AUSTRALIAN CONSERVATION FOUNDATION

17 February 2006

Submission to the Corporations and Markets Advisory Committee on Long-tail personal injury claims

The Australian Conservation Foundation (ACF) welcomes the opportunity to comment on the proposal by the Parliamentary Secretary to the Treasurer to strengthen protection of certain unascertained future creditors of corporations.

The proposed changes, while offering some protection to those who are personally injured by corporate misconduct in a narrow set of circumstances, are a solution neither to the more general problem of long-tail liabilities in insolvency, nor to the larger issue of the ability of corporations to externalise costs on to unwilling and innocent third parties through structures of limited liability.

In particular, the proposal does not address the pervasive problem of long-tail environmental liabilities, which do not always result in personal injury claims but more typically take the form of very large remediation costs that burden public authorities and/or private landholders. Further, the limitations and qualifications on the proposed protections for unascertained personal injury claimants would seriously limit the practical ability of victims of corporate misconduct to recover for their injuries.

1. Environmental long-tail liabilities and limitation of the reforms to the personal injury context.

In the report of the *Special Commission of Inquiry into James Hardie*, David Jackson QC observed that "current laws do not make adequate provision for commercial insolvency where there are substantial long-tail liabilities, that is liabilities that arise may years after the events or transactions that give rise to them."

The problem identified here is a general defect in the current laws regarding the treatment of long-tail liabilities in the insolvency context, whether those liabilities happen to relate to future personal injury claims or other possible claims. The general defect requires a general solution, not a partial solution that remedies the situation of personal injury claimants only.

The shifting of long-term environmental liabilities from private companies on to the public or other private parties is a serious and recurrent problem in Australia. One of

the more recent and egregious cases is that of the Mt Todd gold mine in the Northern Territory. Following only three years of operation, a decrease in world gold prices led to the cessation of operations by U.S.-based Pegasus Mining at Mt Todd, and ultimately the Australian operating subsidiary went into receivership. Pegasus left behind a toxic mess, including cyanide stored on site and a tailings pile leaching heavy metals and acidic water. The estimated total remediation costs of at least $20 million will fall heavily on the government of the Northern Territory.

The Mt Todd site is but one instance of a wider problem. Australia is pockmarked by similar sites, including Brukunga in South Australia, Captains Flat in New South Wales, Mt Lyell in Tasmania, Mt Morgan in Queensland and Rum Jungle in the Northern Territory. At many of the sites, the environmental damage has caused great costs to be incurred long after the original site operators have extracted their profits from the land and been wound up.

If unremediated by governments, such orphaned sites would cause more extensive contamination and could give rise to widespread personal injuries. However, while the proposed reforms would allow consideration of future personal injury claims in winding up procedures, they would not appear to allow similar consideration of costs incurred to prevent such personal injuries.

This is a perverse effect. If personal injury costs are cognisable and worthy of compensation, then what can be the justification for denying recognition of costs incurred by governments or even claimants themselves to mitigate what would otherwise result in such compensable personal injuries? Surely avoidance of injury is better than compensation. Therefore, compensation funds should be set up not only to cover personal injuries as they occur, but also to fund preventative measures (such as safe removal of asbestos, or environmental remediation) that lower costs and avoid injuries in the first place.

Recommendation: The proposed reforms should encompass all long-tail liabilities, including environmental liabilities, and not be limited to personal injury claims.

2. Limitations in the proposed test for "mass future claims".

The proposal contains a number of significant limitations on the scope for consideration of possible future claims. In particular, the protections are triggered only in the event of an "unusually high number of claims for payment arising from particular acts or omissions leading to personal injury" against the company or other similar companies, and only where there is a "strong likelihood of numerous future claims of this type." Furthermore, the protections do not apply if it is not "reasonably possible" to identify the circumstances giving rise to the claims and the class of persons who will bring the claims, and most importantly if it is not possible to "reasonably estimate the extent of the company's liability".

Taken cumulatively, these qualifications impose very high hurdles on future claimants and render it most unlikely that the proposed protections will be applicable in most long-tail liability circumstances.

The exemption where it is not possible to "reasonably estimate" the extent of a company's liability would unreasonably limit protection. Consider, for example, a case where future claims are almost certain, but the range of estimates of possible aggregate liability is from $20 million to $200 million. In that situation, it could be open to the company to argue that there is no "reasonable estimate" of total liability, with the consequence that the future creditor provisions do not apply at all. As a result, no amount would have to be set aside for future claimants – not even the lowest estimate of liability of $20 million.

The focus on the number of claims is similarly perplexing. If there is a strong likelihood of future claims, it is not clear why claimants should have to meet the additional requirement that there be "numerous" future claims. It would be unjust and again perverse to deny compensation to a small class of unascertained future claimants merely because the corporation's misconduct does not injure a larger group of individuals. Consider a case where a company's conduct has a 50% chance of causing cancer in each of 20 residents of a remote community. There will be on average only 10 claims, which may not fulfil the "numerous claims" requirement – yet why in principle should the interests of those future claimants be disregarded?

A better approach would be to establish a structure through which an external administrator is required to make provision for future liabilities whenever such liabilities are reasonably likely. The amount of provision should be set according to the entirely of the circumstances. Factors such as the number of claims and the range and certainty of estimates of total liability would be relevant to the determination of the required provision.

Recommendation: Provision for unascertained future claims should be required whenever such claims are reasonably likely. Factors such as the estimated or possible number of claims and the certainty of estimated liability should be relevant to the amount of the financial provision, but should not operate to exclude consideration of likely long-tail liabilities.

3. Other reforms suggested by the James Hardie inquiry.

Special Counsel assisting the James Hardie inquiry noted that "the existing exceptions to limited liability do not provide adequate protection for victims of torts committed by insolvent subsidiaries of wealthy holding companies." This is true both for unascertained future claimants and for current involuntary creditors of a company.

This deeper issue is not addressed by the proposed reforms, which are designed only to grant future unascertained creditors some form of standing as creditors under existing processes, not to allow recourse to the assets of wealthy parent companies.

It is regrettable that the proposals put forth for CAMAC's consideration have not addressed the principles of limited liability as they operate to deny compensation for involuntary creditors of corporate subsidiaries. One solution advanced in CASAC's May 2000 *Final Report on Corporate Groups* would be to impose direct liability on holding companies for the negligent acts of their subsidiaries where it would be in the public interest to do so.

The James Hardie case and other ongoing abuses of limited liability (eg, the protection of Eurogold's assets from potentially massive environmental liabilities incurred by its subsidiary Transgold, operator of the disastrous Baia Mare gold mine in Romania) continue to highlight the imperative for such a reform if our *Corporations Act* is to maintain some claim to be a just system of economic organisation.

Recommendation: In response to the Parliamentary Secretary to the Treasurer's question whether the proposed reforms would "protect the interests of future, unascertained creditors", the Committee should consider:

1. ***noting that the proposal at most places unascertained creditors in the position of ascertained creditors, but fails to protect the interests of involuntary creditors insofar as it gives them no remedy if the assets of a company are insufficient to cover its liabilities; and***
2. ***reaffirming the need for direct liability of corporate parents for negligent acts of its subsidiaries, along the lines of the recommendations in the 2000 CASAC Report.***

ACF would be pleased to provide any additional information that would assist the Committee in its inquiry into these matters.

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CHARTERED SECRETARIES AUSTRALIA

Leaders in governance

17 February 2006

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Dear Mr Kluver

Long-tail personal injury claims

Chartered Secretaries Australia (CSA) welcomes the opportunity to comment on the proposal referred to the Corporations and Markets Advisory Committee (CAMAC) for review by The Parliamentary Secretary to the Treasurer in relation to strengthening protection for future unascertained personal injury claimants where the solvency of the responsible company may be in question.

CSA is the peak professional body delivering accredited education and the most practical and authoritative training and information on governance, as well as thought leadership in the field. We are an independent, widely-respected influencer of governance thinking and behaviour in Australia. We represent over 8,500 governance professionals working in public and private companies, a number of whom have been involved in class actions. We have drawn on their experience in the formulation of this submission.

General comments

CSA recognises that it is difficult to determine how to provide for adequate recognition of the existence of long-tail liabilities arising in the case of unascertained future creditors, and that this is a matter of some concern. CSA firmly believes that these issues should be the subject of further consideration and, in principle, has no objections to the proposals as outlined in relation to future eligible claimants, extension of creditor protection provisions, external administration and anti-avoidance provisions.

However, CSA is concerned that any proposed extension of creditor protections under the *Corporations Act* should not interfere with existing creditors' or shareholders' rights.

Areas of concern

CSA has three principal concerns in this respect:
1 First, that whatever steps are taken, the rights of shareholders as they exist under present insolvency laws should not be further delayed or compromised.
2 Second, it is essential that certainty for creditors is not undermined by any reform in this area.
3 Third, that any extension of claimants' rights should not unintentionally disadvantage either creditors or shareholders, or create undue delays in winding up of companies.

Potential disadvantage to shareholders

In the experience of CSA's members who have been involved, class actions can take many years to resolve. If, in a winding-up situation, payments to shareholders under any proposals were to be delayed for, say, up to ten years, the situation would, in CSA's opinon, become unworkable. Many companies have tens of thousands of shareholders. Compounding any such disadvantage would be the difficulties inherent in locating 'lost' shareholders or their estates after a period of many years to ensure they receive their payment.

Furthermore, if shareholders have to wait many years before receiving payment, the delay may also affect their capacity to claim a tax loss, thus doubling the disadvantage to them. Shareholders will not be able to claim a tax loss as, while amendments were introduced last March to enable deed administrators and liquidators to issue a certificate under the *Income Tax Assessment Act* when there are reasonable grounds to believe there will be no further distribution in the winding up of the company, when there is a long-tail claim afoot (or the possibility of one) then the administrator or liquidator cannot issue such a certificate.

CSA notes that any reform to existing creditors' rights under the *Corporations Act* should not disadvantage shareholders.

Potential for uncertainty for creditors

CSA believes that establishing a contingency fund in any winding up of a company where there is strong likelihood of mass future claims is not only prudent but also essential to ensuring that any such claims are dealt with in the most appropriate and equitable manner at the time.

CSA notes that any such contingency fund carries with it the risk that the funding required has been underestimated. Given that the company cannot know to whom payments may be due or quantify such payments, any contingency fund can only be the best possible estimate of future claims at a given point in time. CSA believes that it is not practicable or desirable for the legislation to regulate such a risk.

CSA suggests that, where either preliminary steps have been taken toward certifying a class action or a class action involving mass personal injury claims has been certified, the judge dealing with such a class action should be granted the power to take into account the amount to be set aside in a contingency fund. The fund could then be administered by the court, or other court-approved body, such as an insurance company or an external fund administrator, long after the winding-up is completed.

CSA believes that, while there is a risk that the amount required for the contingency fund may have been underestimated, this risk is balanced by the certainty granted to creditors and shareholders that they need not wait for many years for payment (potentially, given the nature of some personal injury claims, for up to 50 years as evidenced by current asbestos related-litigation). The reverse position, where there is a surplus over claims, may also eventuate, but this again is a matter CSA believes should be left to the determination of the fund administrator at the appropriate time.

CSA also notes that financial institutions, from whom companies raise finance, would also be concerned that creditors' rights are not undermined. Any such uncertainty would have implications for solvent companies, not only for those subject to external administration.

Potential undue delays in winding up procedures

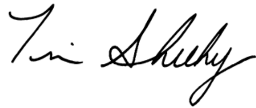
Further to the risk inherent in establishing any contingency fund, any reform to the *Corporations Act* must ensure that it does not create any undue delay in the winding up of the company. Any delay in winding up procedures would disadvantage creditors and shareholders. For example, the establishment of a contingency fund should not interfere with the liquidator's decision as to how to deal with assets.

CSA notes that any extension of creditors' protections to future unascertained creditors where a mass future claim is afoot should not interfere with the winding up of the company but be one more matter that is attended to as efficaciously as possible in the winding-up procedures.

Conclusion

CSA notes that the proposal referred to CAMAC for review in relation to long-tail liabilities has highlighted concerns that any proposed reform protect the interests of future unascertained creditors without compromising current corporate and insolvency law principles. CSA hopes that by identifying and giving further consideration to particular areas of concern, no such compromise takes place.

Yours sincerely



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CHIEF EXECUTIVE

Treatment of Future Unascertained Personal Injury Claims

Submission to the Corporations and Markets Advisory Committee

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Treatment of Future Unascertained Personal Injury Claims
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Treatment of Future Unascertained Personal Injury Claims
Submission to Corporations and Markets Advisory Committee

Introduction

1. The Corporations and Markets Advisory Committee (CAMAC) has been asked to comment on a proposal that certain creditor protections be extended to "future unascertained personal injury claimants". As part of its review, the CAMAC has called for submissions from interested parties.

2. Actuaries play a key role in the insurance industry and are uniquely positioned to provide a detailed insight into the financial dynamics of personal injury liability claims. The Institute of Actuaries of Australia is the professional body representing Australian actuaries and has a keen interest in informing public debate in such areas.

3. This submission is intended to assist the CAMAC with its study of the potential implications of creditor protection policy change in this area. The submission is not intended to be a comprehensive analysis of all the issues. Rather, we have attempted to outline a number of key issues which we believe the CAMAC will need to address as part of its review. We would be happy to participate in a discussion with the CAMAC to elaborate on any of the issues raised or to provide further assistance as required.

Institute interest in issues

4. The Institute of Actuaries of Australia (Institute) is the professional body for actuaries in Australia. We represent the interests of over 1,400 Fellows and 1,600 other members.

5. A substantial number of our members specialise in general insurance. In our role as general insurance professionals, we play an essential role in the sound design, pricing, liability evaluation, and performance monitoring of all general insurance products, but especially of liability insurance, which often involves personal injury claims. From 1 July 2002, members have a statutory responsibility to advise boards of private sector insurance companies on balance sheet provisions for outstanding claim and premium liabilities.

6. Since 1978, the Institute has been running a series of General Insurance Seminars, which are recognised as the premier forum for discussing financial management, design, pricing and reserving issues in this field.

7. The Institute, as a professional body, aims to contribute to and inform public debate on both practical and policy issues, in the interest of the general public. As a result of this background, and because of our skills, which are based on the quantitative and mathematical analysis of financial systems, the Institute's members are uniquely

placed to contribute to a practical understanding of the financial issues involved in making changes such as those proposed.

8. This submission is provided in this context.

The proposal being considered

9. The detail of the proposal being examined by the CAMAC has been reproduced as Appendix A. The following summary of the proposal has been extracted from the Introduction to the Terms of Reference.

10. *"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."*

11. It is further proposed that the 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."*

12. By the nature of our training and experience, actuaries have a strong practical understanding of the evaluation and quantification of risk. In this context, the Institute offers comment on the following elements of the proposal:

    - defining a "mass future claim";
    - estimating provisions and the implications of uncertainty in the estimates;
    - practical considerations with "long-tail" liabilities.

13. Each of these is addressed in turn in the following sections.

Mass future claim

14. The proposal involves the extension of creditor protection where a mass future claim is afoot. The proposal defines this as follows:

    "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."*

Situations which may give rise to mass future claims

15. We would expect that many of the claim situations to be covered by the proposed extended creditor protections will be in respect of personal injury claims involving gradual onset diseases. By their nature, the symptoms of such diseases may take many years to manifest themselves, and the claims themselves can be very complex.

Defining the eligible claimant group

16. One of the issues to consider is how to define the eligible claimant group. There may be a number of dimensions to this, including the following:

    - defining the group for the purpose of estimating the liability;
    - establishing who is eligible to be compensated from the funds once those funds have been set aside for "future unascertained personal injury claimants".

17. The following "potted history" of the emergence of claims for compensation from asbestos exposure, can be used to illustrate the issue:

    Asbestos-related disease can take a number of forms. When compensation claims for asbestos-related disease first emerged, they were primarily for mesothelioma and asbestosis. The former is an almost invariably fatal cancer, with the second a debilitating but often non-fatal lung disease. Claims for lung cancer then became more common. Often these claims were (and often still are) rejected as not being asbestos-related, particularly where the claimant was a cigarette smoker, unless asbestosis was also present. As time went on, claims also emerged for asbestos-related pleural disease, and pleural plaques (the latter typically not producing any ill-effects). More recently some claims have been made for compensation for mental

anguish from fear of contracting an asbestos-related disease following some form of asbestos exposure[1].

In the early years, most claims tended to come from those who mined asbestos, or those who worked directly with asbestos or asbestos-heavy products. Over time, new types of claimant emerged, often with more incidental exposure - children who lived near the mines, the partners of miners, people who have renovated homes built with asbestos products, and so on.

18. Had the extended creditor protections now being mooted been in place some twenty or so years ago, and a company with asbestos-related claim exposure been placed into administration at that time, the estimate of the personal injury claim liabilities would probably have been based on the following:

    - expectations of a relatively large number of claims;
    - 90% or more arising from asbestosis and mesothelioma;
    - primarily in respect of people with relatively high direct exposure to asbestos.

19. This "defines" the claimant group for the purposes of estimating the liability.

20. As we now know, the claimant profile which has emerged is quite different:

    - they involve a larger number of types of asbestos-related disease;
    - they arise from a wider spectrum of claimants (including those with incidental exposure, for example).

21. The question then arises as to whether these unforeseen - or if foreseen, discounted as being unlikely to be material - groups of claimants would also be eligible to qualify as creditors for the purposes of accessing the pool established for "future unascertained personal injury claimants".

22. [The fact that there may well have been higher numbers of claims emerging - even without the widening of the disease categories and the exposed group - is covered in a later section, which discusses uncertainty in the estimates.]

23. Several interpretations are possible, including the following:

    - It is proposed that the amount of funds to be set aside be determined on the basis of an estimated number and average size of claim. Types of claim and claimant not explicitly reflected in that calculation therefore fall outside the definition of eligible claimants.
    - The estimates are, by their nature, uncertain. Any calculation can only establish what might be a **reasonable** pool of funds. The funds should then be available to all personal injury claimants - or at least a broadly

[1] These claims are relatively rare in Australia but have become quite common in the US.

defined group of claimants (for example, "those who suffer personal injury as a result of the use of asbestos in products produced by Company X") - not one based on boundaries established using imperfect information.

Estimating provisions

24. The third element of the proposal is to require external administrators to *"admit and make provision for mass future claims for personal injury"*. It is proposed that the provision be calculated taking into account:

    - the number of potential claimants;
    - the level of damages awarded for similar claims;
    - industry analyses;
    - academic studies;
    - independent actuarial analyses;
    - such other matters as the external administrator thinks relevant.

