Law Council
OF AUSTRALIA

Mr John Kluver
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Corporations and Markets Advisory Committee
Via email: john.kluver@camac.gov.au

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Dear Mr Kluver

Response to the Corporations and Markets Advisory Committee Discussion Paper on Long-Tail Liabilities ("Discussion Paper")

1 Introductory Comments

1.1 This letter sets out submissions of the Corporations Committee of the Business Law Section of the Law Council of Australia (the "**Committee**") in response to the Discussion Paper. Please note that whilst the submissions have been approved by the Business Law Section, owing to time constraints they have not been considered by the Council of the Law Council of Australia.

1.2 The Committee's primary approach in this letter is to respond to the "Referred Proposal" described in the Discussion Paper at a high policy level. The Committee does not support a specific regulatory regime to regulate a concept as ambiguous as a "UFC".

1.3 In the Committee's view, a "one size fits all" legislative response, designed around the Australian experience in the circumstances surrounding asbestos related diseases, is unlikely to be the most efficient means of improving the position of unascertainable future personal injury claimants in all other situations, in light of the potential costs and business uncertainties which would be imposed on other stakeholders by the proposed UFC regime.

1.4 The Committee believes that if implemented the Referred Proposal (and specifically, those parts of the Referred Proposal outlined in section 3.5 of the Discussion Paper relating to recognition of unascertainable future claimants ("**UFCs**") as creditors) and is likely to:

(a) result in more complex voluntary administrations and liquidations for affected companies;

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(b) increase the costs and time associated with those processes;

(c) increase uncertainty for creditors and shareholders as to their return in an external administration; and

(d) arguably heighten the prospect that affected companies will become insolvent before satisfying UFCs.

1.5 More fundamentally, the Committee does not believe that implementation of the Referred Proposals discussed in 3.3 and 3.5 of the Discussion Paper can address the fundamental problem associated with long tail liabilities- namely, the need for a defendant to remain profitable for a sufficiently long period to satisfy all liabilities.

1.6 However, the Committee considers that there is merit in some of the proposals in the Discussion Paper and comments on these in paragraph 6 of this letter.

2 Impact of different circumstances

2.1 The Referred Proposal was a response to the Report of the Special Commission of Inquiry into the Medical Research and Compensation Foundation ("**MRCF**"). As such, its focus was driven by the particular circumstances surrounding asbestos related diseases, the James Hardie Inquiry and the MRCF.

2.2 The issues created by asbestos related diseases are not likely to be repeated in precisely the same way for all future cases which may give rise to long tail liabilities. A number of the circumstances surrounding MRCF which may not be present in future cases are:

(a) the nature of the diseases caused by exposure to asbestos, both in terms of the nature of the pain and suffering associated with those diseases and the absence of any cure;

(b) the time of life at which the diseases tended to manifest themselves;

(c) the means by which persons became exposed to the disease; and

(d) the relatively long period during which products containing asbestos were used after a scientific link had been established between asbestos and the diseases.

2.3 The purpose of mentioning these issues is to highlight that each future instance of products which give rise to long tail liabilities is likely to have peculiar features, which may affect the nature of the community response. A general ex ante legislative response appropriate and effective in all instances is unlikely to be possible.

2.4 Some of the factors which the Committee considers may be relevant to formulating a legislative response to the problems posed by a particular product giving rise to long tail liabilities are set out below:

- *Community impact*

The positive impact which a product has had on the community, as well as the scale of the negative impact which the product has had on the community, may result in a community reaction far different to that created by asbestos. For example, the community may react differently if a successful drug is found to have negative side effects with a long latency period for a particular class of consumers.

- *Timing of realisation of negative side effects*

The time it takes for the scientific and broader community to recognise that a product is unsafe may effect the community's reaction, and also be relevant to how companies respond.

- *Financial position of industry participants*

A fundamental factor shaping the settlement between James Hardie, the NSW Government and others was the need, acknowledged by all parties, to ensure James Hardie remained a viable and profitable business over the long term, to be in a position to satisfy claims by UFCs over a long period. The financial condition of the affected companies and industry as a whole may be relevant to the response.

- *Government reaction*

The reaction and conduct of governments at the time it becomes clear that a product could give rise to latent injuries may be a factor in shaping the ultimate reaction to the long tail liabilities associated with the product. For example, whether governments respond early with legislation which bans products and requires their withdrawal once there is scientific evidence of a risk, or fail to take steps for a long period, may bear on the magnitude of the ultimate liability exposure.

