 paras 55-58.
143 para 60.
144 paras 59-61.
145 paras 62-64.

the size of the liability. For instance, the funding could be limited to the balance of the settlement for medical costs and loss of income, and exclude general damages. This would mean that the claimant receives the full entitlement in respect of medical and income compensation, but only that part of the general damages amount that can be provided directly by the fund. However, this may prove difficult with negotiated settlements, as opposed to damages awards, as the settlements may not be formally segmented by head of damage.

8.4 Possible procedure to implement the Referred Proposal

8.4.1 Overview

Taking into account these submissions, the Advisory Committee puts forward for consideration the following procedure as a possible way to implement the Referred Proposal in relation to liquidations.

The possible procedure has been set out for the purpose of debate, and should not be seen as having been endorsed by the Advisory Committee. This procedure may or may not be limited to circumstances where there is a mass future claim, depending on whether this criterion is adopted (see Chapter 4).

The procedure would apply to all liquidations, whether by the court or under a members' or creditors' voluntary winding up (the latter two not requiring court involvement), but not to a provisional liquidation.[146]

A court order should be required for the establishment of a trust fund for UFCs, given the importance of having some matters settled by the court, not left to the discretion of the liquidator, for instance:

- the amount of the fund
- who can act as the trustee of the fund, and

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[146] Provisional liquidation is an interim procedure only, to freeze a company's assets and liabilities and prevent it from continuing to trade. It is unnecessary to take UFC interests into account in such a procedure. If a company moves to another form of administration, UFC interests can be dealt with in that other administration (namely, a voluntary administration, as discussed in Chapter 6, a scheme of arrangement, as discussed in Chapter 7, or a liquidation, as discussed in this chapter).

- the ongoing remuneration of the trustee.

Thus, when a company that is subject to UFCs is being wound up, the court would be given the power, on application by:

- the liquidator
- any person who may be included in the class of UFCs, or
- someone who was a UFC but whose claim has now sufficiently crystallised for the person to have become an ascertained creditor

to make an order:

- appointing a trustee for the UFCs
- certifying an estimate of the value of the future liabilities to UFCs (this estimate would be used in finally determining the relative rights of ascertained creditors and UFCs to that part of the assets of the company available to unsecured creditors)
- admitting the trustee as an unsecured creditor in the certified amount
- establishing a trust fund based on the certified amount.

Claims on the trust fund would cease to be claims in the liquidation.

To assist the liquidator in deciding whether to apply for such an order, directors of a company in liquidation should be required to disclose whether the company has UFCs.

The consequence of the court making the order would be that the company's obligations and rights in regard to UFCs (including any relevant liability insurance policies) would be assigned to the separate trust fund. UFCs would become beneficiaries of the trust. This would permit the liquidation to be completed and the company to be extinguished.

The legislative provisions dealing with the trust fund should specify that:

- the fund trustee should have broad powers to make instalment payments to eligible claimants in advance of the final

quantification of their entitlements, as well as to litigate and settle claims (see Section 8.4.7 **Procedure for claims by UFCs**)

- where the trust fund gets so many cents in the dollar in the liquidation of the company, UFC claimants should receive the same number of cents in the dollar (the return rate) from the fund, subject to any subsequent variation in that return rate (see also Section 8.4.8 **Varying the return rate**).

8.4.2 Obligation to inform creditors

The liquidator should be required to inform known ascertained creditors at the earliest opportunity of his or her intention to apply to the court for the establishment of a trust fund for UFCs, or of any trust fund application of this nature by any other party that is known to the liquidator.

8.4.3 Creditor right of challenge

Any ascertained creditor should have the right to be heard on a court application to set up a trust fund.

8.4.4 Amount of fund

The amount to be placed in the trust fund for UFCs should be calculated on the basis of:

- estimates of the number of acts or omissions that may give rise to liability under the relevant head of damage
- industry analyses, academic studies and independent actuarial analyses
- the level of damages awarded for similar claims in courts or administrative review bodies in Australia or other common law jurisdictions, and
- such other matters as the court thinks relevant.

If there are insufficient available corporate assets to pay ascertained creditors and UFCs in full, those assets should be divided proportionately, according to the estimated total value of claims by ascertained creditors and UFCs.

8.4.5 Position of the liquidator

Some submissions were concerned to ensure that any procedure to protect UFCs does not impose personal liability on liquidators.[147] However, a provision to protect liquidators would be unnecessary, given that under the proposal discussed in this section the court would approve the amount to be set aside for UFCs.

