PRODUCTIVITY COMMISSION

INQUIRY INTO BUSINESS SETUP, TRANSFER AND CLOSURE

DR W MUNDY, Presiding Commissioner
MS M CILENTO, Commissioner

TRANSCRIPT OF PROCEEDINGS

AT PRODUCTIVITY COMMISSION, SYDNEY
ON TUESDAY, 30 JUNE 2015, AT 08.30 AM

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DR MUNDY: My name is Warren Mundy and I am the Presiding Commissioner. With me is Commissioner Melinda Cilento, the other Commissioner, of this inquiry. Before going any further, we would like to pay our respects to the elders past and present of the Gadigal people, on whose traditional lands we meet today, and to all indigenous nations who have continuously occupied these lands for over 40,000 years and are still struggling for justice.

These proceedings we would like to keep on an informal basis, although I do like to remind you that it's an offence to give evidence to the Commission which is either false or misleading. Also, any evidence that is given here is not subject to any sort of privilege or protection, so anything witnesses say can be used in proceedings against them, although that's never happened.

As I said, we like to keep these proceedings relatively informal but we do have to comply with the Commonwealth's OH&S obligations.

(Housekeeping matters)

We have seven witnesses to hear today, before 12.30. I'm keen to keep us strictly to time, so if we could have the first witness, Mr Peter McNamee. Peter, if you'd like to just, for the record, state your name and affiliation and perhaps give us a very brief, few opening comments and then we can have a bit of a discussion, which I would intend completing by 9 o'clock.

MR McNAMEE: Peter McNamee is my name. I represent myself. I did prepare a draft paper which I sent through, and I'm wondering whether the Commission has had a chance to have a look at that.

DR MUNDY: We have, yes.

MR McNAMEE: That represents some of my opinions on this. Those opinions are formed over a long period of time in business. I thought probably what I should do is just briefly explain how I come to have these opinions, based on what knowledge and authority, so you understand where it's coming from.

I've been in business since I was about 28, working for myself. I started business buying utility with my younger brother. Within two years, we have a fleet of five trucks, within 12 years, we had over 100 employees, we had timber yards in Brisbane and Sydney, we had a manufacturing facility in Seven Hills, where we were manufacturing over $700,000 a month worth of manufactured paper products; we were the biggest manufacturers of telex rolls, fax rolls and bus tickets and the like in Sydney.

We had a recession in the early '90s and the banks called our loans in. One day my brother and I arrived at work and our long-term advisers and our accountants, KPMG, had changed the locks on the building and they had taken over our premises. We were locked out, our bank accounts were frozen, our assets were frozen and they had our business. It took them a year and a half to completely wind down and destroy the business, after which time - I'm sure they did very well with their fees - my brother and his wife were bankrupted and I was bankrupted.

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Fortunately I was able to save my wife, although we had to start again, with five dependent children, two at Loreto Normanhurst high school and three primary school children. We kept our house; it was valued at $700,000 and we had a $530,000 mortgage on it. So, we started again, from nothing; from having established a very successful, large business, which was destroyed by KPMG.

That was fine; we got on with life and we did it all again. Then, about two and a half years ago, I was doing a development in Newcastle, we had a $2.5 million loan and I built a small office building up there, it was a five-year facility, we had eight tenants and three and a half years into this five-year loan I get a phone call from our broker, Balmain Commercial, who said, "Look, the banks want their money back." I said, "Why?" and they said, "Because the loan went out - the loan was written pre-GFC and the interest rates were very competitive. They can now lend it out at a higher rate. Furthermore, the fund they loaned it out in is expensive for them to maintain, so they want to close it down." I said, "Well, I don't want to give it to them back."

This facility was fully leased, had an income of $300,000 a year, interest was $150,000 a year and they wanted the money back. I was told that if I didn't pay it back they would just get a valuation done showing the property dropped in value and they would call it in. They did. They had a valuation done. The original valuation was $4 million and they produced a valuation of 2.3. I wrote back and said, "That's rubbish. Here's a new valuation, showing it's still 4 million."

A few weeks later, I get a call from a fellow who said, "I'm from Hall Chadwick, receivers. We've been appointed receivers to your company. We have been to see all your tenants in Newcastle and we've told them to pay the interest to us, we've been to see the local agent and told him to give us a proposal to sell your property, and we've been to see the NAB and told the NAB to give us all the money in your account." This is a loan which I had never missed a payment on. I'm in a strong financial position and that's what they wanted.

I got legal advice and I was told, "Look, this is really dangerous," this is my lawyers and senior counsel; they said, "These guys could easily go and flick your property for 2.3 million and you'll never get it back. We've got to get an injunction. So, we raced into court. It took us a couple of weeks, up in front of David Hammerschlag J, who I knew, coincidentally, because he represented me when I was trying to avoid bankruptcy 20 years earlier.

Anyway, he gave us the injunction, so they stopped them doing anything. I sat down with our lawyers and they said, "Look, you can't win. It's impossible to win. You have to settle." I wrote out a cheque for $2.5 million, paid off the load, because I was in a strong financial position. I had to pay all my legal costs and we negotiated theirs and paid half of theirs, so I wrote another cheque for $130,000 for legal costs. $130,000 for me was a lesson well-learnt and it just reaffirmed my belief that it is impossible to fight banks in Court, no matter what your position is.

On that day I thought, "Well, this is interesting. This situation cannot be allowed to continue," and, from that day on, I started working on reforming the system, the imbalance of power between the banks and small business. I subsequently wrote a paper on it and I delivered it to the Menzies Research Centre roundtable. Minister Billson was in opposition at the time but he was the chair. That's what started my one-man campaign to have reform in

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this industry.

Just to reinforce a point I made - I know I'm going to run out of time - and just to give you an idea of the problem people face when you're taking on a bank, these are current default conditions from a bank loan: 53 pages of conditions. The conditions contain positive undertakings - things that you have to do, negative undertakings - things you can't do; then you've got default conditions and then you've got common provisions.

I was talking to the Minister for Finance in state government, Dominic Perrottet, recently, I had coffee with him and we talked about this. He used to work for a bank and he used to do these conditions. The fact is, for many years, decades, the banks have been perfecting their conditions, default conditions, and when someone challenges them they just add a few more pages. The point is that, no matter what your case is, you cannot win against the banks in Court.

MS CILENTO: Mr McNamee, given that we do have a limited amount of time, I'm wondering if we could move to what your suggestions are in terms of how you can redress that imbalance.

MR McNAMEE: Yes. I've spoken to various ministers and MPs about it and I've distilled it down to the three points I made in my letter. My view is - my simple proposition is clear, if a person or a business - a small businessman or woman, when they go bed at night and they're paying their interest on their loan, they need to be able to wake up in the morning safe in the knowledge that their facility is still in place - no exceptions, no exceptions. If a person is meeting his monetary obligations, the loan cannot be called in. First thing. That is the principle.

MS CILENTO: If I could just confirm, that would be interest payments and any principal repayments required?

MR McNAMEE: Yes, if it's a principal-interest loan. Any monetary obligations that they have to make on the loan, because they're the only things that they can control. I'm happy to argue that point with any CEO of any bank, and I've done that with one CEO of a major bank and I did it with the treasurer of another bank. They say things like, "We have to go in early. We have to go in early to protect our assets."

The point I make is this, on a million-dollar loan, for example, and the bank lends two-thirds, they lend 650,000, the owner has put in 350, plus another 50,000 in stamp duty, so the owner is in there for $400,000, if that person is paying the interest and ensuring the property, paying land tax and council rates, who is best to look after the value in that asset than the person who's doing that? Do these banks really think that a client who's doing that is going to go in there and damage the property when they're making all those payments? First and foremost, that is my position, and that is also the position in America.

The other two points are just housekeeping points, and that is that I can give you a case where - the second point is about six months' notice. I don't know if you're aware of Rory O'Brien's case against the Commonwealth Bank.

DR MUNDY: No.

