Insolvency Practitioners' Association of Australia

16th National Conference

Official Opening Address by

The Honourable Wayne Martin
Chief Justice of Western Australia

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Burswood Entertainment Complex

It is a great pleasure and an honour to have been invited to provide some brief observations at the opening of this important national conference of insolvency practitioners.

I would like to commence my remarks by paying my respects to the traditional owners of the lands on which we meet - the Wadjuk people who form part of the great Noongar clan of south-west Western Australia, and by paying my respects to their Elders past and present.

We meet today quite close to the banks of the Swan River. Those of you who are not from Perth may not know that this river, and the other water ways in the region, are the home of the Wagyul, a water serpent of great significance in Dreaming, or creation, stories, of the Aboriginal people in this region. So we meet in a place of particular significance to the original inhabitants of this land.

Cynics might also suggest that it is peculiarly appropriate for a national conference of insolvency practitioners to be held in a casino complex, in which fortunes can be made and lost in a very short period of time, given the frenetic rate of fluctuation in our economic fortunes over the last 12 months or so. However, for reasons which I will endeavour to develop shortly, the relatively strong position in which Australian financial institutions and businesses find themselves, by comparison to international counterparts, is more likely to be the product of sound policy and regulatory decisions made over the last decade or so, than the random chance of a rolling roulette wheel.

But before I come to that, might I welcome our many interstate guests to Perth. I sincerely hope that you enjoy the many amenities which our city has to offer, in the limited time permitted outside your challenging conference schedule.

I also hope that you get the opportunity to interact with Western Australian business people. If you do, I think you will discover that, while it would be foolish to deny that Western Australia will be adversely affected by the global economic downturn, there is a sense of cautious optimism of a return to more buoyant conditions in this State. I am not an economist, and I haven't conducted a survey, but if you look around our city, you will see a lot of cranes on our skyline. When I was in the Pilbara two weeks ago, there was no sign of any recession. The major challenge confronting the major centres in that region - Karratha, Port Hedland, Newman and, soon, perhaps Onslow, is the continuing problem of providing the accommodation, services and infrastructure required by a continually expanding workforce. So perhaps, regrettably for insolvency practitioners, while the current economic climate has its challenges, all is not gloom and doom in the West. I would encourage you to look for any optimistic signs while you are here, because, of course, economics is one field in which confidence, or lack thereof, shapes reality.

I would also like to congratulate the organisers of the conference for having assembled such a distinguished group of speakers who will speak on such an interesting range of topics. Your conference will address the big issues, including the impact of the global downturn on insolvency practice, and the impact which the new economic environment has on vital decisions concerning insolvency administration, informed by particular case studies such as the collapse of ABC Learning. In addition, detailed guidance on complex issues of insolvency law and practice will be provided through a series of master classes. Important subjects which will be addressed include the new world of personal property securities, anti money laundering and counter-terrorism financing legislation, and the intersection between personal insolvency and family law. And no conference in Western Australia could be complete without a section dealing with the resources sector which I hope might provide some of the cautious optimism to which I earlier referred.

Current Trends

Obviously, the global downturn in economic activity makes this a particularly pertinent time to hold a conference dealing with insolvency practice. That proposition is easily illustrated by some of the statistics dealing with personal and corporate insolvencies, which I will address shortly.

A less direct measure of the extent of changing economic fortune is provided by the statistics relating to lodgements in the various Supreme Courts of Australia. That is because our business is counter-cyclical, so that when the economy goes down, our business goes up – perhaps a bit like your own. In our court over the last 12 months, the number of new lodgements is 57% higher than over the preceding 12 months. Much of this increase is due to the increase in repossession actions. In the 12 months ending April 2008, 624 actions for repossession of land were commenced in our court. Over the 12-month period ending March 2009, that figure increased to 1,235, an increase of 97.9%. These figures provide a graphic index of the impact which the economic downturn is having upon the lives of ordinary Western Australians. Many of those numbers represent a person, or a family who have lost the right to occupy their home, or their business premises.

Personal Insolvency

A recent paper by Professor Ian Ramsay and Cameron Sim provides a very helpful analysis of trends in personal insolvency over the last 20 years.[1] That study noted that in 1990, there were 9,113 personal insolvencies, whereas in 2008, there were 32,865 - an increase of 261%. Over the same period, the population of Australia increased by only 24%. In 1990, 0.05% of the Australian population was in personal insolvency, compared to 0.15% in 2008.