8.4.6 Fund administration

The trust fund for UFCs would be administered by a trustee appointed by the court. The trustee may, but need not, be the liquidator. In many instances, it might be expected that the liquidator would relinquish control of the allocated funds to a separate trustee.

The court would have the power, in approving the trust deed, to ensure that the trustee's fees are appropriate for the task and do not unduly diminish the fund set aside for UFC claims.

The method of investing trust funds, including any restrictions on types of investments, could be regulated under the trust deed approved by the court. In addition (or in the absence of a provision in the trust deed), general trust law principles regarding the fiduciary duties of trustees to act in the interests of beneficiaries would apply to the investment of trust funds.

8.4.7 Procedure for claims by UFCs

UFCs should be able to claim against the fund as soon as their injuries become manifest.

The trustee should have the power to make instalment payments. In addition, the trustee should have the power to:

(1) accept a claim in its entirety

(2) reject a claim in its entirety

(3) accept a claim, but reject the quantum claimed and, in that instance:

  (a) make an estimate of the claim, or

  (b) refer the quantum of the claim to the court.

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147 BCA, IPAA.

Where the trustee does not accept a claim in its entirety, the claimant should have a right of appeal to the court or, where the trustee has referred the question of quantum to the court, a right to be heard on that question.

This would be similar to the procedure under s 554A, which allows a liquidator to:

- make an estimate of the value of a claim of uncertain value, or
- refer the question of the value of the claim to the court.

Where a claim is referred to the court, the questions to be determined would be the same as in a tort case concerning the relevant injury.

8.4.8 Varying the return rate

The trust deed could state whether the trustee, in light of any relevant changes after the liquidation, may increase or reduce the return rate, or must obtain prior court approval to do either or both. If the trust deed makes no such provision, court approval would be required for any change in the return rate.

It should be left to the discretion of the trustee how often to have an actuarial review undertaken for the purpose of reviewing the return rate.

8.4.9 Residual funds

There should be no specific legislative provisions regulating any residual funds remaining if and when all claims by UFCs have been satisfied. It would be impractical to require the return of any surplus funds to shareholders or unsecured creditors, possibly years after the company has gone into liquidation. This matter could be dealt with in the trust deed, or otherwise under the general trust law concerning the dissipation of surplus trust funds.

8.5 Other matters

8.5.1 Payment of membership-type debts

Section 563A provides that:

> Payment of a debt owed by a company to a person in the person's capacity as a member [shareholder] of the

> company, whether by way of dividends, profits or otherwise, is to be postponed until all debts owed to, or claims made by, persons otherwise than as members of the company have been satisfied.

Currently, UFCs are not treated as persons who are owed debts or have claims against the company. Therefore, the company may satisfy shareholder-type debts without the need to make any provision for UFCs.[148]

In response to this, s 563A could be amended so that:

- debts owed to persons other than as shareholders (as referred to in the second half of s 563A) include any amount to be set aside in a trust fund for UFCs in a liquidation
- no distribution to shareholders pursuant to s 563A may take place unless the trust fund provides for full payment to UFCs
- full payment from the company's assets into that trust fund is taken to be full satisfaction of that debt, thereby permitting distribution of any surplus to shareholders under this section.

The intended effect is to prohibit payments of debts to shareholders if UFCs are only to get a proportional return under the terms of the trust. Comparable changes could be made to s 563AA, which deals with buy-backs.

If, in light of subsequent events, the future liability to UFCs turns out to be greater than the amount provided in the trust fund, the proposed amendment to s 563A may result in shareholders having received payments in their capacity as shareholders, notwithstanding that some UFCs receive less than complete payment when their claims crystallise.

However, if the estimate of the future liability to UFCs at the time of setting up the trust is bona fide, it could be argued that there is a greater public interest in not unduly prolonging liquidations.

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148 As decided by the High Court in *Sons of Gwalia*, the shareholder debts covered by s 563A include a right to recover any paid-up capital, a right to avoid a liability to make a contribution to the company's capital and a right to be paid a dividend.

8.5.2 Corporate groups

A further matter is whether the operation of corporate groups raises any issues concerning how to accommodate the interests of UFCs in a liquidation.

Companies in a corporate group may have arrangements by which group companies guarantee the debts of each of them (cross-guarantees). The activation of a cross-guarantee could result in the ascertained creditors of one group company (company B) having access to the assets of another group company (company A) that is subject to claims by UFCs. If the enforcement of the cross-guarantee would result in company A going into liquidation, the unsecured creditors of company A would include unsecured creditors of both group companies, as well as the UFCs of company A, for the purpose of setting up the UFCs trust fund and determining the pro rata amount to go into the fund. On this analysis, no additional legislative provision needs to be made for corporate groups.