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MR McNAMEE: Rory O'Brien was one of the victims of the one of the Bankwest clients when Commonwealth Bank took over Bankwest. This is now the subject of the up-and-coming PJC inquiry. Rory O'Brien had a $175 million loan on his Whisper Bay development at Airlie Beach. It was a two-year loan. He'd just finished the development. He had $100 million in pre-sales. He had the occupation certificate. Commonwealth Bank took over Bankwest and they immediately called in the loan - seven days' notice to pay back $175 million. Then they sat on it and they didn't exercise any of the $100 million worth of exchange contracts.

Then they tried to claw back the loss against HBOS, who had given an indemnity, or a claw-back provision, as Senator Williams spoke about in the Senate Inquiry, which was denied by David Cohen, the Commonwealth Bank's senior counsel. His position was - that's where the point comes that, if a bank is going to call in a loan, you need to give six months' notice, providing the thing is performing. If the loan is performing, people are paying their interest, then the bank can't say, "Oh yeah, we'll roll it over, we'll roll it over," and then in six months - and then, when the time comes, they don't.

The third thing is this: the bank cannot be the sole arbitrator of when someone is in default. You cannot have the bank being judge and executioner. What I'm suggesting is that it's not that different to a residency Tribunal, where, if a tenant is misbehaving, it goes to the Tribunal and the Tribunal makes judgments and says, "Get your loan back into order. You've got two months" or "You've got a month", "Otherwise you're out." I'm suggesting a third party has to look at the loan and say, "What's the problem?" and if the loan was a couple of weeks behind in the interest, "Can you catch it up?" "Yeah," give them another chance, and if it's looking hopeless, then, they can declare the loan in default.

The big issue here is all about secured creditors. I know a lot of people who have gone bankrupt, I know a lot of people whose businesses have been wound up and I don't know any that have been wound up by an unsecured creditor. Your report talks a lot about the obligations of the directors, personal guarantees of the directors, it talks about all those obligations, but in reality the insolvency industry works in such a way that, after the wind-up, unsecured creditors get virtually nothing anyway. All the money goes to the secured creditors and to the insolvency industry.

DR MUNDY: We have about 14 minutes.

MR McNAMEE: Sure.

DR MUNDY: We do have some questions we want to ask of you.

MR McNAMEE: Perhaps ask a few questions now.

DR MUNDY: Thank you. We made some recommendations about broadening the obligations of receivers to have a more general duty to all creditors, and have regard for them, along the lines of reforms that have been put in place in the United Kingdom in the last couple of years. Would that, in your mind, help with - - -

MR McNAMEE: No.

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DR MUNDY: - - - bearing in mind, of course, that a lot of unsecured creditors - namely, workers - did reasonably well out of the Ansett administration?

MR McNAMEE: You're talking about large organisations. My focus - and I don't know about public company stuff. I'm talking about companies that are midrange. Like, the Bankwest legacy loan book, the average of - the 1100 loans that were reviewed and called in - average was $8 million. This is middle Australia. These are people who have spent their whole life building a business and have been destroyed in their later years. I haven't thought about public company structures.

DR MUNDY: My proposition about expanding the obligations of receivers is general; it's not limited - you yourself made an observation about unsecured creditors. How could we improve the position of unsecured creditors that you seem to also be concerned about?

MR McNAMEE: The way that you do that is you don't let the banks - see, the unsecured creditors lose their money because the banks call in the loans. You've got to stop the banks calling in the loans when people are paying their interest.

DR MUNDY: So issues around loan-to-value ratios should effectively - your proposition would be that loan-to-value ratios should be prohibited by statute as being a condition?

MR McNAMEE: Absolutely.

DR MUNDY: Your proposition is that the Commonwealth should legislate that performance against monetary obligations is the only issue upon which a bank can foreclose on a loan?

MR McNAMEE: Absolutely, and that's exactly what it's like in America. How else can it be the case? I've got a call into the Human Rights Commission to speak to this. Property rights is a big issue and to take someone's property unilaterally, when they're meeting obligations, could be a breach of human rights.

MS CILENTO: In your comments you do refer to Chapter 11 and Chapter 11 as being a preferred approach. Is it just this aspect of Chapter 11 or are there other aspects of the US system that you think would provide a better balance of arrangements for small and medium enterprises?

MR McNAMEE: There are comments there that Chapter 11 is expensive. I don't know how anything could be more expensive than Australia. This fellow here, [name omitted], had his loan called in by Bankwest. This guy is like a - he could be on the rich list but he's been fighting them. He's spent [millions] now, fighting Bankwest, [millions]. Chapter 11 - there's a provision in Chapter 11 called - I don't know if you've seen that It's called the single-asset real estate debtor provision.

DR MUNDY: Yes.

MR McNAMEE: You know about that. What that says is that if the debtor is in financial trouble, then, he applies for relief under that and he's got 90 days to sort himself out and, if in that 90 days he starts paying the interest, at the non-default rate again, the loan can't be called

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in.

Under Chapter 11, a secured creditor cannot move in on a business. If they try to, that company will apply for protection under Chapter 11 and for 180 days all the creditors are frozen, secured and unsecured creditors are frozen, and he can continue trading, debtor - it's an administration where the debtor is in control still and, if you can come up with a scheme or arrangement, then you can start trading again after 108 days if people agree, but that prevents the bank moving in.

My proposition that the bank cannot call in a performing loan, a monetarily performing loan, is built into this system. It's not a problem over there. We've got banks moving in. I've got 100 personal impact statements from Bankwest customers, 100. The Commonwealth Bank moved in there and they just went "whack". They didn't want these commercial loans, for various reasons of their own, and they called in possibly 1000 loans. I've got 100 people's personal statements here, which I'm happy to hand up to the Commission.

MS CILENTO: That would be useful. One of the things that we have heard in regard to lessons learned, if you like, following the Global Financial Crisis and the implications for the financial system, is that banks have developed a slightly different approach more recently, in that they recognise the costs to everyone concerned of going through these default processes and they're now more inclined to spend the time to informally work these things out. Has that been your experience or have you got any evidence to suggest that banks are behaving in a different way or that there is a different practice being employed now?

MR McNAMEE: The banks will behave in whichever way suits them because they have the power. They're the sort of platitudes the banks roll out when they're in trouble. They're just platitudes. My loan here, in my Newcastle property, was in 2013. They decided they wanted their money back and they just used the power they had to do it.

MS CILENTO: If this is the experience with the main four banks, the larger banks, is there competition in the market where there's an opportunity to secure funding from other sources?

MR McNAMEE: I had this discussion with David Murray because I lodged a - this is my submission to the Murray Inquiry. I had an hour and a half with David Murray, discussing this. The point, he tended to agree - I shouldn't put words in his mouth. The words he said to me were, "So you're saying that there is price competition but there's no condition on terms?" That's exactly right. You cannot negotiate terms with the bank.

MS CILENTO: We might, given the time, move on to bankruptcy.

DR MUNDY: Yes. I just wanted to briefly ask - it's often raised that the ATO is quick to get people into administration in order to recover and claim GST and other PAYG taxes and things owing. Has that been your experience or is the ATO a reasonably well-behaved creditor?

MR McNAMEE: I can't comment on the ATO; I've never had a run-in with them.

DR MUNDY: Fair enough. In your material you gave to us, you suggested that the way that people who become bankrupt in Australia - they're treated quite harshly. If you actually read

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our report, I think you can get the sense that we're inclined to agree. We suggested that the period of disqualification should be reduced from three years to one year. There is, I guess, and I'm sure you would concede, a public interest particularly in people who are declared bankrupt for not innocent reasons but where there is malfeasance - that the community has an interest in what these people are up to.

MR McNAMEE: Sure.

DR MUNDY: What would you think would be an appropriate way to treat persons who are bankrupt, and in particular, I guess, their obligations to repay those to whom they owe money?

MR McNAMEE: If someone has been in corrupt conduct, that's got to be dealt with separately to people going bankrupt. My view on that is that you've got to stop people becoming bankrupt. They're being bankrupted, generally, in my experience - all these people here, Bankwest people, have been bankrupted by the banks. I was bankrupted by the bank. I would have been bankrupted a second time, on the Newcastle project, if I wasn't in a strong position.

