Chapter 3

Provisions of the Bill

Aims of the Bill

3.1 The aims of the Bill have been somewhat variously expressed. The legislative policy initiative announced by the Government in June 2001 referred to 'the recovery of bonuses paid to the directors of companies that later collapse'. The legislation does not deal *per se* with 'bonuses'. Its scope is broader in that it includes payments made by the company as well as conveyances, transfers, other dispositions of property, issues of securities including options and the incurring of an obligation to make such a payment, disposition or issue.

3.2 The explanatory memorandum to the Bill states that the purposes of the Bill are :

> To permit liquidators to reclaim unreasonable payments made to directors by companies prior to a liquidation
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> and
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> To assist in the recovery of funds, assets and other property to companies in liquidation where payments or transfers of property to directors are unreasonable.[1]

Background

3.3 Most submissions were generally supportive of the Bill though many took issue with particular provisions offering suggestions for amendments and improvements to the key definitions and operative provisions.[2] Some submissions argued that the scope of the Bill was too broad while others argued that it was too narrow and limited. A number of submissions raised issues concerning the interaction of the provisions of the Bill with other regulatory objectives of the Corporations Act such as corporate governance and shareholder rights. Other issues of concern raised in submissions included the interpretation of the operative provisions, the adequacy of the current law (and hence the need for government intervention), the potential impact

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1 Explanatory memorandum, 1.

2 The Australian Chamber of Commerce and Industry submitted that taken as a whole, it considers the Bill 'to be a focused and proportional approach to dealing with a fairly infrequent issue in corporate governance in Australia'. *Submission* 2, p. 1. The Association of Superannuation Funds of Australia also expressed support for the aims of the Bill. *Submission* 4 p. [2]. Similarly the CPA Australia and the Institute of Chartered Accountants in Australia gave qualified support for the Bill. *Submission* 5, p. 1.

of the Bill and the length of the period—four years—during which transactions may be clawed back.

Outline of the report

3.4 The following section of the report looks at the main concerns that were raised in submissions and during the public hearing. It examines the following issues:

- the need for new legislation;
- the types of remuneration that should be covered by the Bill;
- matters that could be included in the Bill particularly in regard to provisions to cover senior executives, retrospectivity and the importance of preventive measures;
- the interpretation of the term ‘unreasonable’;
- the four year time-frame.

Adequacy of the current law

3.5 Submissions opposed to the Bill argued that the adequacy of the current law in recovering unreasonable payments to directors has not been explored or shown to be deficient.

3.6 While it strongly opposed the Bill, the Australian Institute of Company Directors (AICD) noted ‘the intense public focus on a number of high profile public collapses’ and a need to ‘respond to such public concern in a timely and constructive manner’. Nevertheless, it argued that in addressing such concerns in a precipitous fashion the Government has missed the opportunity of ‘promoting the full enforcement of the existing law in this area’. It would prefer to see extra resources provided to ASIC to test the current law and only if such existing law is found to be lacking should there be legislative reform.

3.7 The Australian Shareholders’ Association (ASA) noted that the Bill applies only in the case of a liquidation and not to other forms of administration. In its view there are other measures in the Corporations Act which allow a liquidator access to monies paid out by a company.

3.8 Others, however, although critical of some aspects of the Bill, believed it had merits. The Insolvency Practitioners Association Australia (IPAA) supported the Bill which it believed would ‘supplement and strengthen the existing provisions and provide liquidators with the powers to reclaim unreasonable payments made to the directors of insolvent companies or “their close associates”’.[3]

3.9 The Department of the Treasury agreed. It told the Committee that:

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3 *Submission* 8, p. 1.

> At present, most payments made by a company prior to winding up are not recoverable by a liquidator unless the company was insolvent at the time it made the payments. As a result, large payments or transfers of property made to a director of a company that is later wound up may not be caught if the company was technically solvent at the time of the payment or transfer.[4]

3.10 The Australian Council of Trade Unions rather than dismiss the Bill argued that while it is heading in the right direction it does not go far enough.[5] It wanted the Bill to be strengthened.[6]

3.11 Some witnesses also saw the proposed legislation as a measure that would encourage a more thoughtful and responsible approach to the remuneration of directors. The Australian Stock Exchange (ASX) commented that permitting recovery of payments in circumstances in which the company is solvent may act as a significant disincentive for executive directors (particularly entrepreneurial executive directors) accepting bonus payments as part of a more modest fixed salary package and constrain some companies from designing appropriate remuneration packages. In stating its support for the proposed legislation it acknowledged ‘the importance in the current climate of demonstrating that directors will not be able to profit in circumstances where their performance has not benefited the company’.[7]