Another issue is whether wholly-owned entities in corporate groups should be able irrevocably to assign any UFC liability to the parent company, enabling the dormant subsidiary to be wound up. One respondent has argued for this additional power.[149]

8.6 Request for submissions

The Advisory Committee invites you to forward submissions on any aspect of the matters raised in this chapter, including:

- the Referred Proposal (discussed in Section 8.2)
- the possible procedure to implement the Referred Proposal (discussed in Section 8.4)
- payment of membership-type debts (discussed in Section 8.5.1)
- corporate groups (discussed in Section 8.5.2).

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149 IPAA.

9 Anti-avoidance

This chapter considers whether an anti-avoidance provision should be included in any legislation dealing with long-tail liabilities and, if so, what form it should take.

9.1 The role of an anti-avoidance provision

The Referred Proposal contains an anti-avoidance provision in the form of a prohibition on persons entering into agreements or transactions to prevent the recovery of all or a significant part of amounts owing to UFCs (outlined further in Section 9.2).

9.1.1 Arguments for including a provision

The intended purpose of any anti-avoidance provision is to provide a clear legislative statement of principle that deliberate avoidance of payment to UFCs is unacceptable. It constitutes a means of deterring behaviour designed to undermine the rights of UFCs that might be conferred by any long-tail liabilities legislation.

9.1.2 Arguments against including a provision

Arguments against the inclusion of any anti-avoidance provision include:

- *over-regulatory.* An anti-avoidance provision would impose an additional level of regulation on corporate decision-making beyond that contemplated in previous chapters of this paper for solvent companies and those in external administration. Directors or administrators may be unduly restricted in their commercial activities through concern that their conduct (for instance, administrators selling corporate assets as part of the external administration process), not otherwise prohibited, could be characterised as a deliberate attempt to avoid or reduce payments to UFCs

- *anomalous.* An anti-avoidance provision could create an anomalous effect if the 'mass future claim' threshold element is also retained. Directors or administrators of companies with long-tail liabilities that do not reach the mass future claim

threshold could lawfully enter into agreements or transactions to prevent recovery by UFCs, whereas it may be a criminal offence for directors or administrators of companies above that threshold to do so. The mass future claim threshold test, with its inevitable imprecision, would therefore become crucial for the purpose of determining criminal liability

- *unnecessary for schemes.* The courts can exercise their discretionary powers to oversee schemes of arrangement, including to determine whether they may be detrimental to the interests of general creditors and UFCs (see Section 7.1).

One submission also raised concerns about the introduction of an anti-avoidance provision in the UFC context (see Section 9.5.2).

9.2 Referred Proposal

9.2.1 The prohibition

Under the Referred Proposal, where:

- there is a mass future claim afoot, and
- the company has a threshold level of information about the nature of expected claims

a person would be prohibited from entering into agreements or transactions to prevent the recovery of all or a significant part of amounts owing to UFCs.

9.2.2 Criminal liability

The Referred Proposal contemplates that any person knowingly involved in the contravention (not just directors) would be liable to up to ten years imprisonment and fines of up to $110,000.

9.2.3 Civil liability

The Referred Proposal also contemplates that affected persons could recover compensation not just from directors or other companies in a group, but from any person who is party to the transaction or arrangement.

Actions for compensation would:

- involve a civil standard of proof
- be independent of whether an offence is proven
- require only proof that the proscribed intent was included in the person's intent (rather than proof of a dominant or sole intent).

9.2.4 Priorities

The Referred Proposal states that:

> There may be merit in considering a special priority for amounts awarded as compensation under the new provision. This way, it is assured that the personal injury claimants who suffered damage from the conduct and are the subject of a claim under the new provision receive the maximum benefit possible from the action.
>
> Such a priority would only come into play if an action for compensation under the new provision was successful, and be limited to the actual amount awarded under the new compensation provisions. Such a priority should not compromise the priority afforded to employee entitlements and should therefore rank below employee entitlements.

9.3 Part 5.8A of the Corporations Act

There is no general anti-avoidance provision in the Corporations Act. The Referred Proposal indicates that the proposed anti-avoidance provisions would be modelled on Part 5.8A of the Corporations Act, which deals with employee entitlements.