The first thing I recommend you do is change the personal guarantee regime. You saw that comment in my letter. Personal guarantees cannot be open-ended. Going back to your original question, the American system is much better. Under Chapter 7 in the American system, if someone is genuinely going bankrupt and their business has had it, you go along and you lay your books out and you say, "I'm in trouble," and the court says, "Righto. Give us all your assets and you're allowed to keep certain assets." In some states of America, you can keep your total equity in your house. In Australia you keep nothing; I mean, you are ground into the dust and you are kept there, in prison, for years.

In America they say, "Righto. You've gone broke. We'll take everything you've got. You can keep certain stuff," and it varies from state to state, and you start again, and there's no period. You start again. If you want to encourage people in Australia to go into business and employ people and generate growth, take on debt, take on commitments, take on contracts, you don't want these people to be penalised. You can't penalise them for failure. You can penalise them for corrupt activity but not for failure, if you're trying to grow the enterprise of this country. In America they don't do it.

DR MUNDY: All the data that we have is - if it's not contested - that the vast bulk of bankruptcy in this country are not business-related, they're personal finance-related. Would you see that general proposition being advanced to people who can't manage their own money, because that's a reasonable description of the majority of bankruptcies in this country, or would you see a separate class of bankruptcy treatment for business - - -

MR McNAMEE: I would certainly see it separate. I haven't addressed the case of where people go out and borrow money on their credit cards and go travelling overseas. I preach delayed gratification to my children all day long. I'm totally opposed to having a gap year, and I've got five pretty well-adjusted young-adult children. My focus is on bankruptcies brought about by personal guarantees. Do you understand my point about the personal guarantees?

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DR MUNDY: Yes, I do. I've given a couple of them.

MR McNAMEE: That's right. The point is, when a bank gives you a loan - this is an example, I have no assets - as a group, my wife and I are very successful, in general terms but I have no assets. I give personal guarantees for my loans and I have no assets because, once you've been through the thing once, you avoid it. If you look at most professionals, they have no assets in their name to protect them. It's the young entrepreneurs who are coming through who get bankrupted because they haven't been advised well.

DR MUNDY: It's almost 9 o'clock, so we might draw the discussion to a close here. Thank you very much for your time, Mr McNamee. I'm reluctant to take those impact statements, only because the Commission has a general policy not to accept information about individuals which they haven't consented to being provided to us. I'm probably happy to accept them but we won't publish them without the consent of the individuals concerned.

MR McNAMEE: I'd like to just - I think it's important you just - don't publish them., I agree with that, but you just read through here.
DR MUNDY: If you could give those to our staff up the back, we will have a good look at them.

MR McNAMEE: It just gives you an understanding of how the banks act. It's these sorts of things which will be in evidence at the JPC. Could I just suggest that - this JPC is going to be a significant event and I'm just not sure it's a good idea to finalise your report on bankruptcy and recommendations in regard to the whole bankruptcy provision.

DR MUNDY: Unfortunately, we have a statutory duty, independent of the JPC, so we have to comply with our statutory duty, and committees of the Parliament will do as they will.

MR McNAMEE: Okay.

DR MUNDY: Thank you, Mr McNamee.

MR McNAMEE: Thank you very much for having me.

DR MUNDY: Next we have the Law Council of Australia. For the record, could you state your name and the capacity in which you appear and perhaps make as a brief opening statement?

MR KEYES: Sure. My name is John Keyes. I'm the Chairman of the Business Law Section of the Law Council of Australia. With me is Bruce Cowley, who is Chair of the Corporations Committee of the Business Law Section; that is one of our 14 or so specialist committees. We're both practising corporate lawyers. The business law section has a responsibility within the Law Council of Australia for federal business law matters, including corporations and insolvency. I'll hand over to Bruce.

MR COWLEY: This morning I'll focus especially on the safe harbour provisions that are discussed in the draft report. Our concern is about directors potentially moving too early to put a company into administration, with the consequent barrier destruction, job losses, all that kind of thing.

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As was noted in the BLS submission, there is the stereotypical image of a company and its directors desperate to ward off insolvency and continuing to trade when the company is close to insolvency. That's just not our experience as corporate lawyers. We spend a lot of time talking to directors who are concerned about that kind of thing and it's a big point of focus for them. What seems to worry them mostly is the need to act quickly, because the law requires them to, and there is a tendency to want to move as early as possible.

One of the drivers for that is the potential for personal liability which they might be exposed to, particularly under 588G for personality liability for debts incurred, particularly because those things are always determined in arrears, so you can never be totally sure at that moment when you pass insolvency; and they know that if that happens they're putting themselves and their personal assets at risk. So they've got an incentive to act and to act early.

I know this is at odds with the view expressed by McGrathNicol which was referred to in that draft report but certainly that's not our experience. Our experience is certainly that directors do worry about these things and are inclined to want to act as early as possible, knowing that their own personal assets are at risk.

We note the Commission's comments that directors' concerns about the risk of insolvent trading might be misplaced, given that research in 2004 that you referred to, that there were relatively low numbers of insolvent trading actions, but a lot of these things don't find their way to Court and, anecdotally, we think the numbers might be much larger now than they were back in the early part of the 2000s. This is something that insolvency practitioners look at in every case, to see whether directors have in fact acted improperly and breached the law.

One of the things that I think was noted by ARITA, featured in the draft report, was the fact that, even though there may not be a lot of prosecutions, this is something certainly on directors' minds and drives a lot of settlements which take place as a result of directors being concerned about their own personal risk.

For all these reasons, we think that directors do have a general apprehension of personal liability and they're inclined to move early, without necessarily having taken every opportunity to save the company or at least thereby cause available opportunities to save the company to be lost.

Saving the company can take many forms - it won't be just selling assets; it might be entering into a new substantial revenue-generating contract, it might be raising additional equity, it might be undertaking additional borrowings or restructuring existing borrowings - and often directors will have several irons in the fire but no firm offer which is capable of acceptance on the table when they decide to appoint the administrators to avoid that further personal risk. The pressure on them, ultimately, just becomes too great and they feel they have to act, and those opportunities are then lost.

The reason for that is that, as soon as the administrators are appointed, equity and debt offers disappear off the table, debt restructures disappear, creditors and counterparties want to take action to protect their positions. On top of that, the companies will be burdened by the not-insubstantial cost of administration. So that, even if there was a possibility of the company being resurrected once administration starts, the additional administration costs sometimes

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make that even less likely.

As a result of all that, we do strongly support the idea of directors being given a safe harbour. While the ARITA proposal, mirroring the business-judgment rule in section 180 of the Corporations Act, has some attractions, in our view, it would be very hard to make out. Directors already have little faith in the business-judgment rule, which has seldom, I think, if ever, been successfully relied on in the context of section 180 of the Corporations Act and, as a result, directors do have little confidence in it. It seems likely that they would probably react in a similar way to any similar defence in 588G, which is why we prefer the Commission's suggested approach in recommendation 15.2.

We do broadly support that proposal. We did have a small number of comments about it. One is that we're a little concerned about the need to disclose the appointment of an insolvency adviser to ASX because the announcement may of itself have a detrimental impact on the company, and we can see that happening.

We're also a little bit concerned about - in the third dot point, there's a reference to a director's business judgment. Since the decision in the Fortescue case, directors have had some concerns that their actions might be determined by the Court not to be a business judgment. For example, if you do nothing, that may not be a business judgment; if you make an announcement to ASX, that may not be a business judgment. So, the concept of what is a business judgment is a little bit muddied and our concern is that, if we talk about directors exercising a business judgment as opposed to just a judgment, that might cause some issues.

In the second dot point, there's also a reference to a duty to creditors. That's not a duty which directors have at the moment and it would be a fundamental reshaping of directors' duties were a duty to creditors to be created. Currently the duty the directors have is to the company to take account of the interests of the creditors, at a time when the company is approaching insolvency. So, to create an independent duty to creditors which they could sue upon would be a very different kettle of fish.

The final point is just that - and it's really just, I guess, giving wider application to the safe harbour but under the tax legislation - actually, not only federal taxation but also under some of the state tax laws - directors can become personally liable for taxation debts and any safe harbour. It would be useful if it expended more broadly than just the Corporations Act, the liabilities that they might have.

In relation to the Commission's information requests, we do acknowledge the need for a limitation on the time during which directors can avail themselves of the safe harbour, and we suggest that 90 days would be a reasonable period.