3.12 The IPAA also believed that the Bill would alert company directors to the dangers of excessive remuneration. It asserted that:

> The insertion by the Bill of a new section 588FDA will give a clear and unambiguous message to officers and management of companies and provide liquidators with the necessary legal framework within which to pursue unreasonable director related transactions.[8]

3.13 Similarly, the Association of Superannuation Funds of Australia saw the advantage in using legislation to send a message to corporate Australia. It hoped that the provisions of the Bill would have a ‘broader impact so far as they will encourage all directors to give greater consideration to broader corporate governance issues when entering into transactions’.[9]

3.14 The Treasurer stated that:

> The Bill gives a strong statutory expression of the Government’s intention that directors should not receive unreasonable remuneration, particularly when creditors, employees and shareholders are at risk. Directors are in a

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4 *Submission* 3, p. 1.

5 *Committee Hansard*, p. E5.

6 *Committee Hansard*, p. E5.

7 *Submission* 6, p. 1.

8 *Submission* 8, p. 1. See also *Committee Hansard*, pp. E8 and E18.

9 *Submission* 4, p. [2].

> better position than most to know the true state of affairs of the company in the short to medium term, and should not profit from this knowledge at the expense of employee and ordinary creditors.[10]

3.15 It should be noted that the Bill was introduced into Parliament with the approval of the Ministerial Council for Corporations, which comprises the Commonwealth, States and Territories.[11]

Committee view

3.16 The Committee considers that the Bill would add to the current mechanisms for recovering unreasonable director-related payments as it would permit recovery of such payments within a longer time frame notwithstanding that the company was not technically insolvent at the time of the payment or transfer. Under the current law most payments made by a company prior to winding up are not recoverable by a liquidator unless the company was insolvent at the time it made the payments. Other avenues for recovery under the voidable transaction provisions are subject to more limited time frames.

3.17 It also believes that it sends a strong message to the corporate world that directors must act in accordance with their responsibilities to their shareholders, to those employed by their companies and other creditors.

3.18 Having accepted that the proposed legislation is an important measure to improve corporate governance in Australia, the report now turns to perceived deficiencies in the Bill.

Title of the Bill

3.19 The joint submission from CPA Australia and the Institute of Chartered Accountants in Australia observed that the title of the Bill implies that it 'relates only to bonus payments to directors whereas the unreasonable director-related transaction provisions are not restricted to just bonus payments.' It supported the broader reach of the proposed legislation stating:

> Director related payments, not just bonuses, should be subject to scrutiny to ensure they are reasonable and have received appropriate approval.[12]

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10 The Hon Peter Costello MP, Treasurer of the Commonwealth of Australia, Media Release, 'Corporations Amendment (Repayment of Directors' Bonuses) Bill 2002, 16 October 2002. See also second reading speech, Mr Peter Costello MP, *House Hansard*, 16 October 2002, p. 7677.

11 The Hon. Peter Costello, MP, Treasurer of the Commonwealth of Australia, Media Release, 'Corporations Amendment (Repayment of Directors' Bonuses) Bill 2002, 16 October 2002. See also Second Reading Speech, Mr Peter Costello MP, *House Hansard*, 16 October 2002, p. 7677.

12 *Submission* 5, p. 2.

Committee view

3.20 The Committee accepts that the title of the Bill does not adequately reflect the scope of the Bill's operation. The Committee suggests that the title be reworded to convey the message that it is concerned with director related payments, not simply bonuses.

Ambit of the Bill

3.21 A number of submissions argued that the Bill is too tame and does not go far enough in addressing the question of excessive executive remuneration. They wanted to broaden the ambit of the Bill to include:

- solvent companies
- remuneration of senior executives
- retrospective provisions
- measures to enhance transparency and accountability.

The following section looks at the proposals for broadening the coverage of the Bill.