The main features of Part 5.8A are set out below.

9.3.1 Overview

Introduced in June 2000, Part 5.8A contains provisions designed to protect the entitlements of employees from agreements and transactions entered into with the intention of defeating the recovery of those entitlements. The Part allows a liquidator,[150] or on certain conditions individual employees themselves,[151] to sue 'a person' for

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[150] s 596AC(2).
[151] ss 596AC(3), 596AF.

employment entitlements where that person has entered into a transaction or agreement with the intention of preventing or reducing recovery of those entitlements.

9.3.2 Prohibited agreements and transactions

All persons are prohibited from entering into agreements or transactions with the 'intention of' preventing the recovery of employee entitlements or significantly reducing those entitlements.[152] The company need not have been insolvent when the transaction was entered into and it does not matter how long ago the transaction occurred.

The terms of the provision are quite broad. The terms 'relevant agreement'[153] and 'transaction' are wide, and the provision applies even if the company is not a party to the transaction or a court approves the agreement.[154] Any prosecution requires proof of an intention to defeat the entitlements, though this need not be the sole intention of the transaction.[155] Also, it appears that the person sued need not be a director or officer of the company.

Prohibited transactions constitute a criminal offence, for which the maximum penalty is 1,000 penalty units (currently $110,000[156]) or up to 10 years imprisonment or both.[157]

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152 s 596AB.

153 Section 9 defines 'relevant agreement' as including an agreement, arrangement or understanding, whether formal or informal, written or oral, legal or equitable and whether or not based on legal or equitable rights.

154 s 596AB(2).

155 s 596AB(1). It has been suggested that, given the severity of the penalties involved, the test of intention must be the actual intention of the person charged: HAJ Ford, RP Austin & IM Ramsay, *Ford's Principles of Corporations Law* (Butterworths loose-leaf) at [27.483].
D Noakes, in 'Recovering employee entitlements and uncommercial transactions in insolvency' (2000) vol 1 no 2 *Insolvency Law Bulletin* 20 at 22, comments that: 'As a practical matter, recovery may be difficult under this new prohibition, given that the criminal standard of proof (combined with the requirement to prove intent) is such a high barrier. Directors may successfully argue that ordinary commercial motives were the reason for an action that had the effect of denying employees their entitlements. Ultimately, the courts may need to resolve the question of whether the director was trying to avoid paying entitlements or whether the decision was aimed at growing the business and protecting jobs.'

156 A penalty unit is currently $110: *Crimes Act 1914* s 4AA.

157 s 1311, Schedule 3, Item 145.

9.3.3 Compensation

Persons will be liable to pay compensation under Part 5.8A if:

- they enter a prohibited transaction[158]
- the company is being wound up,[159] and
- employees suffer loss or damage because of the contravention.[160]

The compensation owed will equal the amount of the loss.

Compensation may be recovered by the liquidator as a debt due to the company.[161] If the liquidator does not sue for compensation,[162] employees may be able to sue directly for their entitlement.[163] Any employee taking such action must either gain the liquidator's consent[164] or, having given 3 months' notice to the liquidator, obtain leave of the court.[165] Direct employee recovery is prohibited where the liquidator has begun proceedings under the insolvent trading provisions.[166] Any amount recovered by a liquidator under Part 5.8A is to be taken into account in the insolvent trading action.[167]

9.4 Do other legislative provisions suffice?

There is a question whether the proposed anti-avoidance provisions are necessary, given other prohibitions on transactions intended to defraud creditors.

For instance, s 37A of the *Conveyancing Act 1919* (NSW) provides that an alienation of property made with intent to defraud creditors will be voidable at the instance of any person prejudiced by the transfer. The section does not apply where the transfer is to a bona

158 s 596AB, as discussed above.
159 s 596AC(1)(b).
160 s 596AC(1)(c).
161 s 596AC(2).
162 s 596AI.
163 ss 596AC(3), 596AF, 596AG, 596AH.
164 s 596AF.
165 ss 596AG, 596AH.
166 s 596AI.
167 s 596AD.

fide third party purchaser who is ignorant of the fraud.[168] Other jurisdictions have similar provisions.[169]

However, provisions such as s 37A are unlikely to provide a remedy where a corporation seeks to avoid liabilities to UFCs. The *Conveyancing Act* does not define the word 'creditors' and the question does not appear to have received judicial consideration in the context of s 37A,[170] but there is no reason to believe that 'creditor' would be given a wider compass in this context than it is under the Commonwealth corporations and bankruptcy legislation.