25. The estimation of liabilities of this type is a core actuarial skill. This is recognised by the Australian Prudential and Regulatory Authority (APRA) which has a statutory valuation role for actuaries in general insurance. Actuarial advice is also regularly sought by non-insurance companies which self-insure risks. In some cases, particularly workers' compensation, actuarial "sign off" of self-insurance liabilities is mandated by another regulatory body.

26. There are a number of formal standards and requirements which apply to the evaluation of liabilities of this type. These are summarised below.

    - The actuarial evaluation of potential liabilities of general insurers, self-insurers and statutory bodies for personal injury claims is covered by the Institute's Professional Standard 300, *Actuarial Reports and Advice on General Insurance Technical Liabilities* (PS300). This standard sets out the process an actuary is to follow and issues he or she is expected to consider when undertaking a valuation of this type. Further guidance is provided in the Institute's Guidance Note 353 *Evaluation of General Insurance Technical Liabilities* (GN353). The principles set out in these documents are equally applicable to the valuation of such liabilities in other contexts.
    - The Approved Actuary for a general insurance company must also comply with requirements set down by the APRA, and in particular the Prudential Standard 210 *Liability Valuation for General Insurers* (GPS210) and

Guidance Note 210.1 *Actuarial Opinions and Reports on General Insurance Liabilities* (GGN210.1)[2].

- Companies must also comply with the relevant accounting standards. In Australia, general insurance claim liabilities are subject to Accounting Standard AASB1023 *General Insurance Contracts* (AASB1023). Insurance accounting standards generally are under review by the International Accounting Standards Board (IASB). It is expected that the outcome of this review will flow through to AASB1023.

  Provisions for other liabilities are generally covered by Accounting Standard AASB137 *Provisions, Contingent Liabilities and Contingent Assets* (AASB137). This, too, is likely to change, following the release of an exposure draft of changes to the corresponding international standard (IAS37) by the IASB in 2005. If the changes proceed as expected, a material liability to future unascertained personal injury claimants will need to be recognised in an entity's accounts.

- Broadly, each of GPS210, AASB1023 and the exposure draft of IAS37, requires a provision comprising a present value estimate of the expected value of the liability, plus a margin reflecting the uncertainty around this estimate.

27. Copies of PS300 and GN353 are attached. Copies of the APRA, AASB and IASB documents can be provided on request.

28. We consider it essential that actuarial advice be sought regarding the evaluation of the liabilities, because of the deep understanding actuaries have of the financial dynamics of personal injury risk and claim experience. In undertaking the actuarial evaluation, the actuary should consider, where available, expert advice specific to the nature of the liabilities. We would expect that the actuary would conduct the study under PS300, and subject to the guidance of GN353, GPS210, GGN210.1 and AASB137 as appropriate.

29. We would also recommend that the estimate be subject to regular, preferably annual, actuarial review - at least while the liabilities remain significant. As discussed below, the estimates are subject to uncertainty and can be expected to change over time.

Uncertainty in the estimates

30. The quantification of liabilities of this type involves making a series of assumptions regarding the size of the group exposed to injury or disease, the proportion of those who are 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

[2] Some elements of the prudential standards are in the process of being changed. As part of the proposed changes, GPS210 and GGN210.1 are to be deleted and replaced by GPS310 *Audit and Actuarial Reporting and Valuation* and GGN310.2 *Liability Valuation*. The thrust of the valuation requirements are unchanged.

people will receive. Allowance also needs to be made for the non-damages costs, including legal costs and the costs of claim management and administration.

31. It is to be expected that the **estimate** of the company's liability for personal injury claims will change over time. There are many reasons for this, including (but not limited to) the following:

- Whilst the company's liability for personal injury claims arises from past actions, the quantum will ultimately depend on future events. The liabilities are affected by a range of factors including claimants' propensity to claim, changes in judicial and societal attitudes, changes in economic conditions, and technological (and particularly medical) advances.
- Estimates will inevitably be based on imperfect data and other information. Over time, information is corrected, replaced and updated, and more reliable estimates can be made.
- The models which are used to determine the liability estimates are themselves imperfect, and 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.
- Changes can have unexpected consequences. Even if the change itself can be predicted as part of the estimation process, the response to that change may be unpredictable.

32. The estimation of liabilities involves interpretation of data and other information, and the application of judgement. The fact that the liability estimate will change over time, does not necessarily mean that the estimate is not "reasonably quantifiable". It is simply a reflection of the fact that the eventual outcome is dependent on future events.

What is reasonably quantifiable for this purpose?

33. At any time, there can be considered to be a range of **reasonable** estimates of the liability. Whilst a single estimate is chosen for the purposes of preparing financial statements, the implications of the range of estimates needs to be considered in decision-making for corporate administration.

34. In some cases, particularly where new types of claims are emerging, the reasonable range may be quite wide. Examples of the range of values which may emerge is available from the recent James Hardie Inquiry. The advisor to the inquiry, for example, suggested a reasonable range of estimates as at February 2001 to have been between $600 million and $825 million[3].

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[3] Table 6.10, *James Hardie Actuarial Expert Witness Report*, prepared by KPMG Actuaries Pty Ltd, and dated 4 June 2004

35. The proposal being considered by CAMAC requires not only that there is a strong likelihood of future claims but also that the liability be able to be **reasonably estimated**. It is our view that a requirement that the liability be able to be reasonably estimated is unnecessary and may be counterproductive. Other creditors may, whilst accepting that the future personal injury claim liabilities exist, argue that those liabilities are not able to be reasonably estimated.

36. 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. *"In other words, if there is faithful representation of information, including the uncertainties surrounding it, it may be possible for it to be regarded as being reliable."* (AASB Statement of Accounting Concepts *Qualitative Characteristics of Financial Information* SAC 3:18).

37. "Reasonable" presumably implies a weaker test. It is our view that, if it is clear that there is a liability to future unascertained personal injury claimants, it should always be possible to place a reasonable, albeit uncertain, estimate on its value. Nevertheless, or perhaps for this very reason, we believe that it would not be desirable to make "reasonable estimation" part of the criteria for protection. If the liability exists and its value is material, then a genuine attempt to protect claimants' interests should be made.

38. We have argued similarly, in response to the IASB's exposure draft of proposed changes to IAS37, which governs accounting for such liabilities, that "reliable estimation" should not be a criterion for recognition. If, as expected, this proceeds, a material liability to future unascertained personal injury claimants will need to be recognised in an entity's accounts. At present, AASB137 would appear to require either recognition or disclosure as a contingent liability, depending on whether it is "probable" (more likely than not) that the entity will need to make payments.

39. The strengthened requirement under IAS37 for an entity to make provision for a material liability for future unascertained personal injury claimants should mean that, in the situations which are covered by the creditor protection proposals, there will already exist at least one estimate of the size of the potential liability. We recommend that independent review of that estimate be required should it appear likely that the proposed provisions are to be invoked.

Responding to the uncertainty

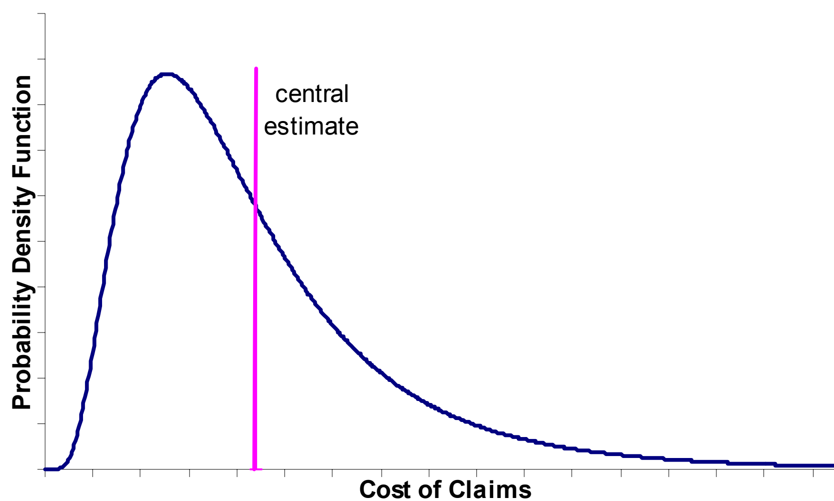
40. This uncertainty in liability estimates is well-recognised in the insurance industry. The prudential regulator, APRA, has established minimum capital requirements for general insurance companies that take into account the company risk profile. As part of the assessment of the minimum capital, APRA requires that provisions for claims

be set by an Approved Actuary on the basis of a 75% probability of adequacy, with allowance for discounting at sovereign debt rates[4].

41. The concept of a probability of adequacy reflects the fact that there is a distribution of possible values. The "expected value" of the liability (which is often referred to as the "central estimate") is the probability-weighted average of all possible outcomes.

42. For liabilities of the sort that we are discussing, the probability distribution is typically "positively skewed". An illustration of a positively skewed probability distribution is shown in Figure 1 below.

Figure 1: Example of positively skewed probability distribution



43. As shown in Figure 1, the positively skewed distribution means that the most likely outcome is that the cost will prove to be somewhat less than the central estimate, but there is a low probability that it may be considerably higher than the central estimate.

44. General insurance companies respond to the uncertainty in the estimates of the claim liabilities by incorporating a margin above the central estimate in the reserves recorded on the balance sheet. Whilst practice varies from company to company, Australian companies generally hold balance sheet reserves intended to give at least a 75% probability of adequacy, the minimum standard required for statutory reporting by APRA. Many insurers adopt a more stringent standard for their accounts, up to a 95% probability of adequacy, but more commonly in the range 80% to 85%.

45. Interestingly, for highly skewed or other unusual distributions, an estimate at the 75% probability of adequacy may provide little or no margin above the central estimate - and may even be lower than the central estimate. This means that care

[4] This is covered in Prudential Standard GPS210.

should be taken in specifying particular threshold probability levels as part of the proposed creditor protection extension[5].

46. The response to uncertainty, for the purposes of the extended creditor protection currently being considered, may depend on the particular situation:

- In a case involving evaluation of the impact on creditors of certain corporate transactions affecting share capital, it may be reasonable to estimate the liability for "future unascertained personal injury claimants" on the basis of a probability of adequacy no lower than that represented by the expected value (or central estimate) - and potentially incorporating a margin above this central estimate. This recognises that one function of share capital is to provide a buffer in the event of adverse conditions. When the company's liabilities are uncertain, an evaluation of an appropriate buffer needs to consider the "size" of the uncertainty in the liabilities.
- In a case involving external administration, the information sought by the administrator in making provision for future unascertained personal injury claimants **should include** illustration of the uncertainty. This may take the form of a range of reasonable estimates, or calculations under a number of claim scenarios. It may be appropriate for an interim distribution to creditors to be based on the high-end estimate from this range, or a higher probability of adequacy. At a later stage a final distribution might be based on the updated central estimate.

Practical implementation issues

47. As noted previously, many of the claim situations to be covered by the proposed extended creditor protections will be in respect of personal injury claims involving gradual onset diseases. By their nature, the symptoms of such diseases may take many years to manifest themselves. Asbestos liabilities, for example, are still emerging more than forty years after exposure. The amount of the liability may not become certain for many, many years – even decades.

48. The framework will need to adequately balance the need for trade creditors to receive prompt payment, with the need for personal injury creditors to receive a fair allocation of the available assets. The following sub-sections discuss a number of issues for consideration:

- management of the claims
- dealing with movements in the estimate of the liability

[5] APRA has considered the scope for such outcomes in its prudential regulations, and specifies that the margin above the central estimate should be no less than one half of the standard deviation of the central estimate. If CAMAC wishes to propose specific threshold probability levels as part of its response to Government we would be happy to work with CAMAC to establish appropriate definitions to accommodate unusual situations.

- changing the size of the liability
- potential for risk transfer
- mechanisms to "top up" the fund.

Management of claims

49. Personal injury claims can be very complex and require specialist claim management skills. The way in which the claims are managed can materially affect the ultimate cost of those claims. The infrastructure put in place to manage the wind-up of the company is unlikely to be the most appropriate from a claim management perspective, particularly in the long term. Alternative claim management mechanisms may therefore need to be put in place to efficiently and effectively handle the claims.

50. The framework which is put in place to put effect to the proposal, should it proceed, should allow the liquidator to enter such claims management agreements as are deemed appropriate. Different claim management pathways that may be followed include the following:

    - Establishment of a trust and a separate company to be the trustee of that trust, and to manage the claims and the fund. Recent examples of this approach include the Medical Research and Compensation Foundation established by James Hardie, and the HIH Claims Support Scheme established by the Federal Government.
    - Outsourcing the management to a third party provider. This may be direct, or through a trust arrangement. For example, as part of the HIH Claims Support Scheme insurance companies were contracted by the trustee to provide certain claims management services.

51. Alternatively, consideration may be given to establishing a statutory body to manage all liabilities of this type for companies in liquidation.

Dealing with movements in liability estimates

52. The estimate of the liability will change over time. Situations will develop where the estimates are revised upwards implying a shortfall in the fund, whilst others will involve downward estimate revisions, implying surplus funds. Measures will need to be put in place to ensure that, as far as is practicable, personal injury claimants who have claims on the fund at different times are treated equitably.

53. An example may help to illustrate this. Assume that a pool for future personal injury claimants is established based on an estimated liability and a liquidation distribution of $0.70 in the $1.00. The experience is heavier than expected, and after five years the liability estimate is increased. How does the scheme manage this situation?

- Does the $0.70 in the $1.00 payable to claimants get reduced for claims lodged after the date of the estimate adjustment?
- Does the payout proportion remain at $0.70 in the $1.00 with claims settled at that level until the funds are exhausted?
- Do all personal injury claimants receive an "interim distribution" based on a worst case scenario, until such time as the liability is reasonable certain, with a final distribution then paid to all claimants if the funds permit?

54. Consideration needs also to be given to how the scheme manages a situation where the experience is better than expected, and there are surplus funds after settlement of all claims.

Changing the size of the liability

55. An issue that often arises with compensation for those suffering personal injury, is whether restrictions on quantum should be applied. Common approaches include use of benefit thresholds, deductibles or caps. Such measures may be used to help achieve a balance between the generosity and affordability of compensation.

56. For example, thresholds or deductibles are commonly used to eliminate trivial claims. This can result in significant administrative savings, and helps to direct limited funds to those who have the greatest need.

57. The CAMAC may wish to consider whether situations may arise in which it may be appropriate for the liquidator to have the flexibility to apply quantum restrictions in order to reduce the uncertainty and/or size of the liability estimate and achieve agreement between all parties. This will clearly be a sensitive issue. Most Australian jurisdictions already apply thresholds and/or caps for personal injury compensation, so applying further thresholds and/or caps may be considered unduly harsh.

58. If the framework put in place to extend the creditor protections was to include the flexibility for such quantum restrictions, we would recommend that it also include significant protections to ensure that the approach was taken only as a last resort.

Potential for risk transfer

59. A practical solution to the problems of uncertainty and timeliness of the liquidation is to have a commercial transfer 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[6]. The downside is the

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[6] The insurance premium may well be structured with an up-front payment (or series of payments), subject to an experience-based adjustment at a pre-determined future date or series of dates. Whilst not removing the uncertainty in the short-term, the period of uncertainty would be significantly reduced.

additional cost - the loading in the premium for the insurer's profit (the return for taking on that uncertainty).

60. In theory, all risk is insurable - the only question is the price. In practice, the market may be unwilling to take on risks of this type. The insurability may be enhanced if the uncertainty can be reduced, for example through applying deductibles, thresholds and/or caps - or even restricting the heads of damage which can be claimed.

61. An insurance mechanism can be structured where only part of a claim is covered by insurance. This may be used to achieve the payout to the claimant which reflects the distribution from the liquidator (for example, if the distribution is based on $0.70 in the $1.00, then the insurance policy could cover 70% of the claim). The creditor protection framework would need to recognise that payment by the insurer also extinguishes the liquidator's liability.

Mechanisms to "top up" the fund

62. An option which CAMAC may choose to consider is for there to be a mechanism for Government to step in between the liquidator and the claimants to "top up" the fund (i.e. to provide the difference between the ultimate cost of claims and the fund established through the liquidation).

63. Such an option may be considered cost effective if it is expected that doing so would reduce the burden that would otherwise be placed on the social welfare and public health systems.

64. The cost of the "top-up" provided may be limited by applying caps or thresholds as discussed previously.

- For example, 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. This may prove difficult with negotiated settlements, as opposed to damages awards, as the settlements may not be formally segmented by head of damage.
- Alternatively the payment may be topped up to a maximum of 90% (for example), an approach that was used in the HIH Claims Support Scheme established by the Federal Government.

Miscellaneous issues

65. Where, prior to liquidation, the company's liability for personal injury claims was covered, to some extent, by existing commercial insurance arrangements, recoveries may arise under those policies. Consideration will need to be given as to whether those recoveries go to the benefit of all creditors, or only to personal injury creditors.

The response may depend on the exact wording of the insurance contract, and the likely extent of the recoveries. In situations 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 unascertained personal injury claimants.

66. The existence of insurance policies does not guarantee payment, particularly over the very long term, as may be associated with claims of this type. Contract conditions may not be able to be maintained, and the possibility of insurer failure needs to be considered.

67. The questions regarding to whose benefit recoveries accrue may also arise where the company has a right of recovery against a third party in respect of the personal injury claims. (These sorts of questions have arisen as part of the HIH liquidation.)

Summary

68. The Institute supports the proposal to strengthen the protections to future unascertained personal injury claimants.

69. The issues involved are complex, largely because of the uncertainty inherent in liability estimates of this type. Establishing a practical framework which can accommodate this uncertainty will be a key challenge.

70. Key issues to resolve include:

- defining the group of eligible claimants;
- determining the means of distributing the funds to those claimants;
- the approach to handle the uncertainty in the liability estimates;
- how claims will be managed; and,
- dealing with the insurance recoveries and existing company provisions.

71. The actuarial profession has established processes and techniques for estimating liabilities for personal injury claims and for illustrating and quantifying the uncertainty of those estimates. Those processes and techniques are continually enhanced and refined.

72. It is our view that, if it is clear that there is a liability to future unascertained personal injury claimants, it should always be possible to place a reasonable, albeit uncertain, estimate on its value. Nevertheless, or perhaps for this very reason, we believe that it would not be desirable to make “reasonable estimation” part of the criteria for protection. If the liability exists and its value is material, then a genuine attempt to protect claimants’ interests should be made.

73. The Institute is keen to assist the CAMAC to develop an understanding of the financial dynamics of personal injury liability claims, and the potential implications in the context of extended creditor protections.