Solvent companies

3.22 The Bill is limited to transactions of companies in liquidation. Some submissions argued that the Bill should not be limited to companies in liquidation but should apply to all companies irrespective of insolvency. The ACTU submission argued that one of the serious limitations of this Bill is that:

> The Bill does not apply to unreasonable or excessive remuneration of directors or executives in circumstances where the company does not become insolvent, even though its performance may not have justified these payments or transactions, and the cost is borne by shareholders.[13]

3.23 The joint submission from the CPA of Australia and the Institute of Chartered Accountants took a similar position in arguing that unless there is a compelling case the voiding of payments provisions should apply to all companies, including those operating normally and those under administration, and not just insolvent companies under external administration.[14]

Committee view

3.24 The Committee considers that broadening the provision so as to encompass all companies irrespective of insolvency would amount to a significantly different and wider legislative proposal that is beyond the scope of the Committee's inquiry.

13 *Submission* 7, p. 2.

14 *Submission 5*, p. 2.

Remuneration of senior executives

3.25 The Bill applies only to directors and is not generally intended to cover employees of companies. The definition of 'director' in section 9 extends the concept of director in some cases to include persons acting in the position of director although not validly appointed to that position (de facto director) and persons in accordance with whose instructions or wishes the directors of the company are accustomed to act (shadow director).

3.26 The ACTU submission suggested that the legislation should extend its application to senior executives who were not directors.[15] The Australian Institute of Company Directors also referred to the focus of this Bill on payments to directors even though the current public controversy is concentrated on executive remuneration.[16] The joint submission from CPA Australia and the Institute of Chartered Accountants in Australia expressed the view that the amendments should first address the granting of bonuses and other benefits to directors and senior executives and consider the interests of creditors and shareholders.[17] Mr Alfred Rofe, from ASA, submitted to the Committee that:

> It is necessary to distinguish between remuneration and termination payments payable to
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> a) Non-executive directors of a company
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> b) Senior executives who are in a position to directly influence the strategies and the results of the operations of the company (who may or may not be directors); and
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> c) Other employees (including executives who are not in a position to directly influence the strategies and the results of the operations of the company).

3.27 In his view 'most of the current debate involves payments to senior executives who, in most cases, are also directors, but there is also an increasing concern with respect to retirement payments to non-executive directors'.[18]

Recommendation

The Committee considers that limiting the Bill to directors (whether formal, de facto or shadow) is unduly narrow and recommends that it apply also to senior executives who are not directors.

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15 *Submission* 7, p. 2; *Committee Hansard*, p. E14.

16 *Submission* 1, p. 1.

17 *Submission 5*, p. 1.

18 *Supplementary Submission*, p. 1.

Retrospectivity

3.28 The Opposition moved an amendment in the House of Representatives to provide that the commencement date of the legislation be 4 June 2001, the day the Prime Minister announced that the Government would legislate to remedy deficiencies in the current law. The ASA was not alone in observing that the Bill did nothing to facilitate the recovery of payments in the case of One-Tel.[19]

3.29 The retrospective application of the legislation was not discussed during the public hearing. The Treasurer, however, in presenting the proposed legislation stated that to avoid constitutional doubt, the legislation would apply with prospective effect, from the commencement of the Bill.

Committee view

3.30 The Committee accepts that the provisions of the Bill should not be retrospective.

Measures to enhance transparency and accountability

3.31 A number of witnesses argued that the proposed legislation was a case of ‘closing the door after the horse has bolted’.[20] The Australian Shareholders Association argued strongly that:

> It is more appropriate to prevent, or at least discourage, the payment of unreasonable remuneration, including bonuses and severance payments and the entering into arrangements to make such payments, rather than to seek to recover them after they have been made.[21]

3.32 Taking a similar view, the ACTU wanted the Bill to deal with the way in which remuneration is determined. It argued that the proposed legislation needed to specify in greater detail the criteria for its application. It proposed that the Government legislate to require boards of public companies to establish independent remuneration committees and require option packages to be subject to performance benchmarks.

3.33 Mr Arthur Dixon, CPA Australia, agreed with the view that increased transparency is a critical issue. The joint submission from CPA Australia and the Institute of Chartered Accountants in Australia suggested that bonuses and other benefits to directors and senior management should be subject to disclosure. In their view disclosure would go beyond that required by Part 2M.5 of the Act and Accounting Standard AASB 1017 ‘Related Party Disclosures’ to include:

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19 See, for example, the comments of Mr Dwyer, National President, Insolvency Practitioners Association of Australia, Committee Hansard, p. E8.

20 See comments by Professor Bob Baxt, *Committee Hansard,* p. E6.

21 *Supplementary Submission* 9, p. 1.