A further difficulty concerns the element of an intent to defraud. The creditor must prove intention.[171] Courts have found that intent to defraud creditors can be established in particular circumstances where a company has entered into a hazardous or speculative business transaction.[172] However, mere intent to delay is not sufficient.[173] It may be difficult to establish the necessary fraudulent intent where directors were unsure of the quantum of future liabilities or even the number of creditors that would exist at the time they entered the transaction.

9.5 Submissions on the Referred Proposal

9.5.1 Support

The Australian Lawyers Alliance supported anti-avoidance provisions and also proposed other measures, which they argued would avoid the harm in the first place:

- imposing duties on the corporation and its directors where a person or class of persons or the environment has been or may be harmed. The submission defines 'harm' and 'environment'

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168 *Conveyancing Act* s 37A(3); *Coghlan v Alexander* (1905) 5 SR (NSW) 441.

169 *Property Law Act 1974* s 228 (Qld), *Law of Property Act 1936* (SA) s 86, *Conveyancing and Law of Property Act 1884* (Tas) s 40, *Property Law Act 1958* (Vic) s 172, *Property Law Act 1969* (WA) s 89, *Law Reform (Miscellaneous Provisions) Act 1955 No 3* (ACT) s 42, *Law Of Property Act* (NT) s 208.

170 Except that the term has been said to include a person's 'creditors as a whole' and a person does not cease to be a creditor when he or she becomes a bankrupt: *Zaravinos v Houvardas* [2004] NSWCA 421 per Sheller JA [63-64].

171 *Ex parte Mercer* (1886) 17 QBD 290.

172 *Mackay v Douglas* (1872) LR 14 Eq 106, *Ex parte Russell* (1882) 19 Ch D 588.

173 *Re Cummins; Richards v Cummins* (1951) 15 ABC 185.

- making each company in a corporate group liable for the consequences of the malfeasance of a subsidiary or related corporation. This would:
  - ensure that any assets within the group are subject to annexation in order to provide the funds necessary for UFCs
  - preclude the temptation to shift assets out of the liable corporation, or to rely upon its lack of assets or capital, to avoid responsibility to UFCs.

This respondent also supported affording priority to UFCs in any liquidation, not only in relation to the funds available from the recovery proceedings proposed, but in relation to other assets of the corporation brought into the liquidation. The respondent argued that:

- if UFCs had known of the injury at the time of exposure to or use of the product, they could have secured their compensation against the assets of the corporation then available by obtaining and enforcing judgments, so as to rank higher in the list of creditors than general unsecured creditors
- creditors other than UFCs had an opportunity to order their relationship with the corporation for their own protection (for instance, by negotiating the terms of contracts with companies)
- the inability of UFCs to protect their entitlements is not due to any failure on their part to take steps to secure their interest: they, like employees with accrued entitlements, are the innocent victims of malfeasance and maladministration
- those who purchased the company's products while unaware of the potential harm, as the direct source of the company's former and distributed wealth and as victims of decisions to place the company's profit before their safety, should have absolute priority over what remains of the company's assets.

This respondent recognised the possibility that 'secured creditors receive nothing with the entirety of assets being retained to provide for the future claimants'.

Chartered Secretaries Australia said that it had 'no objection' in principle to the anti-avoidance provision.

9.5.2 Oppose

AICD opposed the proposed prohibition on intentional avoidance, arguing that:

- it is too broad and would not be appropriate in respect of a threshold test as proposed
- the existing creditor protection provisions which are proposed to be extended [for instance, to capital reductions and buy-backs, as discussed in Chapter 5] are not the subject of any specific reinforcement by criminal sanction
- there is no clear need for such a provision, given that it should only catch transactions made with the intent (sole or dominant) of defeating future creditors, not routine arrangements entered into by a company with a view to ensuring that claims against it are minimised (for instance, for the defence of litigation or the investigation of claims), and in that event would achieve no more than current legislative provisions, such as s 37A of the *Conveyancing Act* (NSW), which sufficiently deal with transactions made with the intention of defeating or delaying creditors (including future creditors)
- the threshold test for the provision is unclear
- the extension of the provision to 'any person who is a party to the transaction or arrangement' may deter competent advisers to companies which might be the subject of a mass future claim from acting for those companies because of the risk of potential personal liability, whereas it is in the public interest that such companies get good advice. As an alternative, AICD suggested that creation of a low-threshold accessorial liability should be carefully considered, even though it also said that this may not be desirable.