74. We would welcome the opportunity to discuss the issues raised in the proposal and in this submission. Please contact Philip French, Director, Public Affairs on philip.french@actuaries.asn.au or phone (02) 9239 6106.

Appendix A: The Proposal

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PROPOSAL FOR THE TREATMENT OF FUTURE UNASCERTAINED PERSONAL INJURY CLAIMANTS

Introduction

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.*

Preliminary test – Mass Future Claim

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.*

1. Extension of general creditor protections

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 (s256B) and share buy-backs (s257A); 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).*

2. Prohibition on intentional avoidance

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. External administration

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

Appendix B: Professional Standard PS300

INSTITUTE OF ACTUARIES OF AUSTALIA

PROFESSIONAL STANDARD 300
ACTUARIAL REPORTS AND ADVICE ON GENERAL INSURANCE TECHNICAL LIABILITIES

A. INTRODUCTION

Application

1. This standard applies to actuaries preparing estimates of the technical liabilities, comprising outstanding claim liabilities and premium liabilities, for any entities involved in general insurance activities, such as general insurance companies, reinsurers, self insurers, insurance pools and statutory authorities involved in general insurance activities.

2. This standard does not apply to estimates of liabilities for life or health insurance entities.

Legislation

3. This standard covers advice which is required by legislation such as the Insurance Act 1973 as amended and any standards issued under that Act, the Corporations Act and accounting standards, the Income Tax Assessment Act and taxation rulings, and the various State and Commonwealth Acts under which Accident Compensation Schemes, State Government Insurance Offices and Workers Compensation operate.

Previous Versions

4. This standard was first issued in May 1994, replacing Guidance Note 350. This revision has been made in response to the General Insurance Reform Act (2001), and was issued in April 2002.

B. DEFINITIONS

5. An **insurer** in this standard refers to any entity in respect of which liabilities covered by this standard may need to be calculated. This includes direct insurers, reinsurers, self insurers, insurance pools, discretionary funds, and Accident Compensation Schemes.

6. An insurer's **outstanding claim liabilities** at a given date (the valuation date) are equal to the value of claim payments to be made after the valuation date, in respect of claims which, under the terms of its contracts, arose on or before the valuation date for which the insurer is expected to be liable. These liabilities will often be expressed as the present value of the claim payments and may include the insurer's internal costs of administering and settling those claims.

7. An insurer's **premium liabilities** at a given date (the valuation date) are equal to the value of claim payments to be made after the valuation date, in respect of claims which, under the terms of its contracts, will arise after the valuation date in respect of premium written on or before the valuation date and for which the insurer is expected to be liable. These liabilities will often be expressed as the present value of the claim payments and may include the insurer's internal costs of administering and settling those claims and other administration costs. Where premiums under existing contracts are payable by instalments or are adjustable on the basis of exposure, claim experience or other factors, it will usually be necessary either to adjust the premium liabilities on this account or to determine the value of an offsetting asset.

8. An insurer's **contractual prospective liabilities** at a given date (the valuation date) are equal to the value of any options or other features, valuable or potentially valuable to the insured, included in or implied by contracts in force on the valuation date. These liabilities will often be expressed as the expected positive (in favour of the insured) net present value of future cash flows, and may include the insurer's associated internal costs.

9. **Liabilities** and **technical liabilities,** where used in this standard, each refer collectively to outstanding claim liabilities, premium liabilities and, if applicable, any contractual prospective liabilities.

10. **Claim payments** refer to payments to or on behalf of the claimant, and any third party costs such as investigation, medical and legal fees associated with each claim.

11. **Recoveries** refer to amounts or expected amounts to be recovered by an insurer in respect of particular claims. A distinction is made between reinsurance recoveries and non-reinsurance recoveries (salvage, subrogation, sharing agreements, etc).

12. A **central** estimate of the liabilities is the expected value of the liabilities. In other words, if all the possible values of the liabilities are expressed as a statistical distribution, the central estimate is the mean of that distribution.

13. A **provision** is an amount set aside in an insurer's accounts, to provide for liabilities.

14. A **risk margin** (often referred to as a prudential margin) refers to the amount by which a provision for liabilities is greater than the central estimate of the liabilities to increase the probability of adequacy.

C. OUTLINE OF PROCEDURE

15. The steps which an actuary should take when advising on technical liabilities are:

    (i) Clarify the terms of reference and purpose of the report.

    (ii) Collect the necessary data.

    (iii) Analyse the experience.

    (iv) Select a valuation model.

    (v) Select valuation assumptions.

    (vi) Do the valuation calculations.

    (vii) Reconcile the results with the previous investigation.

    (viii) Analyse variability and sensitivity.

    (ix) Reach conclusions.

    (x) Present a written report.

16. It may be necessary to carry out several versions of part of the process to determine an appropriate central estimate and/or risk margin, for example collecting and analysing additional data. Steps may be combined or taken out of sequence. It may be appropriate to repeat parts of the process with different models or assumptions.

17. The actuary may be called upon to justify the work undertaken. The actuary should therefore compile and retain documentation which demonstrates that the work conforms with this standard, and any other external standards as appropriate.

18. An approximation to an assumption or method is acceptable provided it does not materially affect the result. A difference is material if it is significant in the context of the purpose for which the advice is given. The actuary should choose a standard of materiality which should reasonably satisfy each anticipated user of the advice.

D. DATA

19. The actuary should be familiar with the relevant aspects of the procedures for the administration and accounting of the insurer's claims and policies.

20. For each class of business, the actuary should be conversant with the general characteristics which may have a material bearing on the estimation of the liabilities. This may include familiarity with the contractual terms and legislated benefits payable under policies written, differences between the unexpired risk exposure (that exposure underlying the premium liabilities) and the exposure underlying the outstanding claim liabilities, changes in underwriting standards, changes in premium rates, case estimation procedures, as well as other attributes, such as deductibles, policy limits and reinsurance arrangements.

21. The actuary should be familiar with the general economic, legal, political and social trends in the community which may have a bearing on the liabilities.

22. It is the actuary's responsibility to ensure that the data utilised are appropriate and sufficient for the valuation. The actuary should, where possible, take reasonable steps to verify the overall consistency of the valuation data with the insurer's financial records.

E. METHODOLOGY AND PARAMETERS

E.1 Scope

23. In some cases the actuary will be asked to give advice on both outstanding claim liabilities, premium liabilities and contractual liabilities. In others he/she may be asked to advise on some combination of these. In either case, the methodology outlined below should be used.

24. Liabilities may be estimated in one of two ways:

    - Deterministically, in which case the methodology outlined below is used to estimate the central estimate, or mean value of the liabilities, or
    - Stochastically, in which case the methodology outlined below is used to estimate the overall distribution of the liabilities.

E.2 Claim Experience Model

25. The estimation of liabilities may require the subdivision of the data into groups of claims exhibiting similar characteristics. In the determination of appropriate subdivisions, a balance must be found between homogeneity and statistical reliability.

26. The claim experience should be analysed with respect to the development over time of claims or cohorts of claims. Depending on the availability and reliability of the data, analysis should include some or all of:

    - the claim frequency relative to some measure of exposure, for example number of policies, employees, wages, or total sum insured;
    - the rate of reporting claims;
    - the rate of settlement;
    - the development of payments;
    - the adequacy of case estimates;
    - the incidence of large claims;
    - the overall pattern of claim occurrence over the duration of the policy period;
    - other analyses relevant to the circumstances.

27. The experience should normally be analysed on a gross of recoveries basis. Analysis of the reinsurance and other recovery experience should be appropriate to the circumstances. In some situations it may be more appropriate to analyse the experience net of reinsurance and/or other recoveries. Separate estimates of recoverable amounts may still have to be made. In making such judgments, the actuary should be aware that the net valuation result will often be the most important.

28. Analysis of experience should take into account any special features of, or developments or trends in, the experience such as changes in deductibles, aggregate limits, claim handling procedures, the mix of business within the portfolio, changes in legislation and the impact of large claims paid and outstanding. The analysis should investigate any trends in the development of the experience, particularly those from causes other than inflation.

29. Selection of the most appropriate valuation model to estimate the liabilities is the responsibility of the actuary. The actuary may investigate more than one model before arriving at an estimate. The model or models should take into account the available data, the nature of the portfolio, and the results of the analysis of experience.

30. Selection of the claim experience assumptions should have regard to the valuation model and the analysis of the experience. These assumptions should allow for trends in the claim experience, changes in underwriting, alteration of policy terms and assumptions about reinsurance or other recoveries.

31. The claim experience assumptions should reflect the latest available data to the extent that these are credible in the forecast of future claim experience.

32. Any change in assumptions should be allowed to emerge fully in the valuation to which they relate, rather than partially in anticipation of further emergence in future valuations. The effect of any change should be disclosed.

E.3 Other Parameters

Inflation

33. Future claim payments may well be greater, as a result of wage or price inflation, court decisions or other economic or environmental causes, than current payments for similar claims. Such factors should be allowed for when estimating liabilities.

Discount Rates

34. A schedule of future single period rates embedded in current market values of riskless debt might normally be the starting point for determining the appropriate discount rate(s). Circumstances may also arise where it is appropriate to take account of the insurer's assets and investment policy. Variations from market rates may be allowed for in the choice of discount rate. A series of rates or the equivalent single rate may be used for the purposes of discounting.

Expenses

35. If an allowance for future expenses is required, this allowance may vary between the outstanding claim and premium liabilities. The complexity of the approach used to determine the allowance should be commensurate with the materiality of the amount of the allowance.

E.4 Consistency of Outstanding Claim and Premium Liabilities

36. The assumptions used to estimate premium liabilities would generally be expected to be consistent with those used to estimate the outstanding claim liabilities. Where the assumptions are not consistent, or where the calculation of premium liabilities uses an approach requiring different assumptions to the outstanding claim liability estimation, the actuary should explain the reasons for the differences.

37. Where consistent assumptions are used to estimate both outstanding claim liabilities and premium liabilities, the actuary should consider and comment on their suitability for the estimation of both liabilities.

E.5 Valuation Results

38. It is the actuary's responsibility to ensure that the valuation calculations are carried out accurately.

39. The actuary has a responsibility to consider the reasonableness of the estimates produced and to quantify the effects of any changes in the valuation basis since the previous actuarial valuation. The actuary should seek explanation where possible for any major departures from past results.

F. UNCERTAINTY AND RISK MARGINS

Uncertainty

40. The extent of the liabilities depends on future economic, social and environmental factors outside the control of the insurer as well as on unknown past and future events and the insurer's own actions. It is part of the actuary's task to comment upon uncertainty, both as a technical matter and in the presentation of results.

41. There are a number of components of this uncertainty, including:

    - **model selection error**, deriving from the difference between the actual process generating the claim experience and the closest member of the family of claim experience models selected;
    - **parameter error**, deriving from the sampling error in model parameter estimates;
    - **parameter evolution error**, deriving from the inclusion in a model as constants any parameters which are in fact subject to change over time;
    - **process error**, deriving from the random departure of future claim experience from model expectations.

42. Assessment of uncertainty will generally require use of one or more of:

- statistical analysis;
- sensitivity analysis - making changes to the model assumptions a nd/or the models themselves;
- analysis of the outcomes of previous valuations; and
- analysis of different scenarios.

43. In some cases, the range of reasonable uncertainty may be large. Care should be taken as conclusions which may be drawn at different ends of this range may be totally different (eg large profits vs insolvency).

Risk Margins

44. In most cases, some judgement will be required in establishing appropriate risk margins. It is the actuary's responsibility to support this judgement with such formal analysis as is practical.

45. For a variety of reasons it may be appropriate that provisions required for the purposes of accounts be calculated to include risk margins. Legislative, accounting or other standards may require this.

46. The directors of the entity have the ultimate responsibility for the provision, and not the actuary. The directors should determine the level of prudence which they consider to be appropriate. The actuary's advice on risk margins should assist them in adopting a provision commensurate with this level of prudence.

47. Where risk margins are calculated, this could be done by reference to either:

- the coefficient of variation of the liabilities; or
- the full distribution of the liabilities.

48. Where a coefficient of variation is used, the actuary should state whether it is obtained by:

- internal estimation, ie estimation from the same data set as the central estimate of liability with which it is associated; or
- externally estimated, ie obtained from some source external to that data set.

49. Where external estimation is used to estimate the coefficient of variation, the source should be stated, and its appropriateness explained. The explanation might make particular reference to one or both of the following:

- the extent to which uncertainty associated with the central estimate is induced by the methodology by which that estimate is produced;
- any differences, such as volume, between the data sets that serve as sources of the central estimate and coefficient of variation respectively.

50. Where internal estimation is used to estimate the coefficient of variation, the actuary should discuss the following:

    - the model of claim experience used to generate the coefficient of variation;
    - the allowance for variability of economic parameters such as inflation and discount rates;
    - any adjustment applied to allow for lack of reliability of the data on which the central estimate is based; and
    - any other components used in the internal estimation process.

51. If risk margins have been calculated on the basis of individual classes of business viewed in isolation, it will usually be appropriate to allow for a reduction in risk margins in respect of individual classes of business resulting from the diversification across different classes of business written by the insurer. The amount of such allowance should be determined consistently with the overall principles used in the determination of risk margins.

52. When advising on risk margins, the actuary should have regard to their reasonableness and consistency over time, between classes of business and between reports for different purposes.

G. REPORTING

53. The actuary should prepare, date and sign a written report. The report should state:

    - who has commissioned the report and, if different, the addressee(s) of the report;
    - the name of the actuary and the capacity in which the actuary is acting;
    - the purpose of the report or the terms of reference given;
    - the extent, if any, to which the report falls short of, or goes beyond, its stated purpose;
    - the extent of compliance with this standard and the reasons for not complying fully with this standard; and
    - any restrictions on the actuary

54. The report should deal with:

- the nature, accuracy and interpretation of the data;
- the analysis of experience;
- the valuation model and key assumptions;
- any changes in the method and key assumptions since the last similar report;
- comparisons of actual experience with that expected under the assumptions in the last similar report;
- the results of the valuation;
- uncertainty of the valuation result.

55. The report should describe the steps taken by the actuary to verify the accuracy of the data, any limitations on the extent or quality of the data and the extent to which the actuary has relied upon the insurer or the insurer's auditor for checking.

56. The assumptions and methods should be stated clearly and their derivation explained. Any qualifications should also be clearly stated. Normally, the report should contain sufficient detail regarding data and methodology that an informed reader be capable of checking the reasonableness of any results included in it.

57. Where the legislation, accounting standards or other rulings require the actuary to use specific assumptions, particularly if they are materially different from those the actuary would otherwise use under this standard, the actuary must clearly state the circumstances, discuss whether or not the assumptions are reasonable and consistent with this standard, and discuss the implications of divergence from this standard.

58. Where the principal requires the actuary to use specific assumptions or the actuary is relying upon an interpretation of legislation, accounting standards or other rulings supplied by the principal or its advisers, the actuary must clearly state the circumstances, discuss whether or not the assumptions are reasonable and consistent with this standard, and discuss the implications of divergence from this standard.

59. If to be used for balance sheet purposes, then sufficient detail of the valuation results should be available in the report or separately to enable the insurer to comply with the disclosure requirements under the accounting standards, and complete Insurance Act and Income Tax returns unless requested otherwise.

60. In some circumstances it may be necessary to prepare a short statement or certificate regarding the valuation. Considerable care is required to ensure that the statement contains the necessary relevant information and will not be

misleading nor quoted out of context. The certificate should include a reference to the actuary's full report and the qualifications stated therein.

H. STATUTORY REQUIREMENTS

61. In certain cases actuaries may be required by legislation or other standards to provide advice regarding liabilities.

62. The provisions of this standard must be considered in the context of the legislation and other standards. Where an apparent conflict exists between this standard and other legislation or standards, the actuary should restrict the application of his/her advice to the context of the legislation or other standards, and refer to the conflict in the advice.

END OF PROFESSIONAL STANDARD 300

Appendix C: Guidance Note GN353

INSTITUTE OF ACTUARIES OF AUSTRALIA

GUIDANCE NOTE 353
EVALUATION OF GENERAL INSURANCE TECHNICAL LIABILITIES

INTRODUCTION

Application

This guidance note is issued to supplement Professional Standard 300 (PS 300) and is to be read in conjunction with that standard. It applies to actuaries preparing estimates of technical liabilities for general insurance entities. Its application is mandatory for valuations under Prudential Standard GPS 210, issued by the Australian Prudential Regulation Authority (APRA) for the purposes of the *Insurance Act 1973* as in force from time to time.

First Issued

December 2002

[Note: The IAAust's Technical Guidance Note (Australian Actuarial Journal, 2002, Volume 8, Issue 2, pp365-396) continues to be a useful practical adjunct to PS 300 and GN 353 but without formal endorsement by the IAAust. In due course, it is expected that the Technical Guidance Note will be superseded by IAAust practice notes and educational material.]

DEFINITIONS

1. The definitions included in PS 300 (paragraphs 5 through 14) apply.

2. The following definitions also apply:

   a) A **valuation unit** is a line of business, a part of a line of business, a group of lines of business or a group of parts of lines of business which is treated as a single entity for the purposes of the actuarial valuation.

   b) **Standard** inflation is inflation measured by a published index, such as AWE for wages or CPI for prices, where an *a priori* link between such inflation and claim payments is believed to be present.

   c) **Superimposed** inflation is the difference between total claim escalation and standard inflation.

PRODUCT KNOWLEDGE AND DATA CHECKING

3. The actuary is required to ensure that the data used for a valuation of technical provisions is appropriate and sufficient for the specified purpose of the valuation.

4. The actuary should be familiar with the characteristics of the insurance processes and claim processes that may materially affect the estimation of the insurance liabilities. This may include familiarity with:

   a) the nature of coverage, including any unusual terms and conditions of contracts;

   b) the underwriting strategy and the nature and mix of risks underwritten;

   c) the benefits payable under policy terms or by virtue of legislation, including deductibles and limits;

   d) the reinsurance arrangements, including any special or unusual features of reinsurance agreements that might affect reinsurance recoveries;

   e) the claim management philosophies, rules and guidelines, and the company's practices in setting case estimates;

   f) any monitoring reports that the insurer prepares of its claim and underwriting performance including any reports into compliance with claim and underwriting guidelines.

5. The actuary should also be familiar with economic, technological, medical, environmental, regulatory and social changes and trends within the broader community that may affect the value of the insurance liabilities. The actuary should also be aware that there may be changes in data quality or interpretation when staff turnover affects key positions, where personnel have a central role in the preparation of accounts or other relevant data.