In addition to the disproportionate increase in the amount of personal insolvency, Ramsay and Sim noticed some interesting trends in the nature of personal insolvency in Australia - most particularly, its increasing application to the middle class, and to older Australians. In 1999, about 11% of bankrupts came from the occupational group classified as "Managers and Administrators, Professionals, and Associate Professionals", whereas in 2008, about 27% of bankrupts came from that occupational group. A similar trend was noted in debt agreements and Part X arrangements.

The percentage of bankrupts in employment has also increased significantly. In 1997, 33% of bankrupts were employed, compared to 56% in 2007. Over the same period, the ratio of debt agreement debtors in employment went from 63% to 92%.

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[1] Ramsay and Sim - Trends in Personal Insolvency in Australia, - Centre for Corporate Law and Securities Regulation - University of Melbourne - 2008.

A similar trend was noted in relation to levels of personal and household income. In 1997, 37% of bankrupts had personal income less than $10,000 and 13% had personal income of $30,000 or more. In 2007, 15% of bankrupts had personal income less than $10,000 and 38% had personal income of $30,000 or more. In 2002, 28% of bankrupts had household income of $30,000 or more compared to 49% in 2007.

And bankrupts are getting older. In 1997, 26% of bankrupts were 45 years or older, whereas in 2008, about 45% of bankrupts fell within that age group.

These figures lend ample support to the authors' conclusion that over the last 20 years, bankruptcy has become an increasingly middle class phenomenon, affecting an older group within our society.

There have also been changes in the causes of personal bankruptcy. In 1991, 32% of bankruptcy was business related, and 68% non-business related. By 2008, 18% of bankruptcies were business-related, and 82% non-business related. In 2008, 28% of all bankruptcies were caused by excessive use of credit, 12% by ill health, and 4% by gambling or speculation.

In terms of geography, in 2008, New South Wales, Queensland, South Australia and Tasmania each had a greater percentage of Australia's bankruptcies than their percentage of the Australian population, whereas the ACT, the NT, Victoria and WA were under-represented in bankruptcies. WA had about 5.5% of Australia's bankruptcies, whereas we have a bit over 10% of the national population.

Corporate Insolvency

Predictably enough, the same numerical trend is seen in corporate insolvencies. March 2009 saw more companies entering external administration in Australia (1,095), and more insolvency appointments (1,590) than any month of 2008. And when 2008 is compared to the year 2000, as with personal insolvencies, a significant increase is noticed. In the year 2000, 4,922 companies entered external administration, compared to 9,113 in 2008 - an increase of 85%. In 2008, there were 14,173 insolvency appointments, compared to 8,258 in 2000 - an increase of 72%.

Corporate Excess

The last 12 months or so have seen the collapse of a number of significant corporate entities. One collapse which profoundly affected a large number of Australians was the collapse of ABC Learning, and as I have mentioned, your conference will be receiving a paper on that subject tomorrow morning. Although those collapses have had a significant impact upon many Australians, they do not appear to have been associated with the same profligate corporate excess, reckless risk taking and corrupt accounting practices as some earlier notable collapses. The collapse which exemplifies those characteristics, and with which I am most familiar, is the collapse of the HIH Insurance Group. I would like to briefly share with you some of the experience which I gained as Counsel Assisting the Royal Commission into that collapse.

The collapse of that Group is generally thought to have been the largest collapse, in dollar terms, in Australia to date. The collapse occurred at about the same time as a number of other major collapses which had profound ramifications for Australian consumers, including Harris

Scarffe, Ansett and One-Tel. This rash of unexpected major collapses at a time of apparent economic prosperity took many by surprise, and properly focused community attention on the soundness of our mechanisms and structures of corporate governance.

HIH was Australia's second largest general insurer. The ramifications of its collapse were extensive. Almost nobody in the community was immune to its consequences. Because it dominated the market in the provision of builders' warranty insurance, many building projects around the country were stopped overnight and new projects were delayed while other insurance was obtained. Many were put out of work in the building industry and in the many industries that supply that industry. Some of those stoppages endured for up to two months. People who had been seriously injured and who depended on insurance payments for their very survival were thrown on to the meagre benefits provided by social welfare. Even people who had no direct dealings with HIH were seriously disadvantaged - one example being the farmers in the wheat belt of this State whose claim against the local Shire for damages arising from a fire which spread from the local tip went unresolved for a very long time, largely because the Shire, in common with many local government bodies around the country, was insured by HIH.