We think the defence should be able to be availed of, we suggest, once every two years rather than the suggested three, because a lot can happen in that time. As we noted in our earlier submission, Australia's insolvent trading regime is already the toughest of all the western economies, and we see no reason to make it any easier to prove insolvent trading, so we wouldn't support a proposal to make insolvent trading simpler to prove. Already there is an obligation on directors to act if they have reason to suspect - not expect but suspect - that a company is insolvent, which is a pretty low bar.

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The final point we wanted to make relates to the proposal that administration only be available before a company is technically insolvent. We don't agree with that part of the proposal. In our view, a company might just as easily be able to be saved after it satisfies the test for insolvency as before because, after all, the safe harbour is designed to protect directors during a period when the company may in fact be insolvent. You've got the safe harbour period. Does that mean that, if the company is insolvent and the directors are availing themselves of the safe harbour and they're unable to pull off a restructure, they then have to put it into liquidation rather than allow a period of administration? We don't support it for that reason. Thank you. They're our points.

MR KEYES: Sorry, can I just add a couple of points? Sorry, Bruce. I'll just reiterate a couple of things. One, in the draft report, at page 353, there's reference to the spectre of action being perhaps larger than the likely consequence. I just think it's very important to note that in this case perception is reality; if the directors perceive there is a threat of action, then the actual statistics will not be relevant. As Bruce has said, and as recognised elsewhere in the draft report, I think at page 346 there's a quote, non-executive directors in particular have no incentive to battle on. From their point of view, it's all downside; there's no upside for them personally. Therefore, they have a clear incentive to act, arguably, precipitously.

As Bruce has said, the test is "reason to suspect insolvency"; it's not whether the company is insolvent or not - the personal liability hinges on whether there's reason to suspect insolvency, which is a much broader test, and then, in order to have a defence, the director needs to prove that they have reason to expect solvency. That is one of the aspects of the Australian regime which is different from other countries and really does cause, in my view, a great deal of the problems.

The other thing I think we just need to note for completeness in relation to the business law section is that we anticipate that you'll be receiving a submission from our insolvency committee later this week. There are a number of the proposed recommendations in relation to insolvency, quite apart from the safe harbour, which are matters that we may wish to make some comments on in relation to changes to receivers' obligations, ipso facto clauses.

We think there may be some unintended consequences of these proposed measures; in particular, it may be that creditors aren't willing to deal with companies under that sort of regime if, for example, secured creditors are unable to realise value in the same way as currently or, alternatively, in relation to ipso facto clauses that suppliers are forced to deal with an insolvent company. I do want to absolutely reiterate that a change to the regime whereby voluntary administration would not be available for insolvent companies would, I think, in our view, be a very retrograde move.

Can I say this, and this is a personal view in relation to Chapter 11: I note from the report that you don't support extending a Chapter 11-style regime to Australia, and one of the observations is the costs involved and also the involvement of external advisers. For large-scale corporate insolvencies, which involve a high degree of complication and indeed a high degree of expense, having the option of a court-supervised regime may well be a great advantage.

Whether that would be of advantage to the wide variety of insolvencies that we might see, particularly in the smaller end of the market, I concede, might be doubtful but providing a

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further option for corporate restructuring and corporate resuscitation, as it were, could well be worth considering. I would also add that in relation to voluntary administrations there is a lot of Court involvement in particularly large and complex voluntary administrations and I wonder whether there would be much of a difference.

Can I just make one point of clarification? On page 334 of the draft report, there is an observation that ASIC indicated that very few scheme administrators have been appointed in recent years, and this is in reference to creditor schemes of arrangement. Many creditor schemes of arrangement don't actually provide for the appointment of a scheme administration. I know from personal experience that in 2011-2012 we were involved in a restructure transaction of the Centro schemes, which didn't involve a number of creditor schemes, so those statistics aren't representative of all the creditor schemes - - -

DR MUNDY: Is the Law Council able to provide us with more reliable statistics than the government?

MR KEYES: I'm not suggesting that the statistics are actually unreliable or incorrect factually, but - - -

DR MUNDY: I take your point but how could we get data which is more reflective of the reality?

MR KEYES: I'll have to take that on notice. I think that would be a question best directed to ASIC. The point is that, as I say - - -

DR MUNDY: We obviously have directed the question to ASIC, and that was the answer we got.

MR KEYES: Okay.

DR MUNDY: If we could perhaps - I'm just mindful of the time. The issue of insolvency and technical insolvency was a matter we discussed at some length in our hearings in Melbourne, with ARITA. I take your point, that insolvencies can effectively be a point-in-time event which comes and goes. The whole purpose of the reforms we're trying to put in place is to ensure that companies which are viable in the long term, if you want to use that sort of language, aren't falling foul of technical events or adverse incentives for directors, or whatever.

I think your concerns about VA and stuff like that are actually - we're thinking through that whole question of "What does it mean to be in VA?" The problem we're trying to get at is - it has been put to us by a range of participants in this inquiry that VA seems to be a place where people can pass through on the way to liquidation, and that's part of what we're trying to get at. We're trying to get people better access to restructuring and, at the same time, get rid of people who are just using VA as a waypoint to liquidation. On that second point, do you have any observations about how we might be able to achieve that goal?

MR KEYES: In a slightly indirect response. I think it is true that voluntary administrations have been statistically, as you say, a kind of waypoint to liquidations in many cases but one could say that it's entirely rational for directors to seek the opportunity of a restructure,

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pursuant to a voluntary administration and the possibility of a deed-of-company arrangement, and one could, I think, argue that it's better that they be given the opportunity to do that, rather than, if you like, proceed direct to liquidation. There would be a number of trade-offs inherent in all of that, and one of the concerns that I think Bruce and I were discussing before the hearing was the fact that, yes, administrations can be quite costly and it may be that proceeding through an administration means that there is greater cost; therefore the creditors are worse off.

However, I think the important thing to do is to work out what is the counterfactual. Going back to before the Part 5.3A provisions were inserted, insolvency led to, in most cases, liquidation. There may have been opportunities for restructures involving creditor schemes of arrangement but the reason for introducing voluntary administrations was to give a greater chance of reconstruction, having regard to the fact that, as you observe in your report, there's economic viability. You can have a business which is economically viable but carrying too much debt and, in terms of restructuring, if enough of the deed is written off, you've got a business that can survive, but that business will be insolvent. So, saying, as soon as the business becomes insolvent, it should proceed direct - - -

DR MUNDY: Part of the discussion we had with ARITA was, really, "Is insolvency the right test? Is the presence of insolvency and perhaps some other test what's causing the legitimate concerns about director behaviour, when it's coupled up with personal liability?"

MR KEYES: Is it the right test for - - -

DR MUNDY: For example, being in voluntary administration - our proposition basically is, an administrator who finds a company which in their view is hopelessly lost should have a duty to move immediately to liquidation, rather than - pardon the expression - pfaff around with the creditors' money, keeping the thing in voluntary administration?

MR KEYES: If you'll forgive me, I think it's necessary to kind of unpick the idea of "hopelessly lost", because, on a kind of a balance-sheet basis, you might say, "Yes, hopelessly lost because it's got debts that the business can't carry," and if those debts are written off as part of the deed-of-company arrangement - - -

MS CILENTO: We were looking at it from a broader context, not just cash flow. We're trying to get - what we've tried to do is come up with an arrangement that encourages businesses to restructure earlier, so that they don't end up down a path where administration fees and everything else totally swamps them. One of the things we have been talking about is that there are definitely business models have just failed, where the business proposition - and they get to a point where the model hasn't moved, yes, they have a lot of debt but a third party would look at it and say, "Even on the base-case scenario, this business is not going to be commercially viable."

MR KEYES: That's essentially what will ordinarily happen in voluntary administration. The administrator will go in and has to call a meeting of creditors very quickly, make an assessment of the viability, what the options are, and I think you would say that, if the business is hopeless and there's no prospect of any deed-of-company-arrangement restructure proposal coming forward, in the ordinary course, yes, that would go to liquidation. The question is, can you circumvent that first step.

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The concern that I certainly have is that, if you take away the opportunity for an insolvent company to restructure through voluntary administration by pushing it forward and saying - - -

DR MUNDY: That's not our intent.