> the likely cost at the time the transactions are incurred [approved] with at least annual updates of the likely eventual cost and approved by shareholders. This would avoid the surprises to the market that have been occurring when the previously unknown magnitude of the payments have eventually been disclosed to the market.[22]

Committee view

3.34 The Committee notes that proposals relating to the matters raised in the ACTU submission are being considered in other contexts (for example CLERP 9 and the exposure Draft Corporations Amendment Bill[23]) and go beyond the scope of the Bill in question.

3.35 The Committee also notes that the recovery of unreasonable director-related payments is to be treated in a similar manner to, and within the current legislative framework, for the recovery of other voidable transactions. It agrees that it is a desirable goal of corporate law to seek to prevent or discourage the payment of unreasonable director-related remuneration. Measures to achieve such a goal are beyond the scope of this Bill. The prevention or discouragement of unreasonable director-related remuneration is also not the only goal. The Committee considers that the Bill should be assessed in terms of the desirability of protecting creditors of companies in liquidation.

The types of remuneration covered by the Bill

3.36 The following section considers suggestions put forward in submissions that certain payments to directors should be exempt under the provisions of the Bill.

Basic remuneration

3.37 Some submissions considered that the Bill should be limited to payments in the nature of bonuses and/or severance payments and exclude basic remuneration. The CPA/ICA submission noted that the title of the Bill implied that it was referable only to bonus payments to directors and indicated that the Bill should be restricted to bonus and severance payments beyond a specified threshold which would relate to varying factors based on the features of companies and their industries.

Committee view

3.38 The Committee considers that restricting the Bill to 'bonuses' would pose definitional problems, unduly limit the scope of the Bill and invite payment in other forms.

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22 *Submission* 5, p. 2.

23 Available from Treasury website, http://treasury.gov.au/, Bills, Acts & Legislation.

Provisions approved by shareholders

3.39 A critical provision determining the scope of the Bill is proposed section 588FDA which sets out the criteria to be used in assessing the 'reasonableness' of a director-related transaction.

3.40 A number of submissions proposed that in determining the reasonableness of a transaction the Court should take account of any resolution passed by members of the company at a general meeting and even exclude, from the definition of 'unreasonable director-related transaction', payments approved by shareholders at a general meeting.

3.41 The Corporations Act requires certain transactions between a director and a public company to be approved by members at a general meeting. The remuneration of directors of public companies is generally regulated by Chapter 2E. A public company is prohibited from giving a financial benefit to a related party of the public company unless the financial benefit falls within one of the exceptions to Chapter 2E or has been approved by a majority of disinterested members after being provided with information as to the costs and consequences of the provision of the benefit.

3.42 Exceptions include remuneration paid to a person in his/her capacity as an officer of the body corporate if it would be reasonable to give the remuneration given the circumstances of the company and the relevant officer's circumstances including the responsibilities involved in the office or employment.

3.43 Other kinds of payments to directors are also subject to similar requirements.

3.44 Division 2 of Part 2D.2 regulates termination payments. Section 200B prohibits a company from giving a person a benefit in connection with that person's retirement from a board or managerial office in a company without member approval under section 200E. Section 200C prohibits a person from giving a benefit to a person who holds or has at any previous time held a board or managerial office in a company or a related body corporate without member approval under section 200E. Section 200E specifies the requirements for member approval for the giving of such a benefit. The benefit must be approved by a resolution passed at a general meeting of the company. Details of the benefit must be set out in or accompany the notice of the meeting.

3.45 The ACCI proposed that in determining the reasonableness of a transaction the Court should be required to take into account any resolution by members of the company in general meeting regarding the transactions under review.

3.46 The ASX drew attention to Chapter 2E, and Listing Rule 10.1 which in certain circumstances requires the approval of holders of an entity's ordinary securities in the case of transactions between a company and its officers. It commented that it is unclear whether transactions which are required to be approved by shareholders at a general meeting under procedures set out in the Corporations Act and the Listing Rules are subject to the clawback arrangements and what weight will be given to shareholders' approval of a transaction.