The question which jumped to a lot of people's lips was "how could this have happened?" HIH had all the apparent trappings of success - large and opulent corporate offices in every State, a fabulous programme of entertainment, gifts, donations and corporate sponsorship. Its CEO was feted as one of Australia's most successful self-made men. Perhaps even more significant than these superficial indicators, was the fact that it had a Board of Directors composed of highly regarded, senior and experienced representatives of the business, legal and accounting communities. It was audited by a highly respected accounting firm - one of the then big five, although its later demise has left us with the big four. The provisions it made for future claims liabilities were the subject of advice from a number of actuaries, and perhaps most significantly of all, it operated in an industry which is subject to the most intensive form of prudential regulation available in Australia, by a recently created and apparently well credentialed regulator - namely, APPRA. So what went wrong? Why did all the mechanisms that are supposed to reduce the risk of this kind of collapse apparently fail?

Now of course Justice Owen has delivered a lengthy three-volume report answering that question in great detail. It would try your attention if I were to try to cover in any meaningful way the broad ground which he has covered in that report.

But the main reasons for the collapse of HIH might be pithily summarised by drawing upon the well-known analogy - "a fish rots from the head". Although HIH had firmly in place all the traditional governance structures including a well-credentialed board, an audit committee, independent auditors and actuaries, the best legal advisors a lot of money could buy and so on, all of those checks and balances failed because of an undue focus upon the letter of the law (although in a number of instances that was also breached), and a failure to give any thought whatsoever to the purpose or objective of the law, or the moral component of the issues which they were addressing. And what struck me perhaps most profoundly, was that although the fish had undoubtedly started to rot at the head, by the time the liquidators were called in, the rot had spread through almost all levels of the corporate group, infecting officers at relatively junior levels, whose key focus was almost always upon whether or not they could get away with what they were doing, rather than upon whether or not what they were doing was right.

Let me try and give you some indication of the dimensions of this problem with some admittedly superficial examples. The profligate expenditure of the Managing Director, unchecked by the Board, set an appalling example of irresponsible leadership. He spent $380,000 of the company's money buying gold watches. He provided an unsecured and interest-free loan from the company to a friend in an amount of $500,000. He gave $1,600 worth of cigars to that man, purchased by the company, at the time the loan was outstanding and no interest was being paid on it. In the last year before the company collapsed, he organised a company Christmas party in Sydney that cost $800,000. He was regularly giving away about $5 million per annum of the company's money to charities of his choice, most of whom reflected his generosity with other people's money by bestowing honours and accolades upon him personally.

It was in that context that a story emerged which is perhaps one of the best known of the Royal Commission. The Managing Director to whom I refer was Mr Ray Williams, although he had taken to calling himself Dr Williams in light of the honorary doctorate conferred by Monash University after he gave large amounts of HIH's money to that university. The amounts expended on travel by him and the other senior executives of the company were extraordinary - there was never any question but that they and their wives would travel, at company expense, in the best available class. Michael West, who as you may know, is a journalist writing for *The Australian*, produced a tongue-in-cheek piece in which he suggested that I had cross-examined Mr Williams to the effect that when he traveled internationally he had always traveled with a companion called Casey Williams, for whom he had also purchased a first class ticket, so that he could put his briefcase on the seat next to him, when his wife wasn't traveling with him. That story was converted into an email which spread like wildfire, and has now translated itself into mythical transcript which exists on a number of websites. But unfortunately I have to tell you that none of its true. So, the irony of it is that my role in that Commission will probably be best remembered for a line of cross-examination which never took place!

Now you might say that I am being a bit petty by criticising these personal extravagances, when obviously they were not of an order of magnitude which could have caused Australia's largest commercial collapse, leaving a deficit of many billions of dollars. And of course that's right. And nor were the extravagances to which I refer illegal. But the lack of respect for proper systems of governance, and the lack of a proper sense of stewardship of the shareholders' funds, came to characterise the major business decisions made at the most senior levels of the company, and also spread like an internet virus through all levels of the company.