MS CILENTO: We're totally on the same page. We're trying to understand what the options are to create a system that achieves exactly what you're talking about, recognising that at the moment there is a perception that, when you're in VA, it is a one-way path to liquidation. Part of what we're putting forward is, can we change the system in a way that encourages a work-out earlier, so that the likelihood of reaching an agreement is increased and the damage done as you progress without a constructed restructure is avoided; so that it is seen as something that is a much more constructive process. At the moment what we're hearing is that businesses have got to such a point of insolvency and cash flow and whatever else that the probability of an effective workout is drastically reduced.

MR COWLEY: I like this concept of having another look at the solvency question.

MS CILENTO: Yes. We hear what you're saying about even - and I understand this, that if you are insolvent you might have a temporary liquidity problem - it doesn't matter what your debt levels are but, for whatever reason, you've got a cash-flow problem, but the business is incredibly viable if you can get over that hurdle. We understand that but we're just trying to figure out how you - and that's why we've been talking about this concept of viability, as distinct from a very strict definition of insolvency.

MR COWLEY: I like the idea of thinking about how that might be able to be re-engineered. I do think that plays into the question of the director safe harbour because at the moment the kinds of things you're talking about often happen. The directors are trying to do those things, they're trying to win new contracts, they're trying to find some new equity, they're trying to renegotiate their debts all at once, so those things are all happening, but I think at the moment they're not doing that with great confidence because at some point they think they're going to cross a line and have to appoint the administrators, and then it is all over. If there is some way we could rethink that question of "What is that line when they - - -"

MS CILENTO: What's the trigger?

MR COWLEY: Yes, "What's the trigger?" that would be very helpful.

DR MUNDY: That's what we're trying - insolvency is a very blunt instrument and it could be temporary. We absolutely get that but it has been put to us, by ASIC and a range of others, that there are some things that go on in hopeless voluntary administrations which probably, in the public interest and certainly in the interests of creditors, should be prevented. What we're trying to do is come up with a package that deals with that. We're trying to get rid of them and do more for the genuine restructuring, so that the director safe harbour issue is the important issue.

I just want to come back on the disclosure point. We take your point about that if a big sign goes up that says, "Hey, we're in trouble, we're in more trouble than we were before we put the sign up." Of course, if there's a listed company that finds itself in this position, it may be

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inevitable, because of the listing rules, that it has to put this big sign up - - -

MR COWLEY: It may but not necessarily.

DR MUNDY: Yes, but it would be something that a director of a listed company would have to think really hard about it.

MS CILENTO: Your disclosure committee would certainly be looking at it.

MR COWLEY: Yes. Absolutely.

DR MUNDY: For the vast range of companies, we're probably concerned if they're not listed. Instead of - could a private notice be provided to ASIC perhaps or - we're concerned, I guess, to some extent about the public perception of this, that there should be some supervision. You could have - you put it on the basis of that directors rely on safe harbour as a defence ex-post or that there is a process where ASIC becomes aware of a problem ex-ante or at least at the point of time of the adviser, and that could be done in private.

MR KEYES: I guess my question is, what is the purpose of that requirement because, if the objective of the measure is to provide a safe harbour to directors and to thereby encourage restructuring, what is the objective, the policy objective, that's being sought by requiring notification, or how does that further the policy - - -

DR MUNDY: It's a question of the policy design, with respect. It's a question of whether it's an arrangement that the state provides to directors to avail upon and therefore the state has a legitimate interest in knowing that it's being availed of, or, alternatively, whether you just want to - I'm not saying - it's a policy choice. The alternative is that effectively it becomes a defence against a subsequent insolvent trading action. So, it's a choice between the policy design model and it may well, to some extent - because there are concerns about the behaviour of directors, particularly around Phoenix companies, there would be some risk around - I think people perceive there would be some risk around the safe harbour arrangement for those who are out to do no good. An arrangement where you notify that you're now availing yourself of this would mitigate that risk of nefarious conduct.

I think, in the broad scheme of things, with people acting reasonably lawfully and with good intent, there probably isn't a huge amount of difference in the incentives but what we don't want is trying to deal with, essentially, nefarious conduct.

MR KEYES: Can I just say this, and I think that it's something that we've experienced over many, many years: the Australian market, if you will, is not homogenous; there are spectrums, particularly within - you've got, as you say, your Phoenix activity, then you've got, I guess, in our experience, the larger listed companies, and trying to legislate and say, "We're going to apply the same approach to both things and come up with a solution that will work perfectly at both ends of the market," I think is a policy challenge that no one has really got right.

MS CILENTO: I guess if you're thinking about that - I think it's an open question as to what your disclosure obligations will be as a listed company and I think it does - - -

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MR KEYES: Can I say this, if a listed company was to seek advice, not knowing whether or not they were insolvent, say, there's been a major claim made against them, they're in the process of seeking advice and trying to figure out whether or not they are in a position of being insolvent, et cetera, there may or may not be a disclosure-obligation trigger at that point because you may have something that's insufficiently geared toward a disclosure.

MS CILENTO: Yes. I agree with that, but if you were to - let me put this to you: if you were to appoint an external adviser, with a view to having to undertake significant restructuring because you have very real concerns about your ability to meet your liabilities as and when they fall due - - -

MR COWLEY: It's not so much the appointment of the adviser; it's more a question of the solvency, "Is your solvency so under threat that you actually need tell the market?" I don't think it's the appointment of the adviser so much; I think it's the solvency question.

MR KEYES: Let's take another hypothetical. Say there is no safe harbour defence at this point but you go and start talking to an insolvency practitioner, lawyers, about the issue, trying to put together a reconstruction proposal, start negotiating your bank, so on and so forth. At that point you've got the incomplete negotiation, provided it's confidential, et cetera, et cetera, so I don't think we should presuppose that there would be an immediate disclosure obligation. We had this discussion in relation to some APRA proposals going back a couple of years. As soon as you trigger that, as soon as there's a disclosure, particularly for a listed company, you will close off a number of the options, including raising equity, potentially.

MS CILENTO: Your concern about even a private advice of what's going on is - - -

MR COWLEY: There's some merit in it because I can see that, if you're a good director and let's say there was a 90-day period during which your claim of safe harbour - I could see some merit in actually notifying ASIC privately and you know you've got this 90-day moratorium with the restructure of the company, so you've got a fixed period, you know what it is and it would give you confidence to do those things.

DR MUNDY: Part of the issue into the Phoenix question is, if you have an arrangement notification, you will see people availing themselves very regularly of them. That act will, hopefully, deter them from - - -

MS CILENTO: Yes. I'm just wondering what the negative consequence of having to notify ASIC would be.

MR KEYES: I guess, from a philosophical point of view, that, if you like, technical procedural process requirement, if the availability of the defence hinges on that, I can see that having the notification - from a statistical and incentive point of view, I can see the benefits in that but if the real problem that we're trying to address is encouraging directors to engage in economically advantageous restructuring, rather than going to insolvency administrations, it seems to me to be a fairly blunt instrument to achieve that objective. I think, if that were the price of having a safe harbour, we'd probably groan and say "Okay."

DR MUNDY: We have to draw this discussion to a close. Given our concerns about - if you

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can have a think about that and if there's anything you'd like to add, please do so, because that's - part of the challenge in all of this, of course, is public and political acceptability of the recommendations we make. There is a substantial public concern, certainly in the Parliament, about Phoenix activity, so anything that looks like providing an out for directors will get dragged into that discussion, so we're trying to buttress - in a sense, with effectively an anti-avoidance arrangement.

MS CILENTO: I think your comments about the one-size-fits-all are well taken. So, again, anything - understanding fully what you think the unintended consequences would be for different groups of business would be very useful, so, to the extent that you can articulate what you think the costs of a particular approach would be that might be aimed at one group and whether it would have adverse consequences for another would actually be very useful for us in thinking about how we can structure it, bearing in mind my fellow Commissioner's comments.