6. It is the actuary's responsibility to ensure that the data gives an appropriate basis for estimating the insurance liabilities. This includes the insurer's own experience and claim experience data, but should extend to industry data, where the insurer's own data is not sufficient to reduce the uncertainty to an acceptable level. Where even industry data is sparse, it may be necessary to rely, to a greater or a lesser extent, on subjective assessment. The appropriate compromise between the cost of better data and the benefit, in terms of more reliable estimation, is a matter for actuarial judgment, which should take into account the materiality of the reduction in uncertainty that might result.

7. The actuary should consider obtaining data at the most basic transactional level, rather than working from data that have already been summarised or

aggregated. This should enable the actuary to better understand the data, and to identify data anomalies and seek appropriate rectification, or allow for errors or anomalies in the calculation of the liabilities.

8. The actuary should take reasonable steps to verify the consistency, completeness and reliability of the data collated, against the company's financial records. The actuary should discuss the completeness, accuracy and reliability of the data with the company's auditor (refer to GN 551 'Actuaries and Auditors'). The actuary should include in the written report on the valuation of the liabilities a description of the measures taken to investigate the validity of the data, and should outline the results of those data checks.

9. The degree to which the actuary relies upon the data provided by the company or upon earlier or later testing of the data by the company's auditors, and the resulting limitations that this places on the reliability of the actuary's conclusions, should be commented on in the report.

10. In order to meet reporting deadlines, the actuary may be asked to value insurance liabilities as at a valuation date prior to the reporting date. In such circumstances, the following approaches are considered to be acceptable:

    a) The valuation may be undertaken at an earlier date, and the resulting estimates subsequently updated to the valuation date.

    b) The valuation models may be derived from data at an earlier date, and subsequently applied to data at the valuation date.

    In either case, the actuary must consider experience between the earlier date and the valuation date, and make such adjustments as considered necessary. In particular, for calculations made in accordance with accounting standards AASB1023/AAS26 the rate of discount adopted in the calculations must be appropriate to market values at the valuation date. The actuary should refer in the report on the extent of any additional uncertainty created by the approach adopted.

GLOBAL ASSUMPTIONS

Claim Inflation

Standard and superimposed inflation

11. For many classes of business, the amount of a claim will depend on money values at the time of payment. This occurs particularly in personal injury claims, where claim amounts are often defined by statute to reflect inflation between date of injury and date of payment. Amounts paid for medical, rehabilitation benefits, etc., will also reflect money values at the time of payment.

12. Even where there is no direct link between the amount of claim and money values at the time, claim inflation can still occur, as a result of legal decisions, for example.

13. Claim inflation may be incorporated into the estimates of outstanding liabilities either implicitly or explicitly. If this is done explicitly, then it is usual to convert past historical payments into values as at the date of calculation. Allowance must then be made for future claim inflation. In doing this, it may be useful to separate claim escalation into standard inflation and superimposed inflation.

14. Analysis of past claim escalation should form a basis for the assumptions regarding future claim escalation. Whatever the source of such escalation, the actuary should allow for all expected escalation in estimating the amount of outstanding claims.

Sources of estimates of standard inflation

15. Standard inflation is not specific to an insurer's portfolio. It is an external factor operating in the economy at large. As such, it is appropriate to refer to publicly available information. Histories of past wage and price inflation are available from the Australian Bureau of Statistics (ABS). However, there are a number of alternative indices and care should be taken to choose the one which is most appropriate to class of business being considered (for example, State-specific, gender-specific, ordinary wages or total earnings, wage cost index, CPI (overall or segment)).

16. In forming an assumption for future standard inflation, the actuary may consider:

    a) estimates made by economic forecasting groups. Economists would often be expected to have greater expertise in this area than actuaries, and most will have highly developed econometric models;

    b) an econometric model derived from past experience;

    c) The returns available on Government CPI-indexed bonds. These can be used to give an indication of the market's assessment of price inflation, which can then be used to determine a corresponding assessment of wage inflation. When using this method the actuary should ensure that they fully understand all of the factors that impact the yield on CPI-indexed bonds before deriving an inflation forecast.

17. Different approaches may be taken to short-term and medium to long-term standard inflation. For example, estimates from economic forecasting groups rarely extend beyond 3-5 years. The returns from CPI-indexed bonds may be a more appropriate basis for medium to long-term assumptions.

Sources of estimates of superimposed inflation

18. Unlike standard inflation, superimposed inflation is specific to an insurer's portfolio. Furthermore, it is specific to the claim statistics being analysed for modelling purposes. Superimposed inflation may be present in one statistic and not another.

19. It follows that an assessment of superimposed inflation should derive ideally from analyses of the insurers' own claim statistics.

20. However, it is often the case that, in smaller portfolios, it is difficult to be definitive as to the existence of superimposed inflation, let alone its absolute level. In such cases, it is reasonable to give some recognition to wider industry analyses, or to generally accepted views adopted by other actuaries.

21. Superimposed inflation may not operate in the same manner as standard inflation. In particular, it may not emerge as a uniform addition to standard inflation. Several years of experience without any superimposed inflation may be followed by a sudden and extreme burst of superimposed inflation, which may persist for some years, and then cease. This feature makes it very difficult to form a view on future superimposed inflation, and there is always a high degree of uncertainty.

22. The sources of superimposed inflation are many and varied, but it tends to be present (at some point) in most classes which cover personal injury claims and which are influenced by judicial decisions.

23. If the sources of superimposed inflation can be identified and quantified, then they should be formally incorporated in the modelling process. For example, payments per claim incurred may be increasing due to an acceleration in the rate of finalisation of claims. This can be explicitly modelled by methods incorporating operational time, such as the payments per claim finalised model in operational time. In many instances, however, it is not possible to identify and quantify the precise causes of superimposed inflation. In such cases, a broad allowance may be made through an addition to the rate of future claims escalation.

Discount Rates

Discounting principles

24. There are a variety of approaches to the derivation of an investment return assumption for discounting insurance liabilities. These include:

    a) the rate of return expected to be earned on the assets supporting the liabilities;

    b) the rate of return on a hypothetical matched portfolio of sovereign fixed-interest securities;

c) the time value of money;

d) financial economic theory.

25. Specific assets or pools of assets are seldom identified as supporting general insurance liabilities. If the expected return approach is used, a distinction can be drawn between assets which earn an identifiable investment return (such as investments) and those which do not (for example, creditors, fixed assets). Under this approach, it is sometimes presumed that, as far as possible, the insurance liabilities are considered to be supported by fixed interest investments, and that equity investments are considered as supporting shareholders' funds or free reserves/capital. It is also important to recognise that the apparent rate of return on assets includes an allowance for any default risk and, to that extent, is greater than the expected rate of return.

26. One way of allowing for the default risk is to assume that this is the only reason for market rates of return on commercial fixed interest securities in excess of the rate of return on sovereign fixed interest securities. In Australia, these are Commonwealth Government Bonds. This leads to the hypothetical matched portfolio approach.

27. The time value of money is usually assumed to be embodied in the yield curve on sovereign fixed interest securities. This is commonly referred to as 'the risk-free rate', even though it is neither totally free of risk nor a single rate.

28. The financial economics approach starts with the principle that the economic value of a sequence of cash flows is their discounted value, and that the appropriate discount rate is determined by the nature of those cash flows. Under this approach, the discount rate is dependent upon the rates of return available in the investment market, and the relationship of the insurance cash flows to that market. The discount rate is therefore independent of an insurer's own asset portfolio.

29. In Australia, there is as yet no consensus on the preferred approach. The actuary should consider the relative merits of the various approaches, and if in doubt consult with professional colleagues.

30. In practice the choice of discount rate is very often strongly influenced by, and sometimes determined by, the regulatory environment in which the actuary is reporting (see paragraph 37).

31. The actuary must consider the taxation environment in which the valuation results are to be reported. For most general insurance operations, the movement in the liability for outstanding claims is tax-deductible and it is appropriate to use a discount rate assumption which is gross of income tax. However, there may be instances where this is not the case (for example, at one stage such liabilities for self-insurers were not tax deductible).

32. As with all other assumptions underlying the valuation of outstanding claims, the actuary must consider the uncertainty in the discount rate assumption when advising on the overall level of uncertainty.

33. For a comprehensive discussion on the principles of discounting, the actuary should refer to 'A Coherent Framework for Discount Rates' by the IAAust Discount Rate Taskforce (Australian Actuarial Journal, 2001, Volume 7, Issue 3, pp435-572).

Liability betas

34. In the financial economics approach, it is necessary to consider the relationship between the insurance claim experience and the investment returns available in the market The Capital Asset Pricing Model (CAPM) formula underlying this theory introduces the notion of a *liability beta,* which quantifies this relationship. (While the theoretical derivation of CAPM is mathematically sound, there is by no means universal agreement as to the assumptions on which this structure is based. In particular, the *efficient market hypothesis*, which is central to the conclusion that the market does not charge for diversifiable risk, is widely questioned.)

35. So far, the work carried out on this aspect suggests that, for many insurance classes, there is little correlation between the two factors. This would imply a liability beta close to zero, and hence the use of a risk-free rate of discount.

36. However, in some classes, there is an *a priori* reason to believe that such a correlation does exist. For example, there are some classes, such as workers' compensation and professional indemnity, where it might be expected that claim experience deteriorates in times of poor market performance. This implies a negative liability beta and hence a discount rate which is less than risk-free. The effect of such a reduction from the risk-free rate would usually be considered as forming part of the risk margin on central estimates.

The regulatory environment

37. The two most important regulatory regimes for actuaries working in general insurance are those of Accounting Standards, particularly AASB1023/AAS26 (and subsequently supplemented in AAG13), and the *Insurance Act 1973*, particularly APRA Prudential Standard GPS 210. Other regulatory regimes, such as state based workers compensation and CTP, may also be relevant.

38. At present, Australian Accounting Standards provide a choice of discount rate between:

    a) a rate derived from the insurer's own assets, and which is 'sustainable' over the claim runoff period (as noted in paragraph 25 above, this rate

should be adjusted for default risk, although this is not clear from AAGN13); or

b) the risk-free rate of return, derived from the market values of Commonwealth Government fixed-interest securities of duration similar to the claim runoff.

39. APRA Prudential Standard GPS 210 is more prescriptive. It requires actuaries to use the risk-free rate.

40. With respect to risk-free rates, it is acceptable to use either an average rate weighted by cash flows or a series of discount rates taken from the corresponding yield curve.

41. There are usually gaps in the maturity dates available and the longest dated security may not be long enough. It is appropriate to smooth, interpolate and extrapolate from the observed yields. When extrapolating, the reasonableness of the resulting rates for use in long-term discounting must be considered.

42. For liabilities in other currencies, the risk-free rate is derived from the corresponding yields on sovereign fixed interest securities in those currencies. Any foreign exchange risk should be considered in setting the risk margin for addition to central estimates.

Policy and Claim Administration Expenses

43. A separate allowance for policy and claim administration expenses will be necessary where such expenses are not included elsewhere in the data being analysed for outstanding claim and premium liabilities.

44. As with all assumptions, the actuary should attempt to analyse historical levels of expenses. However, it is often the case that internal insurer expense analyses do not properly allocate expenses between policy issue, ongoing policy administration, claim establishment and claim management. In such cases, it is acceptable to have regard to allowances made elsewhere in the market, with a comment to this effect included in the actuary's report. The actuary should always ensure that the allowances seem reasonable when considered in the context of the insurer's total administration expenses.

45. The accounting standards require expense allowances to be made on a going-concern basis. They should include appropriate proportions of general overheads, senior management costs, etc.

46. It is conventional to express the allowance for claim administration expenses as a percentage of gross payments. However, where there are unusually large gross outstanding claims, it may be appropriate to make an allowance based on a more usual mix of claims.

47. Claim administration expenses vary by portfolio and by the type and age of claims within a portfolio. For a stable, active portfolio it is usually reasonable to adopt an average rate for all claims. More detailed approaches are also possible, but are unlikely to result in a materially better estimate for a stable portfolio. However, in a closed portfolio, an increasing expense allowance may be needed.

48. While it is possible to develop complex approaches to the question of claim administration expenses, the actuary should be conscious of the materiality of the allowance within the context of the overall estimate of outstanding claims.

METHODOLOGY

APRA Valuation Process

49. The approved actuary undertaking a statutory valuation under APRA Prudential Standard GPS 210 is required to determine a central estimate of the liability and to recommend a valuation margin which, when added to the central estimate, gives a provision intended to secure a 75% probability of adequacy (but not less than half a standard deviation above the mean).

50. Initially, this must be done separately for outstanding claims and unexpired risks for each valuation unit, taken in isolation. In a separate step, the central estimates and valuation margins are added together and the sum of the valuation margins is reduced, by a 'diversification benefit', so that the overall margin, for the reporting entity, meets the 75% adequacy test, but is not less than half of the combined standard deviation.

51. Paragraph 17 of APRA GPS 210 specifies that the central estimate must be intended to be the mean of the underlying probability distribution. Paragraph 12 of IAAust PS 300 extends this requirement to all actuarial valuations of general insurance liabilities.

52. While many actuaries may find it helpful to do so, it is not necessary to form an explicit view as to the shape of an underlying probability distribution, either for a particular valuation unit or of the aggregate liability. What is required is a view as to the mean and 75th percentile, separately for outstanding claims and unexpired risks for each valuation unit, and in aggregate and, in cases where the overall uncertainty is likely to be highly skew, the standard deviation. (The phrase 'intended to secure' covers the situation where these quantities cannot be reliably estimated from an explicit probability distribution.)

53. Where an explicit probability distribution is not used, it is important to recognise that many general insurance probability distributions are positively skewed. That is, there is often a wider spread of larger (absolute) values than of smaller values. As a result, the mean is usually greater (in absolute value) than either the mode or the median. There is a natural

tendency, in informal estimation, to use the most probable value. This can lead to underestimation.

54. When an explicit probability distribution is used, it is important to ensure that it appropriately reflects any material skewness and that the central estimate incorporates any corrections for skewness, appropriate to the distribution. Again, failure to observe these steps can lead to underestimation.

55. The estimated uncertainty for each valuation unit should normally make appropriate allowance for reinsurance, including both the reduction in uncertainty inherent in the reinsurance terms and the diminution in this reduction, on account of the risk that these terms will not be observed.

56. Where a reinsurer is in default, or known to be at serious risk of default, however, such reinsurances should be reported on explicitly, rather than as a component of the net liability. Other asset risks should not be allowed for in determining the liability risk margin for APRA valuations, since they are reported on and allowed for elsewhere.

57. The purpose of the diversification allowance required under paragraph 14 of GPS 210 is to recognise that, when two or more classes of insurance are combined, the risk margin required to meet APRA's criterion may be less than the sum of the risk margins required to meet that criterion for each class taken in isolation. The uncertainties, which give rise to the need for a risk margin, can be crudely classified as either independent or systemic. Independent variation is, by definition, not correlated to anything and always gives rise to a diversification benefit. Systemic uncertainty can be correlated to varying degrees between classes. Some sources of systemic uncertainty are only relevant to a single class, but most affect more than one class. Caution should be exercised in assuming a low degree of correlation, in the absence of experiential evidence.

58. It is also important to draw a distinction between correlations between the uncertainties in different classes, which should form the basis of the diversification calculation, and correlations arising because of trends in the experience. Trends should be recognised in the central estimate, rather than in the margin for uncertainty.

59. The calculation of the diversification benefit can proceed from the top down, starting from an estimate of uncertainty based on Dynamic Financial Analysis (DFA) or similar modelling techniques, or from the bottom up, by combining the uncertainties of the separate valuation units, with due allowance for correlations between them. In either case, once the global risk margin is determined, it (or, equivalently, the diversification benefit) must be apportioned between the APRA lines of business. The actuary performing such tasks is expected to be familiar with the appropriate techniques.

60. It should be noted that, under at least one theoretical approach, this process can result in negative risk margins for one or more lines of business. Such

results are not acceptable to APRA. If such results are to be reported for other purposes, extreme care is needed to ensure that they are reported in such a way that users are not misled.

Changes in Valuation Model

61. The valuation model and assumptions need to reflect the actuary's interpretation of the data available at the current valuation date. The impact of any changes in assumptions should not be smoothed over future periods but should be reflected entirely in the central estimate.

62. Where the actuary has a prior valuation as a starting point, the actuary needs to comment on the new data that has emerged between the valuations in the context of the previous valuation model/assumptions. This could be by reference, for example, to an analysis of expected versus actual outcomes.

63. Where the new data available at the current valuation date suggests a change in approach and/or assumptions from the previous valuation, the actuary needs to discuss the impact on the valuation model/assumptions adopted.

64. New data should be given weight appropriate to the credibility of that new data. The actuary should explain the basis of arriving at the level of credibility and the impact on valuation outcomes. The actuary should take into account the statistical significance of the new data compared to the existing data when determining the level of credibility to give to new data.

65. The actuary should also consider external issues that may change the credibility such as:

    a) changes to the mix of business of the insurer;

    b) changes in processing claims or premiums (for example, administrative delays, changes to case estimation procedures);

    c) identified systems issues (new systems or changes to systems).

Gross and Net Liabilities

66. Both outstanding claims and premium liabilities are to be estimated on both gross and net bases, and separately for each line of business. Under AASB1023/AAS26, amounts recoverable must be split between GST, reinsurance and other recoveries.

67. The gross and net liabilities should be estimated on a consistent basis. The economic assumptions for the gross portfolio and the reinsured business should be the same, except in unusual circumstances (for example, there is convincing evidence that superimposed inflation has had a different impact on large claims than small claims). The actuarial models, for the gross

portfolio and for reinsurance recoveries, should not contain unjustifiable inconsistencies. For example, where the reinsurance is on a simple quota share proportional reinsurance basis, the net liability should be the retained proportion of the gross liability.

68. In many circumstances, it may be appropriate to use the model for estimating the gross liabilities as the starting point for development of the model for estimating reinsurance recoveries.

69. Some reinsurance arrangements embrace risks from more than one class of reinsurance (for example, ‘whole account’ covers). In this case, there may be no obvious natural basis for the allocation of the adjustment to either premium liabilities or outstanding claim liabilities between classes. Consideration of the basis of accounting for whole account covers or other multi-line covers should be given before the first actuarial valuation and the basis of accounting, once determined, should normally be observed consistently over future years.