At the senior levels, a number of utterly disastrous decisions were taken without proper due diligence and evaluation. They included undertaking major reinsurance business in the UK, embarking on a disastrous insurance venture into the US and another into China, and the acquisition of FAI. At lower levels in the company, it included writing what was described as film insurance, which was in fact a form of underwriting the profitability of film ventures in circumstances where the underwriters had no idea what the film was, or as to its likely profitability. That ill-fated venture lost over $100 million. At even lower levels still, it extended to providing insurance against a particular outcome in the European Football Cup, which is of course nothing more than gambling; the provision of personal injury insurance to members of the Taiwanese Military Forces at a time of extraordinary tension between Taiwan and China; and the provision of reinsurance to Israeli motor vehicle insurers at a time when terrorism in that country was having a significant impact on motor vehicle damage. So you can see that although this fish started rotting at the head, the rot spread through the major organs and riddled the flesh. And the mortal illness was concealed from shareholders and investors by the adoption of accounting techniques most but not all of which were legal, but unethical and immoral. Although those accounting techniques differed in detail from those adopted in the United States by Enron, they were implemented by people who had the same lack of commitment to disclosure of the truth in both instances. They might have been the smartest guys in the room, but they didn't have a moral compass.

Thankfully, we don't seem to have seen the same profligate excess, reckless indifference to risk and corrupt accounting in more recent collapses. Assuming that the wool is not being pulled over our eyes (and that may not be an accurate assumption), if those behavioural traits have been diminished in Australian corporate practice, it is likely to be the result of a number of different factors. Those factors would include the publicity which the investigation into the collapse of HIH attracted, and the salutary lessons which one would hope were associated with that publicity, but perhaps more importantly, the significant change in the Australian regulatory environment since 2002. The laws regulating corporate practices in Australia are arguably the strictest and widest ranging in the world, and our regulatory bodies, including ASIC and APRA are well resourced and active.

The current indications are that Australian corporate activity is likely to fare better in the global downturn than many other economies. This may be partly due to the strength of our natural resources sector which may be more resilient than, say, economies which depend largely upon the financial services sector. But it may also be due to the regulatory environment to which I have referred, and its beneficial effect on practices in the corporate and financial services sectors.

The Possible Costs of Regulation

But the question I would like to pose, and suggest that you might consider in the course of this conference, is "at what cost". In other words, while Australia's experience in the face of the global downturn may suggest the benefits which flow from a strict regulatory environment, consideration needs to be given to the offsetting costs of such an environment. Particularly relevant to those assembled at this conference, are the costs which might flow from a regulatory regime which arguably encourages insolvent administration, and discourages financial restructuring and trading out of difficulty.

There are a number of aspects of our regulatory regime which arguably encourage resort to insolvent administration, even in cases in which there is a real prospect that a financial restructure and altered business plan might save the entity involved, to the benefit of its creditors and proprietors. I will briefly identify some of the factors that might contribute to such a tendency.

Insolvent Trading Laws

The laws of Australia which expose directors to personal liability in the event that a company trades while insolvent are arguably the strictest in the world. A very experienced insolvency practitioner, Stephen Parbery, who is to address you tomorrow, has posed the question of whether the strictness of those laws contributes to the creation of a culture in which directors will opt for insolvency administration, rather than take the personal risk that might be associated with a restructure aimed at trading out of short-term financial difficulty. As Mr Parbery has noted, there are obvious advantages from our insolvent trading laws. They:

(a) encourage directors to be aware of their companies' finances;

(b) encourage directors to relinquish control and allow creditors to determine the companies' future; and

(c) may allow creditors to improve their position by suing directors for recovery (although the few successful cases in this area suggest the benefits may lie more in the leverage which is provided for negotiation, rather than in court ordered recompense).