3.47 In the ASX's view:

> The ability of the liquidator to seek to avoid transactions should not extend to transactions approved by shareholders on the basis of an independent expert report that the transaction is fair and reasonable unless it can be shown that the report was inadequate.[24]

3.48 The joint submission from CPA Australia and the Institute of Chartered Accountants of Australia reinforced the opinion that where shareholders have approved the bonus and severance payment agreements when the company is solvent, the payments should not be subject to voiding under the proposed legislation.[25] Similarly Professor Baxt argued that:

> If matters are disclosed to shareholders, the shareholders have the right to vote on those issues. If there is full disclosure and there is no conflict, it seems a bit odd to say four years later—because a company may, as a result of events beyond its control, have suffered losses et cetera—that we now have the ability to seek a repayment of sums that have been voted by the shareholders. If there is a failure of disclosure and if there is fraud in the minority et cetera, I would agree that that is the basis for challenging that.[26]

Committee view

3.49 The Committee notes that in determining whether a transaction is an 'unreasonable director-related transaction' a court may take account of the matters specified in section 588FDA(1)(c)(i)-(iii) including 'any other matter': section 588FDA(1)(c)(iv). It would appear that a court would be able to take into account the fact that a payment has been approved by shareholders of the company at a general meeting and the weight to be given to such a matter.

Remuneration and the company's constitution

3.50 The AICD would exclude from the operation of the Bill remuneration paid to a director in accordance with the company's constitution.

Committee view

3.51 In the Committee's view this would unduly restrict the application of the Bill.

Payments to trusts or payments made by solvent companies

3.52 Two submissions raised the possibility of transactions that may fall outside the strict terms of the definition of 'unreasonable director-related transaction'. ASFA noted the possibility of a payment made to a discretionary trust of which a director or

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24 *Submission* 6, p. 3.

25 *Submission* 5, p. 2.

26 *Committee Hansard*, p. E11.

close associate is a potential beneficiary.[27] The CPA/ICA submission noted the possibility of a parent company appointing one of its directors as a director of a subsidiary and making a payment to the director in his/her capacity as a director of another company. There is also the question of the divestiture of assets in the period after receipt of a payment or transfer of property and the relation-back day.

3.53 Mr Rogers, Department of the Treasury, informed the Committee that:

> The Bill is directed at payments made to directors or to their close associates or on behalf of those directors. If a payment is made to a related party by a company that becomes liquidated on behalf of the director, this Bill is going to catch that. If it is made to any other related party or any other creditor or any other person other than a director, or connected with them, to the extent that it is caught by the existing law, it will be caught on a wind-up then.[28]

3.54 When asked about the situation where the company was a subsidiary company and some directors may be one and the same, Mr Dwyer, IPAA, was of the opinion that:

> The law adequately provides liquidators with provisions to claw that back under the related sections under 588, which relate to uncommercial transactions. This legislation supplements that and provides the ability to claw back directors' bonuses from directors and related parties to directors, which has not been there for liquidators previously. So it is supplementing the existing law. [29]

Committee view

3.55 The question of possible avoidance of the application of the legislation is an appropriate issue to consider. The payment of a director's remuneration by an external party will not ordinarily have the effect of reducing the assets of the company available for distribution to creditors.

Recommendation

The Committee, however, recommends that the Government monitor the application of the legislation with a view to assessing whether appropriate anti-avoidance provisions should be included in the legislation.

Entitlement of shareholders

3.56 The CPA/ICA submission stated that proposed section 588FF(4) appeared to preclude shareholders benefiting from the clawback of a payment as it limited the

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27 *Submission* 4.

28 *Committee Hansard,* p. E19.

29 *Committee Hansard*, p. E19.

court to making orders '…only for the purpose of recovering for the benefit of creditors of the company…'.

Committee view

3.57 The Committee understands that in a liquidation of an insolvent company shareholders are ordinarily entitled to the residual value of assets of the company after payment of creditors. The Bill would not appear to affect the entitlement of shareholders in this regard. Regrettably it is rarely the case that in a liquidation there are assets remaining to be returned to shareholders.

Application to associates

3.58 ASFA noted that the definition of 'close associate' for the purpose of proposed section 588FDA does not extend to same sex couples and neither does the definition of 'relative' in section 9 of the Corporations Act.

Committee view

3.59 The Committee suggests that in bills proposing amendments to the Corporations Act and other legislation concerned with corporate governance the expressions 'close associate', 'relative', 'spouse' or like terms be defined to include same sex couples in light of community standards.