70. For premium liabilities, the unearned premium approach may be applied to produce either a gross or a net value. Where a net value is to be calculated and the reinsurance is written on an events occurring basis, it would normally be appropriate to include an allowance for future reinsurance premiums in respect of that part of the unexpired period after current reinsurances expire. To get the corresponding gross value, it is necessary to add back the expected cost of claims under both current and future reinsurances and to add an allowance for other recoveries, including sharing, salvage, subrogation, third party recoveries and Input Tax Credits (ITC) and Decreasing Adjustment Method (DAM) recoveries.

71. For proportional reinsurance and recoveries under sharing agreements, the adjustment is simply a matter of inverting the average fraction retained. A similar approach should suffice for ITC and DAM recoveries and, unless the amounts are large, salvage and subrogation.

72. For non-proportional reinsurance, the simplest approach is to add back a fraction of the unearned non-proportional reinsurance premium. This requires an assessment of the expense and profit margins contained in those premiums, which in principle, would involve the same considerations as that assessment for direct premiums. In practice, unless these premiums are a substantial fraction of the direct premiums, it is acceptable to make a reasonable assumption.

Use of Case Estimates

73. Where case estimates are used as the basis for liabilities, they need careful interpretation. It is necessary to understand how they are set and how they relate to what is likely to be paid out.

74. Given sufficient historical data, standard actuarial techniques can be used to quantify this relationship, provided that the basis of estimation has not been changed.

75. In the absence of such data, it may be possible to form a view as to the relationship on the basis of discussions with those responsible for the estimates. Care, however, is needed in interpreting such information.

76. Case estimates are often based on what the estimator thinks the claim is most likely to cost. If the potential range is small, this may be close to the mean. Where the potential range is large, however, the probability distribution is likely to be highly skew and the most probable value could be well below the expected value. Even greater bias may result, if the estimates are based on a best case or worst case scenario.

77. Case estimates seldom take account of how long it might take to settle a claim, and do not often incorporate a suitable allowance for either inflation or discounting, where these may be material.

78. For most short-tail lines of business, the estimate will be based on physical examination of the damage or on records of purchase, and can be a reliable estimate of the gross cost. The principal uncertainties may relate to salvage and subrogation, which are not always estimated. Other approaches to case estimation should be considered on their merits.

79. If estimation practices have changed, it may be necessary to make a subjective estimate of the impact of the change, until experience emerges. It should be noted that, even if estimation rules are unchanged, a change in personnel could have a material impact on the case estimates.

80. If the financial reporting deadlines allow, hindsight can be a very useful tool in assessing short-tail case estimates. Even two weeks can show a considerable turnover of estimates into paid claims and conversion of reports into considered estimates.

81. For long-tail lines of business, it is substantially more difficult to derive suitable valuation estimates from case estimates. If there is sufficient data for a proper actuarial analysis, this should be undertaken. If actuarial analysis of case estimates is undertaken, it is important for the actuary to have an understanding of the current and historical case estimation process, as changes in this process can have a material impact. It may sometimes be appropriate for the actuary to obtain independent expert advice on the insurer's case estimation procedures, particularly where large reported claims make up a significant proportion of the liabilities.

82. If the numbers of long-tail claims are too small for meaningful analysis of historical data, then it becomes even more important to understand the nature of the case estimates. It may be possible to draw analogies with other lines of business or with other insurers, or to draw on industry data.

Such comparisons need to take into account any discernible differences between the portfolio being valued and the base portfolio, with particular reference to the case estimation process.

83. It is also important to note that even a large portfolio can contain too few large claims to allow credible statistical analysis: for example, a major environmental disaster in the context of a liability portfolio where most claims are for minor personal injuries. In such cases, there is a danger of 'outlier' claims that cannot easily be dealt with using conventional statistical methods. In such cases, the actuary needs to exercise professional judgment and should take great care in so doing. Very large claims are a lesser concern for a direct insurer with suitable reinsurance, where the main interest is the net liability, which can be estimated from the retention.

84. Case estimates may be particularly useful for identifying the presence (or absence) of large claims or events and in the estimation of amounts recoverable under non-proportional reinsurances. However, the actuary needs to be aware if there are any classes or types of claim for which the company inserts a purely nominal case estimate when a claim is reported.

Reliance on Other Actuaries' Work

85. Larger insurers, underwriting numerous and sizeable classes of business, are likely to require the services of more than one actuary to assess the value of outstanding claim liabilities and premium liabilities, as well as the risk margins. In these circumstances, the Approved Actuary has the responsibility for coordinating the valuations and summarising the results into one opinion for delivery to the insurer's Board and senior management.

86. In such cases, the Approved Actuary should be satisfied that the actuary responsible for each valuation unit has the appropriate experience and competence to carry out a valuation of that particular part of the portfolio. In preparing the summary of the results for the insurer, the Approved Actuary should be satisfied as to the suitability of central estimates, risk margins and diversification benefits prepared by other actuaries for inclusion in the results.

87. In preparing the opinion summarising the insurance liabilities of the insurer, the Approved Actuary should be satisfied that the central estimates, risk margins and diversification allowances are suitable, for each valuation unit. There is no need to repeat the calculations performed by the other actuary, but the Approved Actuary must review the results to ensure that the methods and results are fully understood.

88. The Approved Actuary should discuss the results with the other actuary to ensure the assignment was understood and to resolve any matters of interpretation of the other actuary's results.

89. Where the Approved Actuary is not satisfied as to the suitability of a particular item for inclusion in the overall valuation, then an alternative figure must be provided. The summary report must include the reasons for varying the original figure, and state the difference.

90. While the assessment of the central estimate, uncertainty and independent risk margin for the outstanding claim and premium liabilities for each valuation unit is a relatively independent exercise, capable of delegation to separate actuaries, the assessment of diversification benefits for the company is unlikely to be. The Approved Actuary must ensure that the diversification benefit is assessed on a holistic basis.

91. Some forms of reinsurance may be dependent upon the aggregate claim experience of a number of classes of business. Where an actuary is responsible for the valuation of a group of valuation units which completely encompass such a reinsurance arrangement, then the impact of the reinsurance on the central estimate and risk margins should be considered and included as part of the report. Where different actuaries are responsible for valuation units within such a reinsurance arrangement, the Approved Actuary must ensure that the impact of the reinsurance arrangement on the central estimates and risk margins is appropriately assessed and documented.

92. In order to meet reporting deadlines for published accounts, it may be necessary to invert the natural sequence and determine diversification adjustments before the individual valuation unit valuations are completed. It will normally be acceptable for individual valuation unit reports to show risk margins based on analysis of diversification benefits at the most recent previous valuation. If this is done, the continued appropriateness of those adjustments should be discussed.

Materiality

93. In accounting terms, an amount or difference is material if it is large enough to '… affect the decision making about the allocation of scarce resources by the users of general purpose financial reports…' (AASB SAC3).

94. This test requires a judgment as to how such users might react to a change in the reported amounts. Observation suggests that many users do not have a good grasp of the uncertainties of general insurance. As a result, they are likely to respond on the basis of what seems to be a substantial number, rather than on any concept of statistical significance. A further factor is that, for long tail lines of business, even small percentage changes in the liabilities can give rise to large percentage changes in profit. It is usually possible to assess the threshold of materiality in discussions with management and auditors.

95. It also should be noted that materiality depends on context. What is material in the context of an income or profit and loss statement may not be material

in the context of a statement of assets or balance sheet, or in an assessment of solvency, particularly for long tail classes of business. The converse is also possible, particularly for short-tail classes. In considering materiality, the actuary should consider the purpose for which the provisions or estimates are required, but should also bear in mind the other uses to which they may be put.

96. While it is reasonable to omit individual items on the grounds of materiality, thought should be given to the cumulative impact. It is not acceptable to make such omissions if the overall result would be materially affected.

97. When, as is usual in general insurance, the threshold of materiality is below that of significance, it is vitally important for the actuary to communicate the uncertainty of the results. This can be particularly difficult, if not impossible, where those results are communicated at second hand.

Reasonableness of Major Results

98. Before signing off on the actuarial report, the actuary should ensure that the results obtained from the actuarial valuation are reasonable, both in aggregate and for each valuation unit within the insurer's total portfolio.

99. Reasonableness should be assessed in relation to:

    a) comparable results for that valuation unit in the previous year;

    b) development in the valuation unit over the inter-valuation period;

    c) the experience of the valuation unit since the previous valuation;

    d) changes in economic assumptions, particularly investment and inflation assumptions (including, where appropriate, superimposed inflation);

    e) changes to the actuarial model; and

    f) any industry results or benchmarks.

100. The movement in the actuarial valuation reserves since the previous valuation should be analysed into its components. The actuary should be satisfied that differences between the previous valuation result and the present result can be explained in terms of the experience in the intervening period and changes in the valuation assumptions.

101. If during the performance of this analysis, the valuation of any particular material class appears to be inconsistent with the value of the class at the previous valuation, or the differences cannot be satisfactorily explained, the actuary needs to further investigate the reasons why the unexpected differences arise in order to be satisfied that the cause is not an error in the valuation calculations.

TECHNICAL REQUIREMENTS

Relationship Between Outstanding Claims and Premium Liabilities

102. Different approaches may be taken to the assessment of premium liabilities. The choice depends on many factors, including the nature of the business, past experience, the maturity of the insurer or valuation unit, and changes to underwriting, pricing, claim management and marketing over the previous few years. Whatever approach is taken to the assessment of premium liabilities, the consistency of assumptions and methods between outstanding claims and premium liabilities needs to be considered.

Consistency Between Outstanding Claims and Premium Liabilities

103. In a stable environment there is an expectation that the assumptions and methods for outstanding claims and premium liabilities will be consistent, after adjusting for trends, claim inflation and investment earnings However the environment, whether internal or external to the insurer, is typically not static.

104. Some approaches to premium liabilities are based on the outstanding claim assumptions, adjusted for changes in matters considered in paragraphs 107 to 109.

105. If premium liability assumptions are arrived at independently of outstanding claim assumptions then the assumptions and valuation results for the outstanding claim and premium liabilities should be compared. Significant differences between the assumptions and methods should be explained on the basis of the available information and data.

106. Changes to the matters considered in paragraphs 107 to 109 may result in a significant difference, from past experience to future experience. The timing and extent of change is important, in assessing the consistency between outstanding claim and premium liability assumptions.

107. In forming a view of appropriate premium liability valuation methods and assumptions, an understanding of changes within an insurer’s business needs to be considered. The following matters may affect the actuary’s choice of assumptions for claim frequency, gross average claim size and gross loss ratios for premium liabilities and their consistency with the assumptions for outstanding claim liabilities. Many of the matters need to be investigated, so the actuary understands changes and trends in exposure and the related changes in premium adequacy. The timing of changes in these matters should be understood.

108. In forming a view of appropriate valuation methods and assumptions for premium liabilities and their consistency with outstanding claims, many other matters may need to be considered by the actuary. The timing of the changes in these matters should be understood.

109. In both outstanding claims and premium liabilities, explicit allowance for reinsurance and other recoveries, such as third party recoveries, salvage, subrogation, sharing and input tax credits, needs to be made. Appropriate adjustment to this allowance for the risk of non-recovery of these assets is required.

Central Estimates - Reporting

110. The valuation report should contain a description of the following:

a) changes (if any) to the valuation model adopted, with an explanation for the changes.

b) changes to key valuation assumptions. The content of this will vary according to the valuation model adopted. However, the principle is to provide a commentary of whether an assumption has been strengthened (i.e. results in a higher valuation outcome) or weakened (i.e. results in a lower valuation outcome) as a result of observation of the updated claim experience.

c) key assumptions. For outstanding claims, these will depend on the method adopted but will usually include the number of claims incurred, finalisation and payment patterns, average claim size, future inflation (normal and superimposed), discount rate and, where applicable, case estimate development patterns. For premium liabilities, additional key assumptions may include loss ratios, seasonality and allowances for large claims.

d) the overall change to the net central estimate should be quantified and the key reasons for that change analysed. This should include:

i) previous central estimate plus interest to new valuation date, less

ii) payments from prior accident periods in the inter valuation period plus interest to new valuation date, compared with

iii) new central estimate for prior accident periods at valuation date, plus

iv) separate quantification of any material impact on the new central estimate of changes to the valuation model adopted and key assumptions, plus

v) the impact of new claims and exposure.

Detailed quantification is normally provided at the valuation unit level. There should, however, be an overall quantification of the impact of changes to the valuation model and assumptions at the whole company level.

Risk Margins

Fundamentals

111. A technical provision may exceed the expected value of the present value of future payments in respect of the associated liability, which is its central estimate. This will result in a higher degree of confidence in the adequacy of the provision than would be the case if just the central estimate were chosen. The excess over the central estimate is often referred to as a risk margin.

112. A risk margin sometimes comprises an addition of a percentage of some quantity considered relevant to the risk associated with the liability concerned. For example, the risk margin contained in a provision for outstanding claims might consist of p% of the central estimate.

113. Alternatively, the risk margin may be determined by means of specified level of confidence, for example, such that the provision is adequate to meet the associated liability with q% confidence. In this case, the formulation of the risk margin is manifestly stochastic, and its determination will require a stochastic model of the claim experience to which the technical provision relates.

114. It will usually be necessary to formulate such stochastic models in two distinct parts:

    a) a model of the claim experience specific to the portfolio under consideration, with external influences factored out;

    b) a model of those external influences, which would usually include at least rate of inflation (possibly excluding superimposed inflation) and discount rates.

115. There may be circumstances in which a risk margin may be reasonably determined without reference to a stochastic model, though these would probably not be of the confidence level type mentioned above. The following sub-sections would not apply to such cases.

116. Even where a stochastic model is required, its derivation may be by means other than set out in those sub-sections. They should be regarded as advisory rather than mandatory.

117. Provisions may also be determined by adjusting the discount rate or the probability distributions involved in the valuation, in accordance with financial economic theories such as CAPM or option pricing. Following this approach, it is possible to characterise the risk margin, which is the difference between the adjusted and unadjusted values, as the value of the uncertainty of the liability.

Stochastic claim experience models

118. The actuarial literature contains a number of stochastic claim experience models. Those most likely to be useful in the quantification of risk margins include:

a) Stochastic forms of the chain ladder;

b) Generalised Linear Models (GLM);

c) Credibility models;

d) Other Bayesian models;

e) Adaptive filters, such as the Kalman filter.

This list, while reasonably comprehensive, is not intended to be exhaustive.

119. Some of these models (for example, Mack's stochastic chain ladder) explicitly produce estimates of no more than the first two moments of liability. Others (for example, GLM based models), are conceptually able to give the distribution in full detail, may require prohibitively extensive computation to produce this level of detail.

120. In cases where only the first two moments of liability are estimated, it will be necessary to supplement these with an assumption as to the form of the probability distribution of liability, if the estimates are to be converted into the confidence limit required to produce a risk margin.

Stochastic economic models

121. Models of external economic parameters can be found in the actuarial and economic literature. In the former case, they may be well known to actuaries (for example, the Wilkie model). Models from the economic literature (for example, Cox-Ingersoll-Ross, Heath-Jarrow-Morton) may be just as valid but are less well known to actuaries.

122. Some of these models have been implemented as the economic scenario generators in DFA systems.

123. It is usually desirable to apply a model which generates all of the economic time series required in the liability estimation, in order to recognise the stochastic dependencies between them. For example, it is usually unwise to adopt models which treat future inflation and interest rates as stochastically independent.

Full distribution of outstanding claim liability

124. Where it is desired to produce an explicit estimate of the entire distribution of the relevant liability, the following procedures may be helpful:

a) Bootstrap;

b) Markov Chain Monte Carlo (MCMC) sampling.

The former is well embedded in the actuarial literature and well understood. The latter, which is perhaps ultimately just as useful, is newer and, at present, more experimental.

Practical Considerations

125. It is necessary to base estimates of uncertainty on an insurer's own data as much as possible. However, not all insurers, especially relatively new insurers or smaller insurers, have data that is adequate for this. Consequently, it may be necessary to rely, at least in part, and sometimes wholly, on industry research studies. Such studies should not be used blindly. Most insurers have features which suggest that industry parameters should be modified.

126. If a published industry study is used as a basis for estimates of uncertainty, it is important that the actuary should take note of the context of the study and modify the results of the study if special features of a specific insurer indicate this. Examples include:

a) Risks concentrated in a particular geographical area or industry, relative to the data on which the study was based.

b) The insurer's type of business being different from the industry average. Examples include a portfolio of small commercial business compared to industry data dominated by more volatile large corporate business; and excess business compared to primary business.

c) Differences in reinsurance arrangements, such as lower or higher retention levels, or different types of reinsurance.

d) Variation in the reliance placed on intermediaries in underwriting.

e) Changes in underwriting conditions, such as a change in the legislation governing a line of business.

127. It is also essential to ensure that, if parameters drawn from different studies are combined, they are compatible.

128. Allowance for diversification benefits need to be carefully considered by the actuary as, in many situations, it may not be possible to support an allowance for diversification from empirical evidence. Some industry studies may not use empirical evidence to justify an allowance for diversification, but rather present their view of appropriate allowances. The actuary needs to justify the allowance for diversification. The extent of the diversification benefit depends on many factors. In particular, the way that the line of business margins are determined is important.

129. Uncertainty can be broadly divided into:

a) Independent variation, which operates at the individual claim level and is uncorrelated; and

b) Systemic (also called systematic) variation, which operates at the valuation unit level and affects all claims similarly. Typical sources of systemic variation are economic, social and climatic factors

130. There is always a diversification benefit when the independent variation from different valuation units is combined. The situation for systemic variation is more complex. The extent of any diversification benefit depends on the extent to which the same sources of systemic variation apply across different valuation units. If the dominant source of systemic variation is the same then, in the absence of empirical evidence to the contrary, no benefit from systemic variation should be assumed. Caution should be exercised in assuming low correlation (which implies higher diversification benefits) between even apparently unrelated sources of systemic variation.

Risk Margins – Reporting

131. Where the actuary calculates risk margins by reference to a particular notional distribution, this should be described in the report, along with the reasons why it is considered appropriate. Where this is not done, the actuary should discuss the reasoning behind the figure chosen. Material changes in the probability distribution of insurance liability outcomes by class of business since the previous valuation must be disclosed in the report.

132. The actuary's report should include discussion of the suitability of any industry study, as a basis for estimating uncertainty, for the particular insurer and present reasons for any adjustments that are made.

133. The actuary's report should include discussion of reasons why the adopted allowance for diversification is appropriate.

134. The approach adopted by the actuary who adjusts the risk margins for diversification and reinsurance should be clearly documented. While the apportionment of the diversification benefit between classes of business may be essentially arbitrary, the approach adopted should also be documented.

135. Changes to the model or models since the previous report should also be summarised.

END OF GUIDANCE NOTE.