Can I make one other request, if I could? We are very serious about looking at the ipso facto, obviously, and things like that. You mentioned at the start that there's another area of your organisation that is likely to putting a submission on that. One of the areas that we have actually tried to get feedback on is, if you think there are unintended consequences, have you got any evidence, including, are you aware of evidence from other jurisdictions that have adopted these approaches, rather than, with all due respect, a sort of "We think the sky fall and these are the intended consequences"? Wherever you can point to evidence or experience or a degree of detail about the nature of the unintended consequences and how they flow from that and whether there are alternatives, that would be very helpful to us.

DR MUNDY: Thank you. Could we now have the Property Institute of Australia, please? Could you please state your name and capacity in which you both appear?

MS SANDERS: Gail Sanders, I'm the New South Wales Executive Officer of the Australian Property Institute.

MR SHEEHAN: I'm John Sheehan, I'm Chair of the Government Liaison Committee of the Australian Property Institute New South Wales Division.

DR MUNDY: Thank you. We've received some helpful notes, but perhaps if you'd like to make a brief no more than 10-minute opening statement, then we can have a bit of a chat.

MS SANDERS: I'm just going to give you just a very brief outline of the Australian Property Institute. We've been around since 1927. We were the Commonwealth Institute of Valuers then. We represent individuals and we're a professional association and not-for-profit. Our members work in a wide range of property from property valuation, plant/machinery valuation, funds management, property finance, agency, asset management, funds management, property law. So we've got a very diverse membership. The New South Wales Division has the most diverse membership of our institute nationally and we make the submissions on behalf of our body on a national basis, given that we have the most resources, we're the largest division, and we have the most diverse membership. John is the Chair of our Government Liaison Committee and is responsible for coordinating the majority of our submissions.

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MR SHEEHAN: Thanks, Gail. Commissioners, it's a pleasure this morning to address you. I would like to, first of all, give a brief opening statement, as we said in our submission to Mark Bryant just recently, and then, as you indicated, you might like to ask questions of us. I wanted to particularly look, first of all, at section 3.2 of your draft report and in respect of the planning, zoning and development aspects of starting a business. As we said in the submission, one of the issues lies in the fact that when someone is attempting to start a business up, invariably they are creating that business on a parcel of land, hence our interest as the Australian Property Institute.

Often that involves gaining a development consent from the local government authority and that necessarily involves the preparation of documentation, the submission of development application and, at the very least, it would occupy at least 90 days, from what we're told by our members, if not longer. If there's a rezoning involved, it may take considerably longer. In the case of shopping centres where one of the largest group of small businesses seems to exist what happens there is that even if a development consent is granted to a shopping centre proponent, what occurs also is that there's a condition usually in the development consent that the individual shops, what we might call the speciality shops, and even the supermarkets, have to gain separate development consent.

One of the issues there is that so much with the major operators such as Woolworths and Coles or Aldi or someone else like that – where a smaller operator is involved they have to gain that separate development consent and often the gaining of the lease from the shopping centre owner involves gaining that, first of all, development consent. They can't get the lease until such time as they get development consent. As I said in the opening comments there, you might be looking at least at 90 days or more. So they're reasonably desperate to get a grip on the potential lease. So quite often what would happen, we were advised, that they will even use their own home to provide the necessary funds to either lodge a development application to the council or secure the lease. That's an invidious position to find yourself in as a small operator because you've got a lease perhaps which is subject to development consent. My own experience as a chartered town planner suggests to me that even a basic development application would cost at least about $20,000 by the time you pay the fees. That's an awful lot of money to raise, even against your house, for the prospect of gaining a lease.

Now, it seems to us that the institute's point of view, it's really a hindrance to a business start-up if you have to gain a development consent for a general proposal like a shopping centre or a major industrial complex and then to turn around and have to obtain an individual development consent for the separate occupancies, given, as I said before, that often the separate occupants, separate lessees, are going to be using that lease as a basis of raising funds for the fit-out and all of those things, which is what you've mentioned later on was in the draft report. So that was one concern for us.

One of the other issues also which we raise, which I think was on page 77 of the Commission's report where you very kindly picked up our comments about the Commission's previous report about the fact that planning, zoning and development assessment is clearly a hindrance, more particularly in the fact that there is, and there continues to be, a lack of harmonisation between the six states, the two territories, on the basis of development consent. The requirements in one jurisdiction can be significantly different to what they might be in another jurisdiction. Given, for example, that – let's take

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the example of shopping centres. Given that some of the major shopping centres owners – and we know who those are, Westfield and people like that – they operate on a national basis. It must be very frustrating to small, medium-sized specialty shop operators to find out the rules in Victoria are quite different to what they might be in South Australia to what they might be in New South Wales.

There would seem to be at least an argument, a strong argument, for maybe not completely harmonised legislation between the six states to assist with this in start-up, but certainly to at least see harmonisation of the basic requirements, the documentation that has to be provided. One state might require considerably more. In the case of New South Wales, for example, building applications have some years ago been got rid of. All the information has to be provided upfront. So if you're proposing to gain effectively an in-principle approval for a speciality shop in a shopping centre or a specialty space within an industrial complex, you've got to provide everything down to even the colour swatches of what the carpets might be in the 10 per cent office space. That's a huge cost for a person who's trying to start up a business.

The other issue which we raised in our submission to you was in respect of page 5, and that was that even – it's under section 2 of page 5 of our submission – even within the city, for example, if you have a tenant of office space in the city, a small town, if they want to move from one particular office spot to another office spot, it's quite common for them to have to gain development consent for exactly the same CBD use just because they're not longer in Goulburn Street and they're moving to Elizabeth Street. The cost of that is just enormous for small operators. And, as we've heard recently, small business is something that the federal government is trying to encourage.

Can I turn now to that next section in the Commission's draft report, which we didn't comment on initially but for which I would like to say something about. That's at page 218 under commercial leasing arrangements. One of the issues there which is raised by the various submissions that were obviously received by the Commission was in respect of the renewing of retail leases. The question of whether or not there should or shouldn't be options attached to retail leases is in itself a vexed issue. It's understandable that major landlords for shopping centres and even bulky goods complexes and, of course, major industrial developments, they ordinarily wouldn't like to give an automatic option for five years' renewal, for example, on a five-year lease.

If you harp back to what I said a moment ago, it's obviously very difficult for someone to gain a development consent anyway and then to find out, after perhaps waiting maybe six months for their lease and they're finally secured the lease, to find out they've only got four and a half years to run for the actual lease to be told they don't have the ability of an option to take up for an extra five years. The landlords argue that there's a strong reason for that, because they might want to re-jig the shopping centre or the industrial estate. But at the same time, there's also a more insidious point I'd make in relation to New South Wales, and that is, with an option in the retail leases legislation New South Wales there is an ability for the tenant to be able to renegotiate obviously the rent and if it isn't satisfactorily dealt with, it then goes to a process within the legislation under the Retail Leases Act whereby the small business commissioner gets involved in it and there is a redetermination of what is a satisfactory rent.

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You can see from the point of view of the landlords that they wouldn't like to see that involvement by that Act because it could mean they could end up putting someone relocating in a shopping centre to a lesser location, obviously lesser throughput or lesser people pass the door, and they would obviously – the tenant, relocated tenant, would be seeking a lower rent. You can see why the shopping centre owners wouldn't like that. However, as I said before, there's two issues there with that. So, first of all, I suppose that is an issue in itself, which has been identified in the Commission's draft report.

The other issue, of course, is that the fit-out issue, which you've dealt with in the draft report that mainly relates to shopping centres but they do have an issue in relation to the very high standards that's required of a potential tenant for a shopping centre. Given, as I said before, there is this issue with gaining the lease which is tied into gaining the development consent. The question there is that predominantly major change to the occupiers in shopping centres, it's the smaller operators are the ones that are most at risk because, fairly obviously, the major chains as lessees and certainly the shopping centre owners are well-resourced and very capable of looking after themselves. It's the smaller operator that really hasn't got the capacity to be able to gain legal and town planning advice. They're the people that really the retail leases legislation New South Wales attempts to assist. Again, the issue there, similar to the planning legislation, the state jurisdictions are significantly different from state to state, which, again, given how they operate nationally, it seems to be a major issue.