9.5.3 Need for clarification

The IPAA submitted that:

- the phrase 'threshold level of information' needs to be very clearly defined so that there is no ambiguity about when the provisions will apply

- it should be made clear whether liquidators are to play any role in investigating possible offences by directors against the proposed new anti-avoidance provisions, or whether this is more appropriately undertaken by ASIC. The provision is directed not just at persons entering into proscribed transactions but also at anyone who is a 'party to the transaction or arrangement'. Any such provision should not be such as to deter directors or their advisers from considering or implementing lawful and commercially justifiable attempts to restructure financially distressed companies or place them in a position of unreasonable potential exposure when doing so.

9.6 Priority rights in relation to compensation

9.6.1 Referred Proposal

The Referred Proposal states that:

> There may be merit in considering a special priority for amounts awarded as compensation under the new provision. This way, it is assured that the personal injury claimants who suffered damage from the conduct and are the subject of a claim under the new provision receive the maximum benefit possible from the action. Such a priority would only come into play if an action for compensation under the new [anti-avoidance] provision was successful, and be limited to the actual amount awarded under the new compensation provisions. Such a priority should not compromise the priority afforded to employee entitlements and should therefore rank below employee entitlements.

9.6.2 Current position

The order for the distribution of assets in the case of an insolvent company is:

- first, secured creditors are paid out of the secured assets
- secondly, preferential creditors are paid in the order set down in s 556, which governs the payment of certain unsecured debts in priority to other unsecured debts. Section 556 gives preferential

status, firstly, to the costs, charges and expenses of the winding up and then to employee entitlements[174]

- finally, ordinary unsecured creditors (now including *Sons of Gwalia* type shareholder claimants).

9.6.3 Policy options

There are various options available in considering where any money recovered under the proposed anti-avoidance provisions should come within this order of distribution.

Policy options for dealing with funds recovered under the anti-avoidance provisions include:

- *Option 1:* all funds recovered to go to the trust fund for UFCs
- *Option 2:* adopt Option 1, subject to payment of the costs, charges and expenses of the winding up
- *Option 3:* Option 2, subject also to payment of employee entitlements
- *Option 4:* all funds recovered to be treated as general corporate assets, available for distribution according to the general rules for distribution of those assets.

9.7 Request for submissions

The Advisory Committee invites you to forward submissions on any aspect of the policy questions or other matters raised in this chapter, including:

- whether to include an anti-avoidance provision
- if so, what form it should take
- what priority rights should apply to any compensation received under an anti-avoidance provision.

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[174] There is also a priority for amounts in respect of injury compensation for liability that arose before the winding up began: s 556(1)(f), s 9 definition of 'relevant date'. This priority comes between the priority for wages and superannuation contributions (s 556(1)(e)) and the priority for amounts due in respect of leave of absence (s 556(1)(g)).

10 Other matters

This chapter raises for consideration other matters that were referred to in initial submissions to the Advisory Committee.

10.1 Statute of limitations

The right to commence civil actions is subject to various limitation periods (for instance, six years from the date of the relevant conduct).

One respondent[175] argued that the limitation provisions should be amended or suspended to ensure that the time within which UFCs may sue only starts to run from the time that the symptoms of the injury have, or should have, become apparent, not from the earlier time when the cause of the injury (for instance, exposure to asbestos) occurred.

The counterargument is that courts already have a discretion to extend limitation periods and will tend to do so with 'latent' torts, to take into account the period between the injury that gave rise to the initial cause of action and the time for that injury to become manifest.[176]

Also, issues related to limitation periods are of general application in the context of tort and other remedies. It may be difficult to justify particular provisions in the limited context of UFCs.

10.2 Trade Practices Act

Another matter raised in submissions is whether personal injuries should be included in the category of damages that may arise from negligent or misleading conduct that contravenes s 52 of the *Trade Practices Act 1974*. Currently, these claims are excluded.[177]

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175 Australian Lawyers Alliance.
176 See, for instance, *Briggs v James Hardie & Co Pty Ltd* (1989) 7 ACLC 841.
177 s 82(1AAA).

One respondent[178] argued that UFCs should have rights under the *Trade Practices Act*, in addition to any rights at common law. UFCs should not be confined to common law tort claims (where they would have to prove foreseeability of risk on the part of a company whose controlling officers have long since departed), if instead they can demonstrate misleading and deceptive conduct with respect to public statements (and public silence) on the part of the company that have been a cause of their use of the product and subsequent latent injury.