- *Potential changes to legal regime*

While many asbestos related claims have been based on tort law, it is possible that product liability claims involving future types of long tail liabilities will be brought under other statutes. New forms of legislative causes of action may ultimately have some impact on the practical ability of unascertainable future claimants to make claims.

2.5 The widely differing experience and response of various jurisdictions to asbestos related diseases clearly illustrates the proposition that one size does not fit all and that regulatory issues surrounding regulation of UFCs are very fact specific:

- In Australia it has been estimated that State and Federal governments collectively have the largest uninsured liability exposure to asbestos UFCs, with a net present value of approximately $2.5 billion. The remaining primary liability exposure of the corporate sector is spread across companies, but is concentrated in two companies.

- Many of the companies in the United States bearing primary responsibility for producing and distributing products containing asbestos have gone into bankruptcy, or are undergoing some form of bankruptcy proceedings. The current level of recovery of UFCs for asbestos claims is generally significantly less than 100 cents in the dollar.

- In the United Kingdom, there have been a number of significant bankruptcies of companies facing asbestos claims. However, there has not been a broad based legislative response to the issues created by UFCs.

- In New Zealand, there is a general no fault statutory compensation scheme, which also applies to claims by UFCs.

3 A hypothetical case study

3.1 To try to assess the potential impact of those aspects of the Referred Proposal discussed in section 3 of the Discussion Paper on one industry, the Committee discussed their potential impact in the following hypothetical scenario.

3.2 The hypothetical scenario considered by the Committee assumes that scientific studies emerged suggesting that there could be a causal connection between usage of a particular product and cancer, while other scientific studies suggest there was no causal link. Later scientific studies produce different results, with scientific evidence beginning to more frequently demonstrate that there could be some statistical connection correlation between heavy usage of certain types of this product, by particular members of the community, and cancer. Plaintiffs start commencing actions alleging they suffered injury as a result of using the product, and a number of defendants were held liable at common law for negligence. At some point a plaintiff is successful in obtaining a court ruling linking the product to the personal injury. Ultimately, significant class actions are brought on behalf of thousands of alleged victims against producers and suppliers of the product.

3.3 The question the Committee asked after posing this hypothetical scenario is how legislation of the type suggested by the Referred Proposal will benefit the class of potential victims, and at what potential cost to shareholders, creditors and other stakeholders in the affected companies, such as employees and the community at large.

3.4 The first and obvious point to make about the hypothetical scenario is that if implemented the Referred Proposal would be unlikely to initially have any immediate impact on the industry in this hypothetical example or consumer behaviour, so that it is unlikely to prevent diseases which are ultimately linked to the use of the product, at least until there was some scientific certainty around the causal link.

3.5 At some point in time, possibly where the preponderance of scientific evidence suggests there may be a statistical connection, the legislation may have some impact on the behaviour of participants in the industry (and potentially consumers).

3.6 Depending on a number of factors, including the nature of the scientific evidence, the success of plaintiffs in bringing claims and the potential exposures involved, the industry response may be to withdraw particular types of products, or sell them with health warnings attached. (It should be noted that the industry could be expected to respond in some way, once scientific evidence was clear, regardless of whether the Referred Proposal was implemented.)

3.7 Secondly, once on notice that it was likely to face "mass future claims", an affected company in this industry would need to consider whether to disclose either a contingent liability or make a provision for the liability in its balance sheet, in accordance with the accounting standards. Over time, as both the likelihood of successful claims, expected timing and the anticipated size of those claims becomes clearer to companies, the amount disclosed, and type of disclosure required by the accounting standards, may change. The fact that the company is exposed to future claims is likely to have an immediate impact on the way shareholders and unsecured creditors assess the company, regardless of the introduction of the Referred Proposal.

3.8 If that part of the Referred Proposal described in section 3.3 of the Discussion Paper (the requirement to restrict company transactions which adversely affect share capital) is implemented, affected companies would be restricted from engaging in some forms of

capital management such as share buy-backs and reductions of share capital, as they would need to consider the potential impact on future unascertained claimants. This restriction could indirectly increase the company's cost of equity capital, if it resulted in the company being unable to implement capital management strategies which it otherwise would have implemented.

3.9 If the part of the Referred Proposal described in section 3.4 of the Discussion Paper (the prohibition on intentional avoidance) is implemented, directors may be reluctant to undertake restructuring initiatives designed to increase a company's ability to maintain profitability and ultimately satisfy all creditors and unascertainable future claimants. Whether directors are overly cautious would depend on how clearly defined the prohibition on intentional avoidance is- if there was a clearly defined safe harbour for directors, this may not be a practical problem.