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10 March 2006

Business Council of Australia

Mr John Kluver
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By email: john.kluver@camac.gov.au

Dear Mr Kluver

TREATMENT OF FUTURE UNASCERTAINED PERSONAL INJURY CLAIMS

The Business Council of Australia (**BCA**) appreciates the opportunity to make this submission to the Corporations and Markets Advisory Committee (**CAMAC**) in relation to proposed amendments to the Corporations Act to deal with future unascertained personal injury claims. As this is a complex and at times politically sensitive area, the BCA also appreciates the decision of the Federal Government to refer this matter to CAMAC for considered deliberation before deciding on an appropriate course of action.

The BCA is an association of Chief Executives from leading Australian corporations with a combined national workforce of almost one million people. It was established in 1983 to provide a forum for Australian business leadership to contribute directly to public policy debates in order to build a better and more prosperous Australian society.

The BCA appreciates that the Government wishes to address any potential shortcomings in how the current law deals with future unascertained personal injury claims. Care needs to be taken, however, to ensure any proposed solutions avoid creating further problems or moving the risk from one class of potential claimants to another. A balance therefore needs to be struck between any strengthening of the protection of personal injury claimants and the rights of existing claimants against companies, such as creditors, many of whom can be in small business.

There also needs to be recognition that dealing with the rights of future unascertained personal injury claims is inherently difficult. As the reference to CAMAC notes, in the normal course of business, companies will have little information about the likelihood or magnitude of future claims. The burden on businesses from having to provide for any possible future claims could be overwhelming. It is therefore vitally important that any provisions designed to deal with future unascertained personal injury claims only relate to circumstances where there is a very real expectation of claims based on similar claims or claims actually made against the company. For example, it is relevant that in the case of James Hardie, the company was aware of existing claims and the potential for future claims, as evidenced by its creation of a foundation to deal with these future claims. Any amendments to the law therefore need to be restricted to such circumstances and

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.

Application of the Proposed New Provisions

Under the proposal being considered by CAMAC, the proposed new protections for future unascertained claimants would only apply where two pre-conditions are met, namely:

a. there has already been an exceptional number of personal liability claims arising from the company's action or product; and

b. further similar claims are expected.

The BCA strongly supports the scope of the new provisions being limited in such a way. Without a careful and precise limitation upon the operation of the proposed new provisions, it would be extremely difficult for companies to manage their operations, and for Directors and officers to fulfil their duties. For example, if the provisions were to apply where there is only the *possibility* of future claims, companies would be obliged to make provision for those possible future claims. Given that under such circumstances, the size of such possible future claims would be difficult to determine, 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, particularly as in most cases it will be found that no sustainable actions arise. Experience shows that it is only in rare and exceptional circumstances that mass claims will actually arise and be successful against a company.

It is therefore vital that any new provision to protect future unascertained claimants be restricted to circumstances where mass claims already exist and future claims against the company are a strong likelihood.

Scope of the Liability

Once it is apparent that a company will face future mass claims, there needs to be certainty around the appropriate legal responsibilities of the company. In particular, the company needs to be in a position to ensure it can meet legitimate future claims. It also needs to be able to determine, at any given time, whether the company is solvent. The challenge for the company therefore relates to its ability to assess the total future liability at any particular time.

The total future liability will depend on a number of factors, including the number of claimants and the level of damages awarded to claimants. These will in turn vary depending, for example, on the ways in which future damage or harm to claimants manifests. Similarly, advances in medical technology and expertise could increase the liability where improved diagnostics allow greater certainty over the causes of

harm, or could reduce liability where improved treatment reduces the impact of harm[1].

Actuarial expertise can be relied upon to make a reasonable estimate of the future potential liability. Any such estimate, however, is inherently uncertain, and may be shown to be incorrect over time, particularly as circumstances connected with a mass claim change. It is vital, therefore, that companies are provided with legal protection where they can demonstrate that they have exercised due diligence in determining the potential future liability and have acted according to that assessment.

For these reasons, the BCA supports the position proposed in the reference to CAMAC that the new provisions not apply unless it is possible to identify the circumstances giving rise to the future personal injury claims and the class of persons who will bring the claims. The BCA also believes any new obligations placed upon companies, their Directors and officers, must be matched with a due diligence defence.

Relativity of Claims

The reference to CAMAC recognises that companies may face a range of claimants, including employees, creditors and shareholders. Any proposals to strengthen the claims of future unascertained claimants should not come at the expense of the existing rights of other legitimate claimants. A concern in this regard is the additional time that may be required to wind up a company if there is an ongoing and uncertain level of liability arising from a mass claim.

The reference to CAMAC states that, in the case of liquidation, "*asset distribution 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*"[2]. Given the high degree of uncertainty of the actual level of future claims, this statement over-simplifies the difficulty of reconciling the interests of future unascertained claimants with those of other claimants known at the time of liquidation. If it is assumed that a proportion of the assets needs to be available to meet all actual successful claims, then the allocation of assets will necessarily be significantly delayed, as the claims, by their nature, only arise over a number of years. The only feasible alternative is if, at the time of winding up, a reasonable estimate of future claims is made and assets are assigned to meet this estimate, with the remaining assets distributed to the other claimants (employees, creditors, etc). Such a reasonable estimate of the future claims should be made independently and the validity of the estimate should be 'certified' by a court. The company's Directors, officers and administrator should then be protected from any future action should the assets assigned based on that reasonable estimate prove inadequate to meet actual future successful claims. Without such as approach, other creditors could not gain access to the assets of the company before all future claims are known and settled.

1 A good discussion of these issues is to be found in the submission to CAMAC by the Institute of Actuaries of Australia, paras. 14 – 23.

2 *Reference in relation to the treatment of future unascertained personal injury claims*, Letter of the Hon Chris Pearce MP, Parliamentary Secretary to the Treasurer, to the Corporations and Markets Advisory Committee, 12 October 2005.

Summary

The BCA recognises the desire to ensure that the rights of future unascertained claimants are protected. The very nature of these claims, however, makes it extremely difficult to craft a regime that adequately protects future claimants without undue restraint on the normal operation of companies or without impeding the existing rights of other claimants.

The BCA supports the proposal to limit the operation of the new provisions to circumstances where it is very clear that substantial future claims are highly likely. Any broadening of this limitation will result in significant interference in the day to day operation of companies that are ultimately unlikely to be subject to substantial successful claims.

Even where companies are highly likely to face such claims, great care needs to be taken that a balance is struck with the rights of other creditors. In particular, a system is needed that allows companies to be wound up promptly to allow other creditors access to the assets of the company.

Any new regimes also need to provide protection for Directors and officers who have acted appropriately and with due diligence. This is particularly important as it is clear that the nature and size of future unascertained claimants can vary considerably with time and, even with the best effort at the time, insufficient provision can be made to meet these liabilities.

Overall, the BCA supports the general direction of the proposals under consideration by CAMAC, but believes further refinement is needed to make the proposed new regime practicable.

The relevant contact at the BCA on this issue is Steven Münchenberg (03 8664 2664 or steven.munchenberg@bca.com.au).

Yours sincerely

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14 March 2006

Dear Mr Kluver

Long-tail personal injury claims

We refer to the request for submissions made by the Corporations and Markets Advisory Committee ("the Committee") in respect of a proposal to strengthen protection for future unascertainable personal injury claimants where the solvency of the responsible company may be in question.

As you know, the IPAA is the leading professional organisation within Australia for specialists practising in corporate and personal insolvency. As such, we have a keen interest in ensuring that any amendments to insolvency legislation not only achieve their objectives but are also simple and cost-effective to implement and clear cut in their interpretation. The IPAA appreciates the opportunity to comment on this matter.

The IPAA is supportive of an insolvency regime which properly recognises the claims of a company's creditors and provides for a system to deal fairly and effectively with those claims and disburse available funds amongst those creditors. However, in establishing a process to recognise future unascertained personal injury creditors where a mass future claim is afoot, the IPAA raises the following points:

- The process needs to be very clearly set down in the Corporations Act so that where external administrators follow this process, there will not be the potential for future claimants to make a claim against the external administrator personally;

  In particular, careful consideration will need to be given to the nature and extent of the inquiries which are to be required of the external administrator to ascertain whether a mass future claim situation exists; the extent to which the external administrator can, or should, rely on independent (eg expert) assessment of the likelihood and extent of such claims; and difficulties which will confront external administrators in situations where there are limited funds available or, over the course of the administration, new or further scientific evidence emerges which suggests, or more strongly suggests, the likelihood of mass future claims. Regard should be had to the consideration that often an external administrator will have limited information about the company (and potential claims) and limited funds to conduct the administration and investigate claims, let alone pay creditors;

- A clear and simple test for "mass future claim" must be devised. At the very least, phrases such as "unusually high number", "strong likelihood", "similar industry" and "threshold level of information" need to be very clearly defined so there is no ambiguity about when the provisions will apply;

  If the question whether a mass future claim is 'afoot' is to be determined not only by reference to claims that have been made against the company under external administration but also against other companies in a similar industry etc, it must be borne in mind that the external administrator may not have access to information regarding those other companies. Existing powers of examination of third parties (eg section 596B) may not be wide enough to permit the external administrator to access such information; and 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.

  One solution might be that the provisions only apply to companies which have sold/produced a specific product or operated in a specific industry which is prescribed by regulation the government (eg supply of asbestos products) rather than have external administrators of individual companies potentially spend very significant funds trying to determine whether the company is subject to a mass future claim situation;

- The process needs to be such that it can be completed in a reasonable time period so that current creditors are not unduly prejudiced by substantial delays. The process must also be capable of being conducted in a cost-effective manner;

- There needs to be consideration of what the position is if actual future claims exceed what was estimated and the fund set aside for the purpose of meeting these claims runs out. The estimation of a fund to be set aside can be a very costly process requiring much expert evidence, and the US experience seems to suggest that estimates are often insufficient (see 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))

- The scope for Court involvement in the process needs to be clearly articulated. This will include not only considering whether the existing ability of external administrators to seek directions is sufficient, but also whether court approval should be required for arrangements regarding mass future claims or decisions to make no provision for such claims; and if so, who, if anyone, should be required to be joined to any application as a contradictor

- Consideration should be given to whether it is appropriate to apply the mass future claim provisions in an administration/DOCA situation where the purpose of the DOCA is to facilitate the company's continuation in existence in a more viable financial state. In such a case, the purpose of the DOCA, 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. At the least, it should be permissible to structure a DOCA so that it may bind "future mass claims" or exclude them. If future claimants are to be bound by a DOCA, there is a question of to whom notice is to be given of any meeting to consider a proposal and whether they should have any rights to set-aside the DOCA and, if so, when and how;

- It should be made clear whether external administrators 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 proposed anti-avoidance provision is directed not just to persons entering into proscribed transactions but also anyone who is a "party to the transaction or arrangement". Any such provision should not be such as would 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.

- The submission focuses on external administrators of insolvent corporations. The issue however is just as pertinent in members voluntary liquidations ("MVLs") of solvent companies and perhaps more so because generally in an MVL, the liquidator undertakes no investigations into the company's past activities. If this is not addressed, the risk of unwittingly being exposed to personal liability may render the provision of services for straightforward voluntary liquidations uneconomic. A consequence of this is that otherwise redundant companies will remain registered for no purpose other than to "be there" should claims arise in the future albeit such companies may have long since disposed of the relevant business and all tangible assets.

  Any legislative reform in this area should ensure that in the circumstances of a MVL, the liquidator is entitled to rely upon the disclosures in the Declaration of Solvency (Form 520) executed by the directors. Consideration could be given to amending the form of the Declaration of Solvency to specifically require the directors to disclose whether the company is the subject of "mass future claims". In cases of wholly owned entities, companies should be able to irrevocably assign any liability associated with mass future claims to the parent company enabling the dormant subsidiary to be wound up.

Should you wish to discuss any aspect of this submission, please do not hesitate to contact Ms Kim Arnold, our Technical Director, on 02 4268 3656.

Yours sincerely

J Melluish
President

LONG TAIL PERSONAL INJURY CLAIMS CORPORATIONS AND MARKETS ADVISORY COMMITTEE

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LONG TAIL PERSONAL INJURY CLAIMS

Executive Summary

The Australian Lawyers Alliance makes this submission to the Corporations and Markets Advisory Committee. The Alliance would like to thank the Committee for accepting this submission past the due date. The Australian Lawyers Alliance wishes to make its submission under the following headings:

1. Introduction
2. James Hardie and the Australian Lawyers Alliance
3. Avoiding the problem
4. Liability of parent and group Companies
5. Preliminary Test – Mass future claims
6. Extensions of general creditor provisions
7. Prohibition on intentional avoidance
8. External administration
9. Other necessary steps

The Alliance asserts that the rights of injured people to gain adequate and equitable compensation require promotion and protection. The Alliance recommends that corporations' law should develop so as to protect potential personal injury claimants where the solvency of the responsible company is in question or where that company is no longer in existence.

1. Introduction

The Australian Lawyers Alliance understands that the Corporation and Markets Advisory Committee is considering the proposal to strengthen the protection received by future unascertained personal injury claimants where solvency of the responsible company may be in question.

In doing so the Committee refers to the report of the *Special Commission of Inquiry into James Hardie* in 2004.

The Committee proposes that in certain circumstances, those who have a future personal injury claim shall be placed on the same footing as current creditors of the company responsible. The Australian Lawyers Alliance understands that the Committee is seeking to achieve a balance between protecting potential personal injury claimants, and also providing current creditors, and others, with business certainty.

The Lawyers Alliance understands that the Committee inquiry relates to whether this proposal would unduly compromise current corporate law and insolvency principles.

The Lawyers Alliance understands that this proposal would only apply where certain elements are satisfied. These elements are:

- That there is a strong likelihood of numerous future claims against a company that has already experienced an unusually high number of personal injury claims or is in an industry where many claims have already occurred. The Alliance proposes that an example of such a company might be building products company.
- That the circumstances giving rise to the claims and the class of persons who will bring the claims can be identified.
- That the extent of the company's liability can be reasonably estimated.

The Alliance understands that the proposal being considered may be divided into three main areas:

1. Extension of general creditor protections: The *Corporations Act* requires corporate decision making to consider its ability to pay its creditors. In doing so it aims to provide balance and an appropriate allocation of risk

between creditors and shareholders. So, where a mass future claim is afoot, the existing creditors' protection may be extended to unascertained creditors.

2. Prohibition on internal avoidance: The Committee is considering a proposal to introduce a new offence provision, and related compensation provisions, modeled on Part 5.8A of the *Corporations Act* in regards to employee entitlements. The aim of this is to send a clear message that deliberate avoidance of payment to personal injury claimants is unacceptable. This proposal would provide that a transaction may not be entered into where the intention of that transaction is to prevent the recovery of amounts, or significant amounts owing, in respect to unascertained personal injury claimants. The penalty for such a breach may result in up to ten years in prison and fines of up $110,000. Also, any person involved would be in breach, not just the directors.
3. External administration: The Committee is considering the introduction of a requirement for external administrators to admit and make provision for mass future claims for personal injury. So, 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. Over time, future creditors will be able to make claims against funds set aside for future claimants. This process may be similar to that of s554A of the *Corporations Act*.

The Australian Lawyers Alliance supports this proposal to extend the rights of injured people. The Alliance agrees that where a corporation has a strong likelihood of numerous future claims, and / or the industry concerned has a high number of personal injury claims, certain legal provisions should be established in order to provide adequate compensation for the injured parties. This is especially necessary where liability can be reasonably estimated to a claim giving rise to a class action.

2. James Hardie and the Lawyers Alliance stance

In terms of identifying a company or industry where there is a strong likelihood of numerous future claims, or where there has been an unusually high number of personal injury claims associated with that industry, the Australian Lawyers Alliance must refer to claims associated with asbestos related disease and its association with the James Hardie group of companies.

The history of asbestos related disease in Australia is indivisibly linked to the James Hardie group of companies. There is an abundance of evidence sourced throughout the twentieth century that indicates that James Hardie knew of the detrimental consequences of asbestos. Despite this knowledge James Hardie only ceased asbestos production in 1987. The Australian Lawyers Alliance (formerly Australian Plaintiff Lawyers Association) made a submission to the Special Commission of Inquiry into the Medical Research and Compensation Foundation in April 2004. To view this submission please go to: http://www.lawyersalliance.com.au/documents/public_affairs/James%20Hardie%20220404.pdf . The effect of this submission was that given the circumstances, there can be no doubt that the James Hardie companies are morally and legally responsible for their asbestos related disease legacy in Australia, a legacy that will endure for at least a generation.

It is in this context that the Australian Lawyers Alliance supports the proposition to make companies responsible for future unascertained personal injury claims. The Alliance cites the James Hardie case study as an example of how principles such as justice and the rights of the individual can be severely compromised when companies are responsible for injuries to their employees / claimants without adequate legal ramifications.

3. Avoiding the Problem

Given the major problem that has been identified in the committees letter and attachments, the Alliance believes that the first consideration in terms of amending the corporations law is to seek to prevent circumstances arising where a product or conduct of a company might cause such widespread injury or disease so as to necessitate the provisioning contemplated. Clearly, avoidance of the problem will be to the benefit of the corporation, the creditors and, most importantly, the customers who might otherwise become sick or suffer injury.

One method of avoidance is the prohibition on intentional avoidance with substantial penalties as proposed in the attachment to the committees letter.

Another is the creation of a duty on the corporation and its directors to place the interests of persons likely to be affected by the Corporations Acts on the same level as the interests of shareholders of the corporation.

Often in such cases the corporation's conduct is sought to be excused by directors who state that they would have acted but their only duty is to shareholders. The story of the Enron Chief who made just such a justification to Harvard Business School students is repeated in Gideon Haigh's book about the Hardie debacle, *Asbestos House*.[1]

The Australian Lawyers Alliance proposes the creation of a legally binding statutory director's duty along the lines set out in Attachment One at page 12 of this submission.

4. Liability of Parent and Group Companies

The Alliance believes that the proposals contained in the committee's letter will be most effective if the ability to avoid the effect of the requirements is circumvented by making each company in a corporate group liable and responsible for the consequences of a subsidiary or related corporation's malfeasance.

This will ensure that such assets as are available within the group are subject to annexation in order to provide the funds necessary for future injured persons.

It will also 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 the future injured.

This was certainly a factor in CSR's thinking when it faced the question of what to do about the risk of future claims from the Wittenoom mine operated by its subsidiary, Midalco Pty Ltd which had suffered a massive capital reduction just as the first claims were emerging[2].