On the other hand, he argues that these laws may have negative effects:

(a) businesses are sometimes closed prematurely; and

(b) workouts in restructuring can be difficult because directors, banks and advisors will not take the personal risks associated with trading a business on.[2]

Continuous Disclosure

The disclosure obligations imposed upon the directors of publicly listed companies in Australia are arguably the strictest in the world. Richard

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[2] Parbery - Current Issues and Developments in Corporate Insolvency Law and Practice Seminar - Federal Court of Australia - 2 April 2008

Fisher, who will be well known to all here, has written on the impact of the continuous disclosure regime on the development of a restructuring proposal.[3] He has observed that the strictness of that regime will sometimes create insuperable difficulties during a time when the directors of a listed company may be working closely with major creditors and prospective financial backers to develop a restructuring proposal. In Mr Fisher's view, the obligation to completely inform the market by public disclosure during such a sensitive time may often thwart the fundamental objective being pursued, and make insolvency administration inevitable.

<u>Sons of Gwalia v Margaretic</u>

The landmark decision of the High Court in ***Sons of Gwalia v Margaretic***[4] has blurred the distinction between shareholders and creditors in an insolvency administration. As a result of that decision, shareholders can prove as creditors in a winding up for certain causes of action which they wish to maintain against the company. Their ability to do so, may encourage them to join directors as parties to their proceedings against the company, and as has been observed[5] can have implications for indemnity under Directors and Officers' policies of insurance. It is common for D & O policies to provide cover to directors and to the company in the same policy, up to a limit. The first to successfully claim indemnity under the policy may well exhaust the limit of cover. In the context of a Sons of Gwalia type claim, there may be a race between the directors and the company to claim the benefit of the limited indemnity. If the directors lose that race, they will of course be exposed to un-indemnified personal liability.

[3] 2007 (15 Insolv LJ 23)
[4] [2007] HCA 1; 231 CLR 160
[5] Herron & Moore - <u>Directors face claims alone</u> - The Australian Financial Review, 15 May 2009, p 46.

Risk/Reward Ratios for Non-Executive Directors

A number of commentators have made observations relating to the relatively low level of financial reward provided to non-executive directors in Australia, compared to the very substantial rewards that are often provided to executive directors. However, in terms of risk and personal exposure, the difference between a non-executive director and an executive director is not that great. Often non-executive directors will have little personal stake in the company and therefore little personal incentive, other than the preservation of reputation, in preventing the company from moving into administration. So, in a context in which not only professional reputation, but personal assets are put at risk if, for example, a claim is made for insolvent trading or misleading and deceptive conduct, when choosing between insolvency administration and restructuring, the personal risks associated with trading on will often be much greater than the prospective rewards, viewed from the perspective of an individual director. The course of prudence may therefore often be voluntary administration, even in a case in which there is a real prospect that a restructure might take the company out of difficulty.

Perceived Conflicts of Interest - Advisors

In a climate of financial uncertainty, directors will often take advice from external advisors - most usually accountants and lawyers with insolvency expertise. Those advisors will often consider it their duty to give advice which reduces the risk to those who have engaged them which, for reasons already given, will often result in conservative advice leading to insolvent administration. Of course, the advisors cannot be blamed for giving prudent and conservative advice.

However, that advice is often given in a context which many would see is redolent with the scent of conflict of interest. Sometimes those who have given advice to the directors in respect of possible insolvency administration will be appointed as administrators or legal advisors to the administrators. Creditors and investors will not uncommonly be suspicious about the motives of those who have provided advice in a context in which their own personal interests in the revenue to be derived from insolvency administration might be seen to be in conflict with the interests of investors and creditors, whose interests may be best served by a financial restructure.

The same perception of conflict of interest sometimes arises in the course of insolvency administration. Very often creditors and investors will see their interests best served by a brief administration which provides an opportunity for a scheme of arrangement or other restructure which enables the business to reform and continue, for the benefit of creditors and investors. They may often be suspicious of the advice given by those involved in the administration, whose best interests might be seen to be served by a long and expensive administration. I note that the issue of role and appropriateness of the special purpose liquidator or administrator in seeking to overcome independence issues will be examined later in this Conference.

Summary

Many of the issues I have raised are dynamic and interactive. Almost everyone at this conference will be better qualified by experience to form a view about the appropriate balance to be struck when the various competing considerations to which I have referred arise. All I would hope to do by these remarks this morning, is to encourage you to ventilate these issues and express views upon them, in order that our policy makers and legislators might be better informed as to striking the right balance. The announcement by the Commonwealth Government of an audit of the laws which affect the liability of company directors provides a propitious opportunity for the formulation and expression of views in this important area.

All that remains is for me to wish you all the best in your important deliberations during the course of this conference.