Interpretation of operative provisions of the Bill

3.60 The key operative provision of the Bill is proposed section 588FE(6) which provides that a transaction is voidable if it is an 'unreasonable-director related transaction'. The latter term is defined in section 588FDA. The explanatory memorandum to the Bill describes the effect of the provision:

> It provides that a transaction of a company is an 'unreasonable director-related transaction' if it is made to a recipient in circumstances where a reasonable person in the company's circumstances would not have entered into the transaction. The reasonableness of the transaction is determined with regard to the respective costs and benefits to the company, and benefits to the recipient, of entering into the transaction.[30]

3.61 The AICD proposed that 'extortionate' be substituted for 'unreasonable' as the test for a voidable transaction in section 588FDA and that the transaction be shown to be so 'manifestly unreasonable' having regard to the factors in subsection 588FDA(1)(c) that 'no reasonable person in the company's circumstances would have entered into it'. It submitted:

> The difficulty of judging the 'unreasonableness' of a payment made up to four years earlier will probably lead to a proliferation of litigation. The Bill appears to require examination of the circumstances of the transaction

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30 Explanatory memorandum, para 3.6.

> through the eyes of a reasonable person at the time of the transaction. Will it be possible to disregard the benefit of hindsight in making this judgement? Most likely, the application of such a test will lead to arbitrary outcomes influenced by the fact that at some time with up to four years after the relevant transaction, the company went into liquidation. On this count, the Bill looks more like a means of punishing directors for the failure of their companies (irrespective of fault on their part) than a means of restoring value to creditors.[31]

3.62 Mr Rogers, Department of the Treasury, offered the following explanation for the current definition of unreasonableness:

> Rather than introduce a new definition, it tries to pick up an existing one that is used for uncommercial transactions, which presumably already has a body of case law and common use by insolvency practitioners behind it, and apply that to directors' bonuses…they [AICD] suggested using the extortionate test, which suggests to me a higher benchmark. That has another problem, in the sense that it is currently applied to percentage rates to loans, so it is not something that is translatable to dollar amounts, whereas the current uncommercial transaction is.[32]

3.63 Section 588FB defines an uncommercial transaction as one where a reasonable person in the company's circumstances would not have entered into the transaction, having regard to:

- the benefits (if any) to the company of entering into the transaction;
- the detriment to the company of entering into the transaction;
- the respective benefits to other parties to the transaction of entering into it; and
- any other relevant matter.

Committee view

3.64 The Committee believes that the effect of amendments along the lines suggested by AICD would be to narrow considerably the range of transactions which

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31 *Submission* 1, p. 2. The AICD suggested that the 'reasonableness' test in s588FDA(1)(c) require that:

> (c) the transaction be so manifestly unreasonable having regard to:
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> (i) the benefits (if any) to the company of entering into the transaction;
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> and
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> (ii) the detriment to the company of entering into the transaction; and
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> (iii) the respective benefits to other parties to the transaction of entering into it; and
>
> (iv) any other relevant matter;
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> that no reasonable person in the company's circumstances could have entered into it.

32 *Committee Hansard*, p. E17.

may be caught. The term 'extortionate' may be appropriate to describe the terms of a loan but is not so readily transferable to the kind of director-related transactions that the Bill aims to cover.

Determining reasonableness of transaction

3.65 The Australian Chamber of Commerce and Industry (ACCI) considered that the definition of 'unreasonable', the circumstances of its application (the winding up of the company) and the nature of the remedy (the transaction being voidable to the extent that it is unreasonable) were appropriate. However, it considered it inappropriate for the reasonableness of the transaction to be determined at the time the company actually enters into the transaction regardless of its reasonableness at the time the company incurred the obligation. In its view this approach to the legislation gives undue weight to developments that may take place long after the obligation was incurred. The ACCI considered that proposed section 588FDA(2)(b) should look to the circumstances at the time the obligation was incurred rather than later developments outside the control of the parties to the agreement.[33]

3.66 ASFA also supported the reasonableness test applying at the time the company actually enters into the transaction rather than at the time the company incurred the obligation.

3.67 In relation to the time when the reasonableness of entering the transaction was determined under proposed subsection 588FDA(2) (ie at the time the company actually makes the payment, conveys, transfers or disposes of property, etc) the Treasury, quoting from the Treasurer's second reading speech, commented:

> This enables liquidators to recover payments where the true magnitude of the unreasonableness involved only becomes apparent when the company actually makes the payment, even if it appeared reasonable at the time the company agreed to make the payment.[34]

3.68 Elsewhere in its submission the Treasury noted:

> Directors have the primary responsibility under Australian corporate law for the viability of companies. Further, directors are in a better position than most to know the true state of affairs of the company in the short to medium term, and should not profit from this knowledge at the expense of employees and other ordinary creditors.
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> Mr Rogers, Department of the Treasury, explained further:
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> The Bill has a four-year net period where it can catch transactions. What that provision does in relation to obligations is to say, 'You don't look at the time the obligation was entered into'. For example, people have been talking

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33 *Submission* 2, p. 2.