Lastly, I wanted to take you, if I could, to, again, something that we didn't mention in our submission but which I would like to speak to, which is 10.4, the land tending arrangements at page 222 of the draft report by the Commission. There is a comment, I beg your pardon, at page 223 in relation to the fact that where land, particularly in the central and western divisions of New South Wales, obviously is going to be more likely be Crown land, you may encounter native title. There seems to be a flavour in the comments that are made there that native title is a barrier to business set-up. Well, the Native Title Act 1993 was established to protect native title. Whilst it may be seen as a hindrance to starting a business, it's very clear that the Native Title Act in 1993 and the subsequent 1998 decision in Wik said that native title is protected by the Commonwealth legislation. So I think that that in itself represents somewhat of a hindrance, but it's a desirable hindrance to starting up business in the western and central divisions in our state. Thank you.

DR MUNDY: I think it would be wrong to assume that Commissioner Cilento and I had any objection to state or Commonwealth entitlement. Thanks very much for that. As you're aware, the Commission has waxed lyrical on planning and local council matters since before my appointment almost five years ago and I have had the pleasure of revisiting this with some of my colleagues. You mentioned the issue around "I've got my planning consent for my shop in Pitt Street, then I've had another one to go around the corner to open up in Elizabeth Street."

Now, obviously there may be some building control issues because of where you're setting it up. But the basic planning issues are essentially within – your proposition, presumably, is this is a shop in a retail area and nothing really hangs on it. I guess one of the issues that we explored in our local government as a regulator report was this notion of principle authority or once-off approval for multiple actions. It's very common in the United Kingdom. Would you see that say a circumstance where from a planning perspective you had approval to open your women's fashion store or you got your approval say from the city of Sydney that you

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shouldn't – as long as you acted in accordance with the content of that approval you should be able to pop up and put the shop in Parramatta without having – is that the sort of – is that further than what you're suggesting? Because that's certainly what happens with major retail operations in the United Kingdom.

MR SHEEHAN: Yes, I see where you're coming from, Commissioner. I think the problem lies, until this amalgamations of local government in New South Wales beyond the present status, I can certainly see a very strong argument for if you have a specialty shop, for example, or a shop in the city of Sydney in that particular local government area and you want to move to somewhere else in the city or, as I said before, you've got an office occupying say half a floor in Clarence Street, you want to move to Elizabeth Street, it is just rank stupidity that you can't simply transfer from one location to another.

Moving from one local government area to another, there is some issues there because, in fairness to local government – I mean, the issues in Parramatta may be, for example, if it's close to the title limit on the river there there's always potential for all sorts of issues there in relation to flooding where that's not an issue in the case of city of Sydney. I mean, Brisbane City Council operates a huge area and there is one standard for all development there. I often use in both my own work at the university and also in our discussions at the institute the example of Brisbane. They do have regional offices within the city of Brisbane but you are dealing with one standard.

On that basis alone, you can – you would think you would be able to move from say Ashgrove to maybe somewhere else, say Chelmer or somewhere else, without having to gain a fresh development consent. In terms of a business start-up and a business transfer, even if you perhaps have a new owner of a business and you've got to transfer to somewhere else – and, in fact, you could even argue – putting my law hat on here for a moment – that the change of ownership of the business as the lessee of say an industrial estate or a shopping centre could involve the gaining of a request for a new development consent because the actual applicant, the actual lessee, is now different to who gained the development consent. It's an issue.

MS CILENTO: A question on a point which you haven't spoken to but which I understand was in your submission which relates to run-off insurance.

MR SHEEHAN: Yes, that in itself represents a significant issue. As Gail said at the outset here, the New South Wales division of the institute represents the largest group of property professionals within our institute. Also, one of the things is that our people are the gatekeepers for the banks and financial institutions, because mortgages, real property mortgages, are still the main source of security for a lot of investment. Consequently, when our small business people, who are our members, undertaking mortgage valuations want to close their business down or perhaps look at retiring, they've often got to keep run-off insurance for many, many years after they effectively cease business. That represents a major hindrance to the starting up of a new valuation business and it is a crucial business in terms of banks, because under Western Australian, Queensland and New South Wales legislation you have valuers registration and only that class of individual can value property for the purposes of mortgage or value property per se.

So we are in an invidious position because we're required to have professional indemnity

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insurance as a condition of being on say a bank panel to do the work, but at the same time, once you reach a certain age and you want to either sell the business to someone else, you've still got to – because you pick up individual liability. So people like – being like I am, a director of a public company, you can't avoid the liability. So you've got to spend some years meeting the premium payments as it actually feeds off. It is a significant hindrance to people taking up that particular profession.

MS CILENTO: I'm assuming that you are arguing that people shouldn't be responsible for their advice or their actions for a number of years even if they've retired, or are you?

MR SHEEHAN: Well, look, it's a very difficult issue there. I don't think anyone – and we certainly wouldn't suggest that members ought not to be responsible for their professional advice. But it may well be, for example, that a mortgage valuation is undertaken for the purposes of a long-term loan. How long should the liability exist? Should it exist for – say a person did a valuation for mortgage purposes say a month before they retired at the age of 60. Is it reasonable that they should have that liability until such time as they turn 80 years old? Strictly speaking, you could say legally yes, but you can see what I'm saying, it becomes the significant impediment for people wanting to take up that profession. We know within the institute there has been a reluctance of people to want to become valuers because of the legal liability.

MS CILENTO: So do you see a role for government in this or are you suggesting that it's the issue of seven years is just too long?

MR SHEEHAN: I don't think seven years is too long but I do think that we have a problem where it extends beyond that, even further beyond that.

MS SANDERS: And it does, because professional indemnity insurance is that claims main policy. So it can extend out. We have had examples of members who have claimed against them for a property that they valued 10 years ago and there's been the GFC in the middle of that as well and they've been retired and it's a claim against a valuation they did 10 years ago. So it's an extension of that seven years. I mean, if you could say at least it was limited to seven years, that would be an assistance. But it's not limited to the seven years; it is actually longer.

MS CILENTO: By virtue of a claim taking longer to resolve.

MS SANDERS: Yes.

MR SHEEHAN: I could add to that. One good example is our colleagues in the property law profession. A lot of them have capital liability schemes. On one occasion a partner in an unnamed legal firm in the city said to me that to gain a contract with a particular bank they had to sign off the fact that they wouldn't be using the capital liability scheme if they gave advice. Well, you can see the issue.

DR MUNDY: Thank you very much for that.

MR SHEEHAN: It's our pleasure. Can I ask a question of both Commissioners. We referred in our submission to - and we attached a copy in case you didn't keep a copy of our

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submission in relation to a planning, zoning and development assessment study or inquiry that the Commission did. That was now some years ago. One of the things that seems to be at the moment is that we've had the failure in New South Wales of the planning Bills. We've had really – as we said in our submission now and we've referred to it in our submission to you in the business start-up inquiry, there seems to be no movement occurring in terms of either harmonisation between the states or, more particularly, at least modernisation within each of the states that they're planning.

From the point of view of the Productivity Commission, I have to say on behalf of the institute that we've been quite open about that, that we believe that's a significant hindrance in terms of business start-up. It's a significant hindrance in terms of investment per se. We seem to be getting nowhere despite the good efforts of the Productivity Commission.

DR MUNDY: I think it's fair to say that there has been some reasonable progress in Victoria around the recommendations that we made. We are a Commonwealth body who regularly makes recommendations about matters within the province of the states and territories. As you would know better than I do, the failure of planning reform in New South Wales was not for the want of trying by the government of New South Wales, it was an act of the sovereign right of the Parliament of New South Wales that killed it off. So, as you say, I mean, we have revisited issues of planning and zoning in our report on local government as a regulator. We revisited it on regulator engagement with small business. We've revisited it here. I don't think there's a Commonwealth agency that talks – in fact, I suspect we talk more about planning and zoning than every other Commonwealth agency put together.

MR SHEEHAN: I think you're right.

DR MUNDY: And I and some of the people working on this inquiry are the principal talkers on those matters. So, yes, but disappointment in governments taking up our policy recommendations is really our lot in life.

MS CILENTO: It goes with the territory.

DR MUNDY: It's part of the job.

MS CILENTO: (Indistinct) sufficiently direct in this report in saying, "Please get on with."

DR MUNDY: Get on with it.

MR SHEEHAN: We congratulate you on that.