The submission on the operation of the *Trade Practices Act* raises general policy matters concerning the scope of that legislation, going beyond UFCs, which are outside the terms of the long-tail liabilities reference.

10.3 Request for submissions

The Advisory Committee invites you to forward submissions on either of the matters raised in this chapter or any other matters relating to long-tail liabilities that have not been raised elsewhere in this paper.

[178] Australian Lawyers Alliance.

Appendix US law

Introduction

The problem of how to provide adequately for long-tail liabilities in insolvency has been considered in overseas jurisdictions. The United States enacted a specific provision dealing with asbestos liabilities following the experience of one firm with asbestos liabilities that restructured itself under Chapter 11 of the US Bankruptcy Code.

Chapter 11 of the US Bankruptcy Code permits US corporations that are insolvent or facing insolvency to restructure their affairs. It was used by the Johns-Manville company to deal with its long-tail liabilities for asbestos claims.

The US Congress subsequently enacted s 524(g) to overcome uncertainty about the use of Chapter 11 to deal with long-tail asbestos claims by codifying the experience in the Johns-Manville case. That provision allows a company forced into Chapter 11 by asbestos claims to establish a compensatory trust from which to pay present and future asbestos claims. It relates only to corporate reorganization (Chapter 11), not to liquidations (Chapter 7). In contrast to the Referred Proposal, US law does not make any special provision for asbestos claims where a company is wound up.

Background to the US law—the Johns-Manville case

Johns-Manville filed for bankruptcy in 1983 in the face of overwhelming asbestos claims. In 1986, the United States Bankruptcy Court for the Southern District of New York approved its plan of reorganization, a cornerstone of which was the creation, through the court's discretionary powers,[179] of a trust to compensate individuals suffering personal injury from exposure to asbestos sold by Johns-Manville. The trust would settle claims and Johns-Manville would fund the trust to meet expected demand by issuing new shares to it. When Johns-Manville emerged from

[179] s 105 of the *Bankruptcy Code* 11 USC s 105(a).

bankruptcy in 1988, these contributions meant the company was 80% owned by the compensation trust.[180]

It subsequently became clear that the fund would not be able to meet the claims being made and the trust itself sought bankruptcy protection. When a settlement was finally approved in 1995,[181] it required that the trust's assets be distributed to qualifying claimants on a pro rata share basis computed to equalise payments to present and future claimants at an initial level of 10% of total liquidated claim value, since reduced to 5%.

Johns-Manville survived the process and was acquired by Berkshire Hathaway in 2001.

The effect of s 524(g) on Chapter 11

Overview

The basic steps involved in US Chapter 11 are:

(1) *entry into Chapter 11:* a company files a petition under Chapter 11

(2) *automatic stay:* the initiation of the Chapter 11 proceeding immediately freezes the rights of all creditors, secured as well as unsecured, as at that date[182]

(3) *development of plan:* for 120 days, the company generally has the sole right to file a reorganization plan[183]

(4) *notification to creditors:* creditors are sent the plan or a summary of the plan and a written disclosure statement approved by the court[184]

(5) *creditor approval:* each class of creditors considers the plan and is taken to approve it if two-thirds in amount and more

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180 J Bannister & R Hudson, 'Once More into the Breach: Toward Resolving Burgeoning Asbestos-Related Bankruptcies' (2005) 1 *Perspectives On Law & Contemporary Culture* 6.

181 *In re Johns-Manville Corporation*, 878 F.Supp. 473 (1995).

182 s 362.

183 s 1121.

184 s 1125(b).

than one-half in number of the creditors in that class approve it[185]

(6) *court confirmation:* the court confirms the plan after considering, among other things, whether each class of creditors has approved the plan. Under the 'cramdown' section of the Bankruptcy Code, the court may confirm a reorganization plan despite the objection of one or more impaired classes of creditors, if at least one impaired class assents and the proposed plan is found by the court to be 'fair and equitable' to any objecting class.[186] A class is impaired if the plan would alter any of the legal rights of its members compared with their pre-Chapter 11 position

(7) *effect of plan:* the plan binds the company, any entity issuing securities under the plan, any entity acquiring property under the plan, and any creditor, equity security holder or general partner in the debtor.[187]

The key elements of s 524(g) adapt the court confirmation procedure (step 6) to deal with asbestos claims, by:

- setting out the prerequisites for using the s 524(g) procedure in a plan that provides for asbestos claims[188]
- establishing a trust to meet asbestos claims[189]
- providing a specific court power to injunct present[190] and future[191] asbestos claimants
- establishing special protections for future claimants, including the appointment of a legal representative to protect their rights.[192]

There are also features that relate to notification to creditors (step 4) and the procedure for creditors to approve the plan (step 5).