34 *Submission 3*. See also Mr Peter Costello MP, Second Reading Speech, *House Hansard*, 16 October 2002, p, 7677 and media release 16 October 2002.

> about reference to remuneration by market capitalisation. On the face of it, it may be an entirely reasonable and appropriate measure to use for executive remuneration. But down the track when the transaction is made—the case of One.tel is a prime example, I guess—it has gone bust and the payment of X million dollars is not reasonable where it has gone bust, even though the obligation was framed in a reasonable way.[35]

Committee view

3.69 The Committee considers it appropriate that the reasonableness test apply at the time the company actually enters into the transaction rather than at the time the company incurred the obligation. It is at the point of 'entering into the transaction' that a company is best placed to determine the benefits and detriments to the company, and the respective benefits to other parties, of entering into the transaction and ultimately the appropriateness of the payment.

General interpretation of the term 'unreasonableness'

3.70 Many witnesses were concerned about the lack of guidance being offered in the legislation to assist in the interpretation of the term 'unreasonableness'. They foresaw courts struggling with the interpretation of the term.

3.71 As noted in paragraph 3.61, the AICD commented that the difficulty of judging the 'unreasonableness of a payment made up to four years earlier will probably lead to a proliferation of litigation'. The requirement to examine the circumstances of the transaction through the eyes of a reasonable person at the time of the transaction may result in arbitrary outcomes influenced by the possibility of hindsight in making this judgment and the fact that the company was placed into liquidation. In the AICD's view the Bill had the potential to punish directors for the failure of their companies irrespective of fault.

3.72 The ACTU wanted to establish clear and tight guidelines as to what would constitute unreasonable. It wanted greater specificity with regard to performance which is to be reported through benchmarks to shareholders and a prima facie presumption of reasonableness.[36] Ms Sharan Burrow argued that:

> If we are talking about directors' fees with a $100,000 remuneration base, 40 per cent of that at $40,000 ought to be seen to be, prima facie, unreasonable. If we are going to set community standards, governments have to be brave enough to put something on the table.[37]

3.73 Mr Dwyer, IPAA, accepted that the court would be required to determine what is unreasonable. His concern was with the lack of resources where there are no assets to assist the liquidator rather than the wording of the law. He stated:

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35 *Committee Hansard*, p. E17.

36 Sharon Burrow, *Committee Hansard*, p. E14.

37 *Committee Hansard*, p. E14.

> We think that we are far better to get something into the law to trip the next payment, albeit we cannot make it retrospective, or at least start the ball rolling in terms of having legislation to target any future payments that are unreasonable or, indeed, are related party transactions.[38]

3.74 As noted in paragraph 3.62, the Department of the Treasury pointed out that the proposed legislation picks up an existing definition that is used for uncommercial transactions in the same part of the current law to reduce the kind of uncertainty surrounding the meaning of unreasonableness raised by witnesses.[39]

3.75 The Opposition in the House of Representatives moved amendments designed to provide some parameters to the court about what things it ought to consider in determining whether payments to a director were reasonable. It proposed that the following should be considered:

- the payments and benefits received by directors relative to payments and benefits received by employees in the company; and
- whether the payments or benefits were subject to appropriate performance conditions; and
- the time the payments or benefits were received, in particular, their proximity to the time at which the company was placed into administration or liquidation, and whether the company was insolvent at the time they were received.[40]

3.76 Mr Peter Slipper in the second reading debate responded to this proposal as follows:

> Under the Bill the reasonableness or otherwise of a payment is determined along the lines of mechanisms already present in the Corporations Act under the uncommercial transaction provisions. Reasonableness is determined by having regard to the benefits and detriment to the company, the respective benefits to other parties to the transaction and any other relevant matter. The amendments moved by the opposition introduce additional elements which will add uncertainty to the operation of the Bill or simply limit its operation.[41]

Committee view

3.77 The Committee notes that the factors that a court is to have regard to in determining the reasonableness of a director related transaction replicate the factors to be taken into account in considering an 'uncommercial transaction' under section 588FB. The proposed criteria are consistent with those currently in force for another

38 *Committee Hansard*, p. E14.