3.10 Assuming that part of the Referred Proposal described in section 3.5 of the Discussion Paper is implemented (allowing UFCs to prove in external administrations), other unsecured creditors may also take into account the risk that, upon liquidation:

(a) the amount distributed on winding up will be reduced as a result of the requirement to include unascertainable future claimants as creditors; and

(b) the time at which distributions will be payable may be later than it otherwise would have been, due to the need for a liquidator to quantify and set aside amounts for unascertainable future claimants.

These factors could indirectly increase the cost of an affected company's debt, in turn reducing the ability of the affected company to maintain profitability and ultimately solvency.

3.11 If an affected company did go into external administration or liquidation after the Referred Proposal was implemented, a number of issues arise. Firstly, current personal injury claimants (along with other unsecured creditors), may face a delay in receiving a distribution while the external administrator or liquidator determines the amount to be set aside for future claimants.

3.12 Secondly, the liquidator may be required to ration the amount to which unsecured creditors are entitled, to ensure there are sufficient funds to pay UFCs. Rationing of current claims may in effect mean that currently afflicted individuals (and other creditors) receive very little of their liquidated claim, so that the capital can be preserved to allow anticipated future claimants to be compensated.

3.13 UFCs may however have an advantage over currently affected personal injury claimants. While they may suffer compensable injury, given that by their nature the injuries will only be realised at some time in the future, a medical cure may have been found by the time they are diagnosed. Accordingly, the compensable amount to which they would be entitled, which is necessarily uncertain, may fall over time due to medical progress.

3.14 If the nature of the exposure of participants in the affected industry is sufficiently widespread, affected community interest groups (e.g. consumer protection lobbies or unions) may demand a tailored legislative solution, aimed at ensuring that all potential claimants are adequately compensated. Some circumstances which could encourage this type of community reaction are:

(a) if one or more industry participants have been wound up even before the claims fall within the scope of the legislation, leaving large numbers of potential claimants without recourse;

(b) if the potential number of claimants is so great, and the potential costs and time associated with pursuing a range of class actions so significant;

(c) if the nature of the injuries inflicted by the products is such that victims, once diagnosed, have a need to access compensation quickly; or

(d) if the size of the potential claims is such as to seriously endanger the ability of one or more significant industry participants to continue operate, which could have broader economic implications for the community.

3.15 There are a range of industries which could conceivably be confronted with "mass future claims" in the future, including the telecommunications industry and genetically modified food industry (if scientific evidence established a causal connection between the industry's behaviour and a particular disease), to which this hypothetical example might possibly be relevant. The giving of these examples is not to suggest any likelihood of liability but to highlight the key concerns identified in paragraph 1.4 above.

4 Support for the introduction of an "*Edwards*" type power

4.1 The Committee proposes the introduction of an additional discretionary power into section 1318 of the Corporations Act, along the lines argued for by the plaintiffs in *Edwards v Attorney-General* (NSW) [2004] NSWCA 272, to permit the Court to grant relief to directors who may face future liability to UFCs. In the *Edwards* case, the directors of the Medical Research and Compensation Foundation sought relief from future liability arising from their actions in paying out the full entitlement of presently existing asbestos claimants, instead of rationing the amounts. The provable claims against the subsidiaries of MRCF in a winding up were minor, but the potential future claims were significant.

4.2 In *Edwards*, the Court held that it did not have power to grant relief under the section 1318 of the Corporations Act in its current form in respect of potential future claims against directors. The Committee believes it is important for the courts to be able to provide certainty to directors that they will not be faced with future personal claims arising out of decisions taken in good faith in this type of scenario.

5 Application of accounting standards

5.1 Companies are under an obligation to consider disclosing and quantifying unascertainable future claims under AASB 137, either as a contingent liability or a provision. This disclosure obligation ensures that companies and their directors do not ignore the interests of unascertainable future claimants, notwithstanding that they are not treated as creditors on a winding up.

5.2 The Committee considers that the accounting standards provide an adequate and certain (to the extent possible, given the need for estimates of contingent liabilities and provisions and the inherent uncertainties around such estimates) means for company's measuring and disclosing unascertainable future claims.

5.3

6 Specific responses to questions raised in the Discussion Paper

6.1 Brief responses to some of the specific requests for submissions raised in the Discussion Paper are set out below.

Comments on Chapter 3 of the Discussion Paper

(a) For the reasons outlined further above, the Committee does not support the reforms discussed in sections 3.3 or 3.5.

(b) The Committee broadly supports the introduction of a prohibition on intentional avoidance of a company's obligations, as proposed in section 3.4, providing it is very clear in its operation and scope.