The protection of the corporate veil was also a fundamental consideration in the planning by James Hardie to cut away its asbestos liabilities as revealed in the Special Commission of Inquiry into the Medical Research and Compensation Foundation.

This problem is in part, addressed by the prohibition on intentional avoidance proposal in the committees letter.

In the Alliance's (then known as the Australian Plaintiff Lawyers Association) submission to the Special Commission of Inquiry into Medical Research and Compensation Foundation in April 2004, we proposed that the problem to be statutorily addressed. The Alliance repeats it hereunder. Please see Attachment Two at page 15 of this submission.

5. Preliminary Test – Mass Future Claims

The proposed test requires that there have been claims of the type to be provided for against the company or another company. It is submitted that this pre-requisite is far too restrictive.

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

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[1] Haigh, G Asbestos House: the secret istories of James Hardie Industries Carlton North, Vic. : Scribe Publications, 2005

[2] see Vojakovic and Gordon "The Victim's Perspective" in Peters and Peters "Sourcebook on Asbestos Disease" Volume 13, Michie, 1996.)

For example, CSR Limited knew of the risk of cancer to Wittenoom asbestos miners in the 1940s. The first case of mesothelioma associated with the mine presented to Dr McNulty in 1959, and the first claim against the subsidiary (which had nominal insurance coverage for most of the period and had already embarked upon capital reduction) was not made until 1977. As a result of company tactics and government pronouncements, there would not have been "an unusually high number of claims" until the issue of some 300 writs against the company in January 1987. The company could long since have reorganised its affairs or liquidated itself before the threshold requirement set out in the reference could have been made out.

The same history might be said to apply to rubber products and bladder cancer; see *Wright v Dunlop Rubber*.[3].

Accordingly, the Alliance strongly urges that the test incorporate some other requirement than the existence of a high number of claims as a necessary prerequisite to the triggering of the other proposed provisions.

We suggest knowledge of an association between the product or conduct and the disease or relevant injuries in persons exposed to the product or the conduct.

6. Extensions of General Creditor Provisions

The Australian Lawyers Alliance supports the extensions proposed.

7. Prohibition on Intentional Avoidance

The Alliance supports such prohibitions as proposed.

However, the Alliance believes that priority should be afforded to future personal injury claimants in any liquidation, both as to the funds available from the recovery proceedings proposed, but also generally with respect to the other assets of the corporation brought into the administration and liquidation.

The case for this depends on a number of factors:

[3] 1972 13 KIR 255

1. Had the persons who will be injured in the future, known of the injury at the time of exposure or use of the product, they could have secured their compensation against the assets of the corporation then available. They could have obtained judgments (and enforced them) which would have ranked them higher in the list of creditors than general unsecured creditors

2. Other creditors had an opportunity to order their relationship with the corporation for their own protection. Future injured persons did not.

3. The inability of the future injured to protect their entitlements is not due to any failure on their part to take steps to secure their interest. They, like employees who have accrued entitlements, are the innocent victims of malfeasance and misadministration;

4. The wealth and assets of the corporation depended on the very purchasers who committed their funds to buy the company product, unaware (unlike the company that was directly or constructively aware of the foreseeable risk) of the potential for harm that entailed. The company over the ensuing years returns that wealth to shareholders and eventually dissipates the assets so as to render the corporation liable to liquidation. Those who provided the direct source of the corporation's former and distributed wealth, who now are the victims of decisions taken years before to place the corporation's profit before their safety, deserve absolute priority in accessing whatever remains of the corporation's assets.

8. External Administration

The Alliance supports generally this proposal.

The reference to the US Bankruptcy Code causes concern, and the precise matters arising therefrom would need to be expressly addressed, as the Chapter XI procedures in the USA have, with some notable exceptions, proved disastrous for asbestos related disease claimants.

In the context of this proposal we repeat the submission made above regarding the priority to be extended to future claimants. They should not stand with other unsecured creditors on an equal distribution basis. We reiterate that other creditors had an opportunity to order their relationship with the corporation for their own protection. Future injured persons did not. It may be of course that such a result means that secured creditors receive nothing with the entirety of assets being retained to provide for the future claimants. That is unfortunate but a necessary consequence of the circumstances which we submit render future claimants higher in the order of priority. We believe that community attitudes and public policy would support that view.

The other proposals for marshalling assets, notifying claimants and representation seem reasonable.

9. Other Necessary Steps

In circumstances giving rise to the sorts of administrations and liquidations discussed in the committees letter there are several other things that the Alliance believes should occur in the interests of the future-injured:

9.1. All relevant insurance coverage against the risk that will manifest should be identified and secured. The liquidation of insurers after acts which have given rise to long-tail liability has caused substantial problems for future claimants in the past. So too, the withdrawal of coverage on the basis that the insured corporation has failed to properly inform the insurer of the potential risk, contrary to the *uberrimae fidei*[4] provisions of the insurance contract.

Any such potential contest should be identified and resolved at the earliest possible time and long before claims start in abundance.

Once that question is resolved, the insurance coverage for future claimants should be secured, either 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.

[4] utmost good faith

It goes without saying that the funds obtained from insurers should be preserved solely for the future claimants and no other creditor.

9.2 The statute of limitations (ie any and all relevant limitations provisions) should immediately be suspended for all persons within the group identified as potential claimants. There may otherwise be arguments that awareness of the potential for injury starts time running such that by the time the injury occurs the person is out of time (and subject to prejudice arguments on an application for extension).

9.3 The provisions prohibiting claims for personal injury and death caused by breach of Section 52 of the *Trade Practices Act 1974 (Cth)* should be made inapplicable to all persons within the group identified as claimants. The future victims of corporate malfeasance should have at their disposal all available protections to further their rights including this important statutory consumer protection. They should not have to depend upon proving foreseeability of risk on the part of a company whose controlling officers have long since departed, if they can demonstrate misleading and deceptive conduct with respect to public statements (and public silence) on the part of the corporation, which has been a cause of their use of the product and subsequent latent injury.

Conclusion

The Australian Lawyers Alliance notes that the Corporation and Markets Advisory Committee is considering the proposal to strengthen the protection received by future unascertained personal injury claimants where solvency of the responsible company may be in question. The Australian Lawyers Alliance agrees that where a corporation has a high probability of many future claims, and / or the industry concerned has a high number of personal injury claims, legal provisions should be established in order to provide adequate compensation for the injured parties. This is especially necessary where liability can be reasonably estimated to a claim giving rise to a class action.

The Australian Lawyers Alliance stresses the need to promote and protect the rights of injured people.

Attachment One

Gordon, J 'Duty of Directors and Corporations to Prevent Foreseeable Harm'. Presentation paper produced for Corporations Law teachers Association Conference, Sydney, 8 February 2005

Duty of Directors and Corporations to Prevent Foreseeable Harm

Definitions:

"harm" means any injury, loss, or damage of which the risk as a consequence of the decision, activity, product, act or omission in question, is not far-fetched or fanciful;

"environment" means components of the earth, including:

(a) land, air and water, and

(b) any layer of the atmosphere, and

(c) any organic or inorganic matter and any living organism, and

(d) human-made or modified structures and areas,

and includes interacting natural ecosystems that include components referred to in paragraphs (a)–(c).

(1) When a Corporation knows, or ought to know, that any decision, activity, product, act or omission by the corporation, or that any officer, employee, servant or agent of the corporation, has caused, or may in the future cause foreseeable harm to any person, or any class of persons, then:

(a) the directors of the corporation owe a duty to any person, or the class of persons foreseeably at risk, to prevent the harm, such duty to be of no less a standard than the duty owed to the corporation's own shareholders;

(b) the corporation is required to take all steps reasonably necessary to warn such persons and to prevent the harm;

(2) this section is intended to have extra-territorial effect;

(3) this section is not intended to cover the field or to preclude the bringing of any other action at common law or pursuant to statute that may be open to prevent, or to provide a remedy or relief from, the harm;

(4) this section is intended to create rights in persons who are harmed or suffer loss from such decision, activity, product, act or omission by the corporation, to recover damages for such harm or loss in an action for breach of statutory duty against the corporation, and the directors of the corporation or any of them;

(5) breach of this section is an offence and renders the corporation and any director of the corporation liable to a fine of $ and in the case of a director, to imprisonment for a period not less than x years.

The paper continues:

(1) When a Corporation knows, or ought to know, that any decision, activity, product, act or omission by the corporation or that any officer, employee, servant or agent of the corporation, has caused, or may in the future cause foreseeable harm to the environment, then;

(a) the directors of the corporation owe a duty to the environment and to any person living in, or dependent upon, the environment foreseeably at risk, to prevent the harm, such duty to be of no less a standard than the duty owed to the corporation's own shareholders;

(b) the corporation is required to take all steps reasonably necessary to warn the local, state, regional or territorial, and national governments in which the environment is situate, and to prevent the harm;

(2) this section is to have extra-territorial effect;

(3) this section is not intended to cover the field or to preclude the bringing of any other action at common law or pursuant to statute that may be open to prevent or to provide a remedy or relief from the harm;

(4) this section is intended to create rights in persons who are harmed or suffer loss from such decision, activity, product, act or omission by the corporation, to recover damages for such harm or loss in an action for breach of statutory duty against the corporation, and the directors of the corporation or any of them;

(5) breach of this section is an offence and renders the corporation and any director of the corporation liable to a fine of $ and in the case of a director, to imprisonment for a period not less than x years.

Attachment Two

Extract from the Australian Lawyers Alliance submission to the Special Commission of Inquiry into the Medical Research Compensation Foundation, April 2004. Available in full at:
http://www.lawyersalliance.com.au/documents/public_affairs/James%20Hardie%20220404.pdf .

5. Law Reform Proposal

5.1. Recovery under insurance policy from corporation in liquidation and recent Government reforms of Corporations Law – A model for corporate liability reform?

The Commonwealth parliament addressed the recovery of funds by company creditors against liquidated corporations by making available the funds of any insurance policy directed to the losses faced by the creditors. It finds expression in Section 601 AG of the Corporations Law.

APLA submits that a similar provision might address the specific problem contemplated in this inquiry.

The sort of provision needed might be along these lines:

6.2. Proposed Legislation

"Definitions; In this section;-

***"acts or omissions"** means act or omission which has caused the injury for which the applicant seeks or has been awarded damages;*

***"applicant"** means a person who has suffered a physical or psychiatric injury or disease as a consequence of any act or omission or any alleged act or omission by a subsidiary company, its officers, servants or agents and includes any legal personal representative and any dependent of the applicant;*

*"**benefit**" means any fiscal or financial benefit including but not limited to transferred profits, dividends, receipt of cash, property, loan funds, shares or any form of chose in action; any financial or fiscal advantage including but not limited to taxation deductions, taxation benefits or the use of transferred losses which reduce net income, assets or profits; or any guarantee or indemnity;*

*"**parent company**" means any company that at the time of the acts or omissions of the subsidiary company owned, or held more than 50% of the issued shares of the subsidiary company, and at any time received a benefit from or by reason of the existence of the subsidiary company;*

*"**subsidiary company**" means any company that at the time of the acts or omissions of that company, was owned by or had more than 50% of its issued shares held by another company, which other company, at any time received a benefit from, or by reason of the existence of the company";*

*"**successor company**" means any company that succeeds to the parent company either by acquisition of a majority of shares of the parent company, or is assigned by the parent company or otherwise receives a benefit from the existence of the subsidiary company that the parent company would have received; or is incorporated by the parent company for the purpose (whether it be the sole purpose or otherwise) of avoiding liability of the parent company for the acts or omissions of the subsidiary company or any acts or omissions of the parent company;*

xx)

a) If any person suffers any injury as a consequence of acts or omissions of a subsidiary company, and is unable to recover damages for that injury from the subsidiary company, or from any insurer of the subsidiary company pursuant to Section 601 AG or otherwise, then the person (hereinafter "the applicant") may recover the amount of such damages from the parent company of the subsidiary company, or from any successor company of the parent company.

b) For the purpose of giving effect to the recovery of damages referred to in (a), the applicant may:

i) proceed to enforce any judgment obtained by the applicant from the subsidiary company against the parent company or any successor company as if the judgment against the subsidiary company was a judgment against the parent company or the successor company;

ii) proceed against the parent company or any successor company in any proceedings brought in relation to the acts or omissions, if it appears that the subsidiary company will be unable to satisfy any judgment ultimately obtained against it by the applicant.

c) In any proceeding of the kind referred to in b) i) brought by the applicant against the parent or any successor company, any acts or omissions of the subsidiary company are to be regarded as acts or omissions of the parent company and any successor company, and any judgment, but for the apparent inability of the subsidiary to satisfy such judgment, that might have been entered against the subsidiary, may be entered and enforced against any parent or successor company.

Such a scheme - a statutory piercing of the corporate veil - may be regarded as somewhat radical, but it is unlikely to be often required, as historically judgments for injuries are likely to be satisfied by tortfeasors or their insurers. But it does provide the comfort in situations of which the present James Hardie case is an exemplar that an injured person, their family or dependents will not go uncompensated for corporate misconduct because of the inability of the subsidiary to meet its obligations. Where a parent or successor corporation has control over the subsidiary and has received a benefit from having the structure in place, we consider that most in the community would regard it as fair that the liability flows up (and if necessary along) the corporate chain.

Were it otherwise, then the ability for a corporate group to restructure itself to avoid liabilities is too easy, or only becomes subject to injured creditors through the problematic blunt instrument of insolvency law.

WHO WE ARE

Background

The Australian Lawyers Alliance is the only national association of lawyers and other professionals dedicated to protecting and promoting justice, freedom and the rights of individuals. We have some 1,500 members and estimate that they represent up to 200,000 people each year in Australia. We promote access to justice and equality before the law for all individuals regardless of their wealth, position, gender, age, race or religious belief. The Lawyers Alliance started in 1994 as the Australian Plaintiff Lawyers Association, when a small group of personal injury lawyers decided to pool their knowledge and resources to secure better outcomes for their clients – victims of negligence.

Corporate Structure

APLA Ltd, trading as the Australian Lawyers Alliance, is a company limited by guarantee that has branches in every state and territory of Australia. We are governed by a board of directors made up of representatives from around the country. This board is known as the National Council. Our members elect one director per branch. Directors serve a two-year term, with half the branches holding an election each year. The Council meets four times each year to set the policy and strategic direction for the organisation. The members also elect a president-elect, who serves a one-year term in that role and then becomes National President in the following year. The members in each branch elect their own state/territory committees annually. The elected office-bearers are supported by ten paid staff who are based in Sydney.

Funding

Our main source of funds is membership fees, with additional income generated by our events such as conferences and seminars, as well as through sponsorship, advertising, donations, investments, and conference and seminar paper sales. We receive no government funding.

Programs

We take an active role in contributing to the development of policy and legislation that will affect the rights of the injured and those disadvantaged through the negligence of others. The Lawyers Alliance is a leading national provider of Continuing Legal Education/Continuing Professional Development, with some 25 conferences and seminars planned for 2005. We host a variety of Special Interest Groups (SIGs) to promote the development of expertise in particular areas. SIGs also provide a focus for education, exchange of information, development of materials, events and networking. They cover areas such as workers' compensation, public liability, motor vehicle accidents, professional negligence and women's justice. We also maintain a database of expert witnesses and services for the benefit of our members and their clients. Our bi-monthly magazine *Precedent* is essential reading for lawyers and other professionals keen to keep up to date with developments in personal injury, medical negligence, public interest and other, related areas of the law.

1 May 2006

Mr John Kluver
Executive Director
Corporations and Markets Advisory Committee
GPO Box 3967
Sydney NSW 2001

Dear Mr Kluver

Provisions for mass future claims for personal injury

I refer to your letter of 31 March 2006 seeking the ICA's assistance in relation to the Committee's investigation of a proposal to require external administrators to admit and make provision for mass future claims for personal injury.

In particular, you indicate that one of the key prerequisites for the proposal to apply is that it must be possible to estimate the extent of a company's liability under such claims.

Obligations on Insurers

As you correctly note, similar estimates are in fact required when insurance companies make provision for outstanding claims. Section 28 of the *Insurance Act 1973* requires insurance companies to hold assets in Australia of a value that is equal to or greater than the total amount of its liabilities in Australia. An insurance company that breaches this requirement commits a serious criminal offence.

The Australian Prudential Regulation Authority has published Prudential Standard GPS 210 in order to establish a set of principles for the consistent measurement and reporting of the insurance liabilities of general insurers. The Prudential Standard is supported by Guidance Note GGN 210.1, which provides further information in relation to the valuation of general insurance liabilities.

The Role of Actuaries

GPS 210 requires the Board of an insurance company to have an Approved Actuary, and to obtain written advice from the Approved Actuary on the valuation of its insurance liabilities. Hence, insurance companies now rely on the work of their Approved Actuary when determining the appropriate amount to be provided for in relation to the outstanding insurance liabilities of the insurer.

The Institute of Actuaries of Australia has issued Professional Standard 300 relating to Actuarial Reports and Advice on General Insurance Technical Liabilities. This Professional Standard provides further guidance on the calculation and presentation of the assessment of outstanding claims liabilities.

I note the Institute of Actuaries has provided a submission to CAMAC entitled Treatment of Future Unascertained Personal Injury Claims. This submission is very helpful in identifying a number of important issues relating to the assessment of potential future claims liabilities. In particular, the submission helpfully outlines a number of the uncertain events that can have an impact on this assessment.

Proposal

For the purpose of completeness, it is worth noting the proposal set out in the correspondence attached to your letter. Attachment A 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."

When does a liability arise?

The general law and a number of statutory provisions create potential liability in circumstances where a company's action or product gives rise to personal injuries or death. In addition to the broad range of remedies in tort, Part VA of the *Trade Practices Act 1974* creates a range of important remedies against manufacturers and importers of defective products. A person who has suffered personal injury may have other remedies under other provisions of the *Trade Practices Act*.

These obligations and remedies exist today in respect of all goods and products. There are however, goods and products in broad use within the community which, at the present time, are not the subject of claims, but which may become the subject of claims at some point in the future. An example is mobile telephones. If science shows that they do in fact cause injury, an existing legal obligation will be triggered, even though there is no expectation today that there is or may be a legal exposure in relation to this product.

The second aspect of legal liability is that, in general terms, it arises when a cause of action accrues. It is therefore important to understand, and be able to measure with some degree of confidence, whether and when causes of actions are accruing against a company. In the case of frank injuries and trauma, the date of the cause of action is usually clear, and provision for the claim can be made with a degree of confidence. In the case of gradual onset disease, the timing of the cause of action (and hence the need to make some provision for the cost of the claim) can be more difficult to establish. This was an issue in the case of *Orica Ltd v CGU Insurance Ltd* (2004) 13 ANZ Insurance Cases ¶61-596.