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185 s 1126(c).
186 s 1129.
187 s 1141(a).
188 s 524(g)(2)(B)(ii).
189 s 524(g)(2)(B)(i).
190 s 524(g)(1)(B), (3).
191 s 524(g)(4)(B), (5).
192 s 524(g)(4)(B).

Court confirmation

Prerequisites for using the s 524(g) procedure in a plan

Before confirming a plan, the court must determine[193] that:

- the debtor is subject to present claims for asbestos injuries and is likely to be subject to substantial future claims of a similar nature
- the actual amounts, numbers and timing of such future claims cannot be determined
- pursuit of future claims outside the trust procedure is likely to threaten the plan's purpose to deal equitably with present and future claims
- certain requirements for disclosure to creditors have been satisfied (see below under **Notification to creditors**)
- certain class voting requirements have been satisfied (see below under **Creditor approval**)
- there are mechanisms to ensure that the trust will value and be able to pay present and future claims in substantially the same manner.

Establishment of the trust

A trust having the following features[194] should be established:

- it takes on the liabilities of the debtor that at the time of entry of the order for relief (that is, at the time the petition commencing the voluntary case was filed) has been named as a defendant in asbestos-related actions for damages
- it is to be funded, wholly or partly, by the securities of the debtor and by the obligation of the debtor to make future payments, including dividends
- it is to own a majority of the voting shares of the debtor, its parent corporation and any subsidiary of the debtor that is also a debtor

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193 s 524(g)(2)(B)(ii).
194 s 524(g)(2)(B)(i).

- it is to use its assets or income to pay claims.

Injunction on confirmation of plan

The court has the power, when confirming a Chapter 11 plan of reorganization that adopts a s 524(g) trust for payment (in whole or in part) of asbestos-related claims, to issue an injunction to prevent present claimants[195] and future claimants[196] from pursuing their claims in court (unless a court action is expressly allowed by the injunction, the confirmation order or the plan).

Special protections for future claimants

Given that future claimants can have no say in the adoption of the Chapter 11 plan, they are protected by requiring, as a prerequisite to the enforceability of the injunction, that the court:

- appoint a legal representative to protect their rights

- determine, before confirming the plan, that making them subject to the injunction is fair and equitable, in light of the benefits they will derive under the trust.[197]

Notification to creditors

The plan and disclosure statement to be sent to creditors (step 4) must set out the terms of the injunction that the court would issue.[198]

Creditor approval

There is an additional element to the creditor approval requirement (step 5) where a plan provides for payment of asbestos claims out of a s 524(g) trust. The plan must be approved by at least 75 percent of those voting in a separate class or classes of claimants to be paid out of the trust.[199]

This contrasts with the usual requirement for approval by a class of creditors, namely two-thirds in amount, and more than one-half by number, of creditors who vote.[200]

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195 s 524(g)(1)(B), (3).
196 s 524(g)(4)(B), (5).
197 s 524(g)(4)(B).
198 s 524(g)(2)(B)(ii)(IV)(aa).
199 s 524(g)(2)(B)(ii)(IV)(bb).
200 s 1126(c).

US reform proposal

The US National Bankruptcy Review Commission has proposed that the US Bankruptcy Code be amended so that it covers all mass claims, not just asbestos claims as under s 524(g), and that provision for mass claims be made for companies going into liquidation as well as companies reorganizing under Chapter 11.

The Commission recommended that a statutory definition of 'mass future claim' be added to Chapter 11 and that classes of people who have claims covered by the definition be represented in bankruptcy proceedings. Under the proposed definition, a claim is a mass future claim if it was caused by acts or omissions of the company and if at the time of bankruptcy:

- the act/omission has occurred
- the act/omission may be sufficient to establish some legal liability if injuries are later manifested
- the debtor has been subject to numerous claims on similar grounds and is likely to be subject to more claims in the future
- the holders of these claims are known, or can be identified or described with reasonable certainty, and
- the amount of such liability is reasonably capable of estimation.

The proposal then lays out a method for protecting these claims. Interested parties would be allowed to petition the bankruptcy judge. If the petition succeeds, the court would appoint a representative for each class of mass future claimant. This representative would then have exclusive power to file claims or vote on behalf of that class. A member of the class would also be permitted to opt out of being represented.