39 *Committee Hansard*, p. E17.

40 *House Hansard*, 11 February 2003, p. 11439.

41 *House Hansard*, 11 February 2003, p. 11442.

category of voidable transaction. It is important that this legislation is consistent with existing legislation that deals with voidable transactions. The Committee considers that the factors that the Bill proposes be taken into account in determining the reasonableness of a transaction are appropriate.

Interaction of the Bill with other corporate regulatory objectives

3.78 A number of submissions commented on the interaction between the Bill and other regulatory objectives and provisions of the Corporations Act.

3.79 The ASX saw the Bill as part of a wider review of legislation and self-regulation impacting the governance of companies and as being aimed at encouraging companies and their officers 'to ensure that there is an alignment between company performance or value added to the company and payments (or other benefits) made to directors'.

3.80 The Committee considers that the Bill may serve to complement other measures in the Corporations Act which seek to enhance the corporate governance of Australian companies. It concurs with ASFA's hope that:

> The presence of the amendments will have a broader impact in so far as they will encourage all directors to give greater consideration to broader corporate governance issues when entering into transactions.

A four year clawback period

3.81 Some submissions commented on the appropriateness of a four year claw back period.

3.82 ASFA pointed out that the four-year clawback period is shorter than the Corporations Act's mandatory record retention requirement. (Under the Corporations Act financial records must generally be retained for 7 years after the transactions covered by the records are completed: section 286(2)). In ASFA's view it was arguable that there should be no time limit for unreasonable transactions that should never be knowingly entered into by, or with, directors, officers or others.[42] It added that the longer the period involved, the less likely recovery might be. On the other hand the ASX argued that four years may be excessive and also limit the structuring of executive remuneration packages.[43]

3.83 Mr Rogers, Department of the Treasury, told the Committee that:

> A range of periods for clawbacks are allowed under part 5.7B of the Corporations Act, ranging from six months for any payment while the company is insolvent up to, I think, an unlimited period for certain payments done with a high degree of culpability. This fits somewhere in between. It is

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42 *Submission* 4.

43 *Submission* 6.

most like the existing related party clawback allowance, which is also four years.[44]

Committee view

3.84 The Committee considers that a four year clawback period is justifiable.

Impact of the Bill

3.85 A range of concerns were expressed about the overall impact of the Bill.

3.86 The explanatory memorandum indicated that the Bill would have a low impact economy-wide given the narrow application of the amendments contained in the Bill to companies in liquidation. ASFA expressed the hope that it would encourage directors to give greater consideration to broader corporate governance issues when entering into transactions.

3.87 The IPAA supported the Bill commenting that it would strengthen existing provisions for recovering unreasonable payments made to the detriment of employees, secured and unsecured creditors. However, in the IPAA's view the practicalities of investigation and legal assistance in pursuing these claims are a concern given the extensive litigation that will be required of recover these payments. This is particularly so in the case of 'phoenix' companies which have inadequate assets available to a liquidator to ensure payment of reasonable costs and expenses.

Committee view

3.88 The Committee acknowledges that the Bill will be subject to elucidation by the courts over time. It notes that there is an extensive body of case law on the subject of voidable transactions.

Process

3.89 The AICD pointed out that since the commencement of the Corporate Law Simplification Project and the Corporate Law Economic Reform Program significant changes to corporate legislation have gone through an extensive consultation process before a change is introduced into the Parliament. According to some witnesses, this consultation process was lacking in regard to this Bill.[45]

3.90 It further considered that recent legislation dealing with the rights of employees in an insolvency context have not been given an opportunity to be tested in the courts. The AICD argued that until the courts have been given an opportunity to assess that legislation no further changes to the law (in relation to the rights of employees in an insolvency context) should be made.

44 *Committee Hansard*, pp. E18–19.

45 *Submission* 1, p. 1, and comments by Professor Baxt, *Committee Hansard*, p. E2.

3.91 The Committee draws the Government's attention to clause 509(1) of the Corporations Agreement 2002 which envisages that in principle all Commonwealth Bills referred to in clause 506(1)—bills that would amend or repeal the Corporations Act and other Acts relating to the national companies scheme—will be exposed for public comment for at least 3 months before introduction. This in principle commitment appears to be honored more in the breach than in its observance.