I presume from the terms of the proposal set out above that there will need to be "an exceptional number" of existing claims and likely future claims. This will mean that legal liability issues should be reasonably clear, in terms of the initial duties of the company and the existence and causes of personal injury claims, and that no provision will need to be made for claims that may arise at some time in the future but where no known cause of action currently exists.

Measuring exposure

The assessment of outstanding liabilities now involves a careful examination of a number of key factors.

Firstly, there must be some understanding of the nature and extent of the level of exposure. In other words, how many products were sold that might give rise to an injury and subsequently to a claim? In compulsory third party motor vehicle insurance (CTP), the exposure measure is the number of registered motor vehicles. In workers compensation, the exposure measure is often the volume of wages.

Secondly, there needs to be a system of measuring the number of injuries arising out of the use of the product. In some areas, there are good statistics of this nature, in other areas the available information can be very limited.

Thirdly, there needs to be an examination of the number of injuries that give rise to a claim for compensation. This can be measured either in its own right (ie trends in the number of claims being made against a company) but it is often expressed as a claim frequency. For CTP, the claim frequency might be 4.5 claims for every 1,000 vehicles; for workers compensation the claim frequency might be 1.5 claims per $million of wages. If a company is regularly receiving "x" number of claims for every "y" volume of production, this is a very useful indicator of the likely number of claims that will be made against the company in the future.

Claim frequency is an important factor in the calculation of outstanding claims liabilities. Actuaries measure known claim frequency as accurately as possible, and then extrapolate 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, and can therefore be fraught

with danger and subject to considerable uncertainty, particularly if past trends do not prove to be an accurate indicator of future experience. Only actual experience can confirm whether the projections were accurate. The submission to CAMAC from the Institute of Actuaries of Australia discusses these elements of uncertainty very well.

The fourth element is the cost of claims, invariably expressed as the average cost of claims. Once again, actuaries measure known claims costs as accurately as possible, and then extrapolate trends in claims payments according to the number, nature and timing of expected future claims.

The level of compensation being awarded over time can and does vary, and actuaries need to take account of any known or likely legal developments relating to the assessment of damages when calculating the likely cost of claims.

I note that the proposal being considered by CAMAC presumes "an exceptional number" of claims have already been made. This should give some comfort to actuaries asked to measure a potential outstanding claims liability. It is possible, however, for a number of developments to occur which can influence the reliability of the estimate. Once again, these uncertainties are discussed very well in the Institute of Actuaries submission.

When undertaking assessments of this nature, a number of important assumptions must be made regarding likely future experience. When forming judgments of this nature, the actuary will certainly take account of directly available and relevant statistics, but will also take account (where relevant) of related information from similar types of claims against other companies, either in Australia or, if necessary, overseas. These are very much matters of judgment, though, and as noted previously, only actual experience will indicate whether the judgments, assumptions and projections of the actuary have been accurate.

Conclusion

The assessment of outstanding claims liabilities can be undertaken with a degree of confidence if there is a consistent body of previous claims experience, and the trends in claim numbers and claims payments are reasonably consistent over time. The greater the degree of variation in trends, the more uncertain any projections of likely future experience will be.

For this reason, APRA requires an insurance company's approved actuary to value insurance liabilities with an additional degree of confidence being built into the valuation. Initially, the actuary will derive a "central estimate" of the outstanding liability (which means that there is just as much chance of the estimate being more than adequate as there is of the estimate being less than adequate). APRA requires insurance liabilities to be assessed with a minimum probability of sufficiency of 75% (which means that there must be a 75% probability that the estimate will be adequate, and less than 25% chance that the estimate will be inadequate). Many insurance companies assess future liabilities at 90% probability of sufficiency.

CAMAC may wish to consider whether a requirement should be imposed whereby future claims liabilities are assessed at greater than the central estimate, and in particular whether the assessment of liabilities of this nature should be undertaken generally in accordance with APRA Prudential Standard 210 to the extent to which it is relevant.

Please do not hesitate to contact me if you or the Committee would like to discuss any of the material set out in this letter.

Yours sincerely

Dallas Booth
Deputy Chief Executive

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The Institute of Chartered Accountants in Australia (Institute) appreciates the opportunity of providing Comment to the Corporations and Markets Advisory Committee (CAMAC) on its Current Review of Long-Tail Liabilities. As a general principle the Institute supports the principle Proposal for reform of the Corporations Act that: Provision be provided by a Company that is subject to a mass future claim subject to the specified protections contained in the Proposal being;

- there are an exceptional number of personal injury claims; more claims are expected; and
- either the Company has been subject to an unusually high number of claims; or there are other Industries or companies that have been subject to similar claims; and
- there is the strong likelihood of numerous future claims of this type.

The Institute supports the Comments made in particular by Chartered Secretaries Australia and the Business Council of Australia that there needs to be a balance struck between existing Shareholders and Creditors compared to potential Claimants of the mass future claims, particularly given the challenges in estimating at any one point in time, the likely commercial exposure for payment of future mass claims.

The Institute acknowledges the importance of obtaining on-going expert advice on the calculation of the quantum of expected mass future claims and in particular the role that the Actuarial Profession has in the estimation process. There are existing Standards that would have some relevance for such Claims including the Australian Prudential Regulatory Authority's (APRA) Prudential Standards - PS 210 Liability Valuation of General Insurers (GPS 210), The Institute of Actuaries (IAA) Professional Standard 300 'Actuarial Reports and Advice on General Insurance Technical Liabilities' (PS300), and the Australian Accounting Standards Board's (AASB) AASB 1023 'General Insurance Contracts' and AASB 137 'Provisions, Contingent Liabilities and Contingent Assets', both of which are presently under review by the International Accounting Standards Board (IASB).

From an Accounting perspective AASB 137 requires Provisions to be recognised as a Liability on the Balance Sheet where the amount of the Liability is probable and is able to be measured with reliability. Contingent Liabilities which are required to be disclosed in the Financial Statements but not included on the Balance Sheet, are defined in part as Liabilities that are not yet 'probable' or cannot be measured with sufficient reliability. The IASB has proposed changing these Definitions so that a Liability would be the amount at which a Company could pay an External Party to take over the Obligation (future mass claims). However there is strong debate on this Issue which is yet to be resolved.

Either way, the Actuarial Profession would be relied upon to estimate the amount of the future mass claims, and the Accounting treatment would then follow, probably by way of a specific Liability (Provision) and disclosure of additional information around the estimation process.

As detailed in the IAA’s Submission, "...it should always be possible to place a reasonable, albeit uncertain, estimate on its value.". The Institute agrees with the IAA’s Conclusion: "...that it would not be desirable to make 'reasonable estimation' part of the criteria for protection. If the liability exists and its value is material, then a genuine attempt to protect claimants' interests should be made.".

AICD **Policy & Advocacy**

AUSTRALIAN INSTITUTE OF COMPANY DIRECTORS
ABN 11 008 484 197

Submission

to

Corporate and Markets Advisory Committee

on

Long-Tail Personal Injury Claims

22 December 2006

AUSTRALIAN INSTITUTE OF COMPANY DIRECTORS
ABN 11 008 484 197

Australian Institute of Company Directors

Australian Institute of Company Directors (AICD) is the peak organisation representing the interests of company directors in Australia. Current membership is over 21,000, drawn from large and small organisations, across all industries, and from private, public and the not-for-profit sectors. Membership is on an individual, as opposed to a corporate basis.

AICD has seven State divisions, each of which is represented on the AICD Board. Overall governance of the AICD is in the hands of its Board which is comprised of the seven Division Representatives, the Chair, three National Directors and the CEO.

AICD has several national policy committees, focusing on issues such as law, accounting and reporting and corporate governance.

The key functions of AICD are:

- to promote excellence in director's performance through education and professional development
- to initiate research and formulate policies that facilitate improved director performance
- to provide timely, relevant and targeted information and support services to members and, where appropriate, Government and the community
- to maintain a member's code of professional and ethical conduct
- to uphold the free enterprise system
- to represent the views and interests of directors to Government, regulatory bodies and the community
- to develop strategic alliances with relevant organisations domestically and internationally to further the objectives of the AICD.

AUSTRALIAN INSTITUTE OF COMPANY DIRECTORS
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Long-Tail Personal Injury Claims

1. Overview

1.1 This submission is provided by the Australian Institute of Company Directors (AIDC) in relation to a reference on the treatment of future unascertained person injury claims from the Parliamentary Secretary to the Treasure to the Corporations and Markets Advisory Committee dated 12 October 2005 (Reference).

1.2 Regulation of corporations which are required to account for provisions in respect of actuarially certain future mass claims exposures to take account of those provisions may be appropriate in some specifically defined circumstances. However, the legislation should provide genuine guidance and certainty to directors in terms of its application and what must be done to comply with it. The currently proposed threshold test is too uncertain and onerous to be applied.

1.3 Corporations which may be subject to the mass future claims regime should still be able to reasonably and responsibly manage their capital consistently with modern market expectations.

1.4 The proposed prohibition on intentional avoidance is too broad and would not be appropriate in respect of a threshold test as proposed. Any such provision must be very clear in its operation and be based on a demonstrated need to specific legislative provision.

1.5 Whilst the inclusion of future creditors to participate in formal insolvency situations is consistent with notions of basic fairness, the inclusion has significant consequences for insolvency administrators and creditors. The potentially very significant costs and delays that will be occasioned must be considered carefully, together with how the inclusion of such a class will affect the ability of a company to undertake a reasonable and responsible restructuring of its affairs.

2. Would the proposed reforms unduly compromise current corporate law and insolvency principles?

2.1 The key proposed reforms would significantly alter the policy of the Corporations Act 2001 (Act) towards the assessment of the solvency of corporations in particular circumstances and for particular purposes. The alterations are proposed

to affect the general creditor protections provisions identified in the reference (i.e. ss. 256B, 257A and s 563A) and for the purposes of external administration. Persons having no present right of action against a company for damages are not creditors (actual, prospective or contingent), though actuarial opinion is that claims will emerge in the future.[1] It is clear that the Reference does not propose a definition of creditor for the purpose of the whole of the Act which would include a potential future claimant in circumstances where actuarial opinion is that such claims will emerge.

2.2 The proposed reforms would have a very significant effect on both liquidations and administrations, altering the long standing position that only creditors may participate in either. The legislation would create an unknown and unspecified class of person who would be entitled to participate through a nominated person.

3. The preliminary test – "mass future claim"

3.1 If a reform proposal of the nature contemplated by the Reference were to be put into effect, it is most desirable that it provides genuine guidance and certainty to a board both in determining whether the provisions apply to any particular company and, if so, what must be done to comply with the legislation.

3.2 The test for "mass future claim" proposed in the Reference is very complicated. It would potentially require a company to make extensive enquiries which may not provide reliable information on which to form an opinion as to whether a "future mass claim" situation exists.

3.3 The key concepts from the proposed threshold test include an "*unusually high number of claims for payment*" in respect of personal injury against the company or more than one company of a "*similar industry*" or with "*similar business operations*" to the company and a "*strong likelihood of numerous future claims*" of that type.

3.4 The most immediately noticeable feature of the suggested key concepts is that they involve the determination of a number of differently described opinions (eg. "*Unusually high*", "*similar*", "*strong likelihood*"), which could be the subject of different views and potential dispute, rather than an easily determinable objective criteria. Further, to form a view about whether the proposed definition might be met would potentially require significant investigations to be made of matters not within the knowledge of any particular company as to the nature of claims against other companies and the nature of the "*industry*" or "*operations*" of other companies.

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[1] See *Edwards v The Attorney-General* [2004] NSWCA 272 – though the position in the United Kingdom is a little more generous, at least for some purposes : see *In the matter of T&N Ltd* [2005] EWHC 2870

3.5 It is further proposed that the threshold test will not be met in cases where 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*". In basic conceptual terms, these provisos do appear to identify the type of situation in which a company should not be subject to the regulation of the kind proposed. But these qualifications illustrate the inefficiency of the principal key concepts suggested for the threshold determination, and involve further matters of opinion. They do 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.

3.6 It will be quite difficult, and potentially onerous or oppressive, for directors to determine whether the preliminary test is met on the conceptual basis proposed. In short, the proposed preliminary test appears be too complicated and difficult to apply.

3.7 This lack of certainty will add to the inherent difficulties for directors and officers in determining whether a company is trading solvent or otherwise. It makes a strong case for the extension of the business judgement rule in the form of s180(2) of the Act to the insolvency provisions applying to directors and officers in that Act. The introduction of a 'safe harbour' will not excuse directors and officers from liability where they are clearly in breach. However, it provides a framework against which sensible business decisions can be made if directors and officers comply with the criteria. We understand that the Federal Treasurer will release in early 2007 a discussion paper on penalties for breach of directors' duties. We intend to recommend an extension of the business judgement rule to the relevant solvency provisions of the Act.

3.8 The question then is whether (assuming that reform intended to provide regulation in the situation of a company with significant prospects of future claims is considered appropriate) a clear and simple definition could be formulated which could be applied without undue difficulty and incurring significant costs.

3.9 In this context, Accounting Standard AASB 137[2] presently requires disclosure of provisions in respect of a "contingent liability".[3] Paragraph 86 provides:

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[2] Accounting Standard AASB 137 July 2004 Provisions, Contingent Liabilities and Contingent Assets.

[3] For the purpose of the standard the term "contingent liability" is wider than the recognised legal operation of that term: cf. *Edwards v Attorney-General {2004} NSWCA 272 [check reference]*

"*Unless the possibility of any outflow in settlement is remote, an entity shall disclose for each class of contingent liability at the reporting date a brief description of the nature of the contingent liability and, where practicable:*

(a) an estimate of its financial effect, measured under paragraphs 36-52;

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

(c) the possibility of any reimbursement."

3.10 In this regard a "*contingent liability*" is defined by clause 10 as:

"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 future events not wholly within the control of the entity".

3.11 Hence, a review of AASB 137 discloses that companies subject to the Accounting Standards are already required to consider and make provisions for the best estimate of the present amount required to settle future personal injury claims.

3.12 If there is to be a definition of "future mass claim" which requires an opinion to be formed on the basis of a specified test or formula, then it is desirable that the test should be consonant with the relevant accounting standards. At present, the requirements contained in AASB 137 to disclose the company's best estimate of the amount required to make a current financial settlement of the "possible obligations" may provide a better framework than a complicated and legalistic notion of "mass future claim". The test is simpler, and can be made on the basis of the information available to the company at the relevant time.

3.13 However, the reform proposal is intended to deal with the limited circumstances of mass future claims. It is most likely that companies which are subject to those circumstances will operate in industries which have become publicly identified with the risk of mass future claims (eg the sale of asbestos products). A far more appropriate way of regulating particular industries at risk of mass future claims would be through the formal identification of those particular industries: i.e. by prescription through regulation which clearly and specifically identifies industries or products which the government considers are appropriate to be subjected to such regulation.

4. Extension of existing creditor protection

4.1 In considering the Reference, it is suggested that regard should be had to the following notions:

(a) It must be regarded as being clearly in the best interests of future personal injury claimants that companies which have potential exposure to such claims continue to trade and have the resources to meet claims as they develop. The regulatory environment should not unduly discourage this

(b) Any regulation should not inappropriately impact on the ability of such a company to manage its capital, consistently with modern expectations of capital management

(c) The need to provide genuine guidance and certainty to companies and their boards in managing the affairs of a company which may be the subject of a regulated future mass claim situation

4.2 It is desirable for such legislation to operate cohesively with the relevant accounting standards (eg AASB 137). In this context we note 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.[4]

4.3 The proposal contained in the Reference appears to suggest that companies subject to a future mass claim would be restricted from entering into transactions which might adversely affect their share capital such as reductions of share capital (s 256B of the Act) and share buy-backs (s 257A of the Act). A complete prohibition on capital management would severely affect such companies, and is not appropriate.

4.4 Similarly, the proposal may affect the payment of dividends out of profits which is provided for by s 245T of the Act.

4.5 However, 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. Prohibition on Intentional Avoidance

5.1 The existing creditor protection provisions which are proposed to be extended are not the subject of any specific reinforcement by criminal sanction. There does not appear to be a need for a specific provision of the type contemplated.

5.2 A prohibition of this kind should not be imposed unless there is a clear need for it. That is, the other more general provisions of the Act are insufficient. Nor should it be applied unless the threshold test is very clear.

[4] Cf the Submission to the Corporations and Markets Advisory Committee by the Institute of Actuaries of Australia in relation to the Reference, paragraphs 30-32; AASB 137

5.3 There is potential for routine arrangements to be entered into by a company with a view to ensuring that claims against it are minimised: e.g. for the defence of litigation or the investigation of claims (though the categories are not closed). If such a prohibition is to be implemented it should only catch transactions made with the intent (sole or dominant) of defeating future creditors. It would achieve no more than current legislative provisions such as s 37A of the *Conveyancing Act* (NSW), which sufficiently deals with transactions made with the intention of defeating or delaying creditors (including future creditors).

5.4 The prohibition is suggested to apply to "not just directors or other companies in a group, but also … any person who is a party to the transaction of arrangement". It is important that competent advisers to companies which might be the subject of a mass future claim are not deterred from acting for such companies because of the risk of potential personal liability – it is in the public interest that such companies get good advice. The creation of a low-threshold accessorial liability should be carefully considered, and may not be desirable.

6. External Administration

6.1 The third aspect of the proposal is to extend the definition of creditors for the purposes of administration and liquidation to include a class of mass future claimants (being a class who cannot be specifically identified).

6.2 Such a proposal raises issues which include:

(a) The assessment of the value of the claims of future mass creditors

(b) How to distribute funds when the body of creditors is fluid both as to identity and quantum

(c) The prejudice to non-mass future claims creditors

(d) The delay in finalising insolvency administrations and the costs involved in the administrations

(e) The information and resources available to a liquidator or administrator.

6.3 There is a policy case for the recognition of future creditors in liquidation. If they are not recognised, they will be paid nothing – the funds will be distributed and the company dissolved before many of the claims may mature. However, the inclusion of such creditors within such an administration will potentially involve a very significant (and difficult to quantify) cost to the other creditors in terms of increased costs of administration, delay in distribution and decreased dividends.

6.4 The inclusion of such claimants into the class of creditors who may participate in an administration or liquidation should also provide for suitable mechanisms to allow the early crystallisation and assessment of such claims to permit a liquidation to be completed within a reasonable time and also to facilitate the restructuring of the affairs of financially distressed companies in the interests of all creditors.

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