Comments on Chapter 4 of the Discussion Paper

(c) Assuming the Referred Proposal is adopted (which the Committee does not support), the Committee considers that it would be appropriate to adopt a high threshold for the definition of "mass future claim", and accordingly considers that the approach proposed in section 4.2 is preferable to that in section 4.4 and 4.5.

Comments on Chapter 5 of the Discussion Paper

(d) The Committee does not support changes to the share capital reduction, share buyback, or financial assistance provisions as discussed in sections 5.2 to 5.5, as it considers there is a risk of perverse consequences associated with introducing such changes.

(e) The Committee considers that the disclosure proposal in section 5.6 has merit. If a disclosure requirement is introduced, the Committee submits that it should be consistent with accounting standards.

(f) The Committee queries the implicit suggestion in section 5.7 that share buy-backs (in particular) are discretionary in a way which relevantly distinguishes them from dividends. Both actions are discretionary and in many instances economically equivalent.

(g) The Committee would not support an extension of the Referred Proposal to insolvent trading due to potentially perverse outcomes that could give rise to.

(h) The Committee agrees that it is not necessary to introduce a provision permitting directors of solvent companies to set aside a portion of the company's assets in trust to meet anticipated claims by UFCs, as discussed in section 5.10.

(i) The Committee broadly supports the introduction of either Chapter 11 style procedures, or procedures to enable schemes of arrangement between a company and an identified class of UFCs, which are designed to provide a framework which solvent companies can elect to use to address the issues associated with UFCs. One alternative to either of these approaches would be to provide a discretionary power in the court to enable it to provide protection to companies seeking to implement these types of arrangements. Any of the above proposals (although unlikely to be a general panacea to the issues created by long tail liabilities) would at least increase the prospect that affected companies would

survive to satisfy claims by UFCs, without introducing the undesirable effects of allowing UFCs to participate in voluntary administrations and liquidations.

Comments on Chapter 6

6.2 The Committee does not support the ability of UFCs to prove in voluntary administrations, due to the increased cost, complexity and uncertainty such a reform would create for unsecured creditors, shareholders and other stakeholders in administrations. However, the Committee considers that, of the options proposed in sections 6.3 and 6.4, the best one would be to require the administrator to appoint a legal representative of UFCs, and to amend section 445D to provide the legal personal representative a basis for challenging a proposed deed of company arrangement on behalf of UFCs (as proposed in section 6.6), so that the court can protect the interests of UFCs in appropriate circumstances.

Comments on Chapter 7

6.3 The Committee considers that it would be practically difficult to permit UFCs to participate in schemes, except in limited situations such as those in *Re T&N Ltd (No 2)* [2005] EWHC 2870 (Ch). However, the possibility of appointing a legal personal representative, as outlined in section 7.3, who would have the right to challenge any proposed scheme on behalf of UFCs, would provide UFCs some protection against company's seeking court approval of schemes which would endanger their ability to ultimately satisfy UFCs.

Comments on Chapter 8

6.4 As discussed above, the Committee does not support the Referred Proposal discussed in section 8.2, as it believes that allowing UFCs to prove in a liquidation will create uncertainty, increase costs and result in delays to liquidations, without providing any assurance that UFCs will be able to recover their loss.

Comments on Chapter 9

6.5 The Committee supports the introduction of anti avoidance measures modelled on Part 5.8A of the Corporations Act. These provisions should be sufficiently narrow so that they do not limit the ability of affected companies to conduct capital management initiatives or enter other transactions for the company's benefit, which in turn may ultimately benefit UFCs by contributing to the survival of the company.

Comments on Chapter 10

6.6 The Committee agrees that it would not be appropriate to seek to amend limitation periods for the benefit of UFCs. As noted in Chapter 10, the courts retain discretion in any event in relation to limitation periods.

Miscellaneous comment on the Discussion Paper

6.7 The Referred Proposal only suggests reforms to permit unascertainable future personal injury claimants to prove as creditors in an external administration. The Committee does not appreciate why, in principle, economic loss or environmental liabilities should be treated differently (although it does recognise that there may be added complexity in estimating UFCs for economic loss).

7 Conclusion

The Members of the Committee involved in the preparation of this submission would be pleased to discuss with representatives of the Advisory Committee some of the difficult, broader philosophical issues which the Referred Proposal give rise to, which are likely to be more easily communicated verbally than in written submissions. Please contact the Committee Chair,Greg Golding, on (02) 9296 2164 if you would like to arrange a meeting of members of the Committee and representatives of the Advisory Committee.

Yours sincerely,

Peter Webb
Secretary-General

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