DR MUNDY: No one has ever told us our recommendations are poor either in that regard. They often tell us they're poor in other areas. Thanks very much for your time.

MR SHEEHAN: It's a pleasure. Thank you.

DR MUNDY: Could we please have the Shopping Centre Council of Australia? When you settle, could you please, for the record, state your name and the capacities in which you appear and perhaps make a brief opening statement.

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MS PRYCE: Yes. My name is Kristin Pryce, I'm a senior adviser with the Shopping Centre Council of Australia.

MR COCKBURN: I'm Milton Cockburn, I'm an adviser to the Shopping Centre Council.

MS PRYCE: And I have a brief opening statement.

DR MUNDY: Yes, sure. Off you go.

MS PRYCE: Thank you for the opportunity to appear. The Shopping Centre Council's executive director, Angus Nardi, extends his apologies that he can't make it this morning as he is travelling interstate.

The Commission's draft report picks up on three issues relating to commercial leasing arrangements, which are outlined on page 220 of the report. Specifically, and I'm quoting from the draft report, that tenants often don't have the right of refusal when renewing a retail lease. Second, obligations of tenants with respect to store fit-out and refits, and the inconsistency of regulations imposed by different state and territory governments.

I'll now just address each of those issues raised. The Shopping Centre Council strongly opposes the concept of a first or last right of refusal as it would stop shopping centres from reinventing and redeveloping, discriminate against other small retail tenants by limiting competition and restricting the entry of new retail tenants. It would also afford quasi-freehold property rights to a tenant without the corresponding risk and capital cost of property ownership. Certainly it's our strong view that good retailers want to be surrounded by other high-performing retailers and not underperforming tenants with an out-of-date retail offer which does not attract customers.

With regard to fit-outs, as the draft report correctly notes, these requirements are negotiated and agreed to in the context of a lease negotiation. A landlord can't make a tenant do anything that they haven't agreed to in their lease. It should be considered an investment by retailers to ensure that they take full advantage of the customer base the shopping centre attracts. On the last issue, the Shopping Centre Council strongly supports the premise of a national approach to retail leasing. This is certainly to address the issue of the disparity across jurisdictions that's been noted earlier, but stresses that it must come in place of, and certainly not in addition to, the current system of state and territory legislation or retail lease legislation.

Each of those three issues that I've just talked through was considered by a recent Senate Committee Inquiry into the need for a national approach to retail leasing. Certainly the Shopping Centre Council provided a number of submissions, appeared at a relevant public inquiry and responded to a number of rounds of question on notice to assist the Senate Committee interrogate those issues. So it should be noted that in its final report the Senate Committee noted the benefits a harmonised approach that retail leasing would bring but acknowledged that this is a matter for the state and territories.

It's also important to note that the Senate Committee didn't make any recommendations regarding first right of refusal for shop fit-outs – sorry, first right of refusal on lease from your floor shop fit-outs. We are generally comfortable that the Commission has not made

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any specific recommendations on these matters and, instead, defers to the recommendations of previous inquiries and views.

With regard to planning and zoning issues, it remains our overarching view that despite many reviews and inquiries, a generally simplistic view of retail planning and policy exists. Coupled with this is our view that too much attention has historically been given to the pleas of so-called “new entrants” rather than delivering a level playing field for all participants. And these are all comments that I’m sure the Commission has heard before. The Shopping Centre Council is generally satisfied with the recommendations in the Productivity Commission’s performance benchmarking of Australian business regulation planning and zoning and development assessment and commended those to the competition policy review panel in the process of that group’s deliberations. We have since offered general support to the competition policy review panel’s planning and zoning recommendations in its final report to government which was released in March.

In particular, we supported the specific and deliberate link that the Harper Review Panel drew with the proposed introduction of a public interest test as it applies to planning and zoning. We have provided a submission to federal treasury outlining our views on the competition policy review panel’s final report back in late May and we do look forward to having further discussions with federal treasury and other jurisdictions across the country to move this forward.

The final issue that we’ll address that wasn’t canvassed in our submission but was raised in the Commission’s draft report is the proposed business-to-business unfair contract term protections. We strongly disagree with the Commission’s analysis and comments on page 219 of your report regarding standard form contracts and the federal government’s commitment to extending existing unfair contract term protections under the Australian consumer law to business-to-business contracts. The Commission has overlooked that retail leases, i.e. contracts, are already heavily regulated by all states and territories. For our industry this will be an unnecessary and costly piece of double regulation. This is also true of franchise agreements.

It is inevitable that given the choice between a chain retailer who would not be covered by the unfair contract term provisions and an independent retailer who would be covered, some landlords may play it safe, if you like, and choose the chain retailer, thereby minimising any risk they may be exposed to in terms of costly litigation. This is obviously relevant to the Commission’s current inquiry. We believe the legislation also – well, the unfair contract term protection extension to business-to-business also runs the risk of creating moral hazard for many small businesses, thereby discouraging them from doing the necessary due diligence before entering into contracts, i.e. their lease. We can certainly go into any of these issues in further detail and would be very pleased to take your questions.

MS CILENTO: I just want to go back to the start to some comments you made and also some comments that were made in your submission around innovation. Obviously one of the things that we’re interested in and particularly when you look at the rationale for why a business set-up and all the rest of it is particularly important, innovation is one important aspect of that.

MS PRYCE: Yes.

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MS CILENTO: There are a few comments made in your paper about the role that you play in innovation. I was wondering if you could just sort of elaborate on that. I guess the way we tend to think about it is that innovation involves a new product, a new service or a new way of doing something. So it would be useful for me if you could sort of explain what role shopping centres are playing in that, based on our definition.

MS PRYCE: Okay. Well, I guess the issues that we canvassed in our submission largely deal with innovation in terms of bringing whether it be the Omni channel type discussion where they have different platforms for integrating the bricks and mortar with online. So the example that we reference in our submission I think is an example in a city shopping centre which facilitates that interaction between the online and bricks and mortar. Certainly from our perspective, innovation is also the hard work that our members do to bring out the next generation of retailers. So injecting new products, new retailers specifically into the market. So certainly our members do a lot of heavy lifting. I think re-reading our submission this morning I described them acutely as the retail business development managers across the country.

The other area of innovation is taking what is a – and I use the term "bread and butter" because I'm about to start talking about food and beverage – but actually looking at how they can innovate in providing that service where there is a need for it and delivering it in a new and interesting way. So looking at shopping centres with fresh food precincts, more precincts akin to sort of the farmer market proposition. Also looking at opportunities around licensed premises as well. That's something that we reference in our submission about how you can actually use a shopping centre to become a community hub and also in terms of that's also a night-time economy issue as well. So how that transition to day to night can be achieved in a community hub sense. So they're how we communicate and how our members deliver innovation.

MR COCKBURN: Just to give you a couple of concrete examples, here in Sydney, for example, not far away in Westfield Sydney, the bottom – the basement level of Westfield Sydney was deliberately set up to bring in independent first-time leading edge fashion retailers. These are the sorts of retailers who might not normally have the sort of exposure of being in a shopping centre because they couldn't afford the sort of the rents that would usually apply in a regional shopping centre or CBD shopping centre like Westfield Sydney.

Again to take another Sydney example, the Broadway shopping centre here in Sydney, they've deliberately set up what I think from recollection is called The Collection Bar, the idea being that you can actually order your goods online from an online retailer and have them collected at this Collection Bar. I think there's something like about 70 online retailers that have signed up in the scheme. So I can order online from my home and pick up the product from the Collection Bar inside the shopping centre. Obviously, as Kristin said, in terms of the interaction between online retailing and physical retailing, that's the sort of convergence that we're looking for and experimenting with in terms of - - -

DR MUNDY: I've had a bit to do with retailing in airports over the last 20 years and what you're saying is, quite frankly, nothing new. But I guess what we're interested in is why would lease terms need to change to facilitate this in any profound way or why would they be affected by the recommendation we're proposing to make? I mean, most of the retailers in

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airport terminals would be subject to the unfair contract provisions. They tend to be relatively small and a lot of them tend to be franchisees and therefore small by definition.

MR COCKBURN: Are you talking about unfair contract terms here or are you talking about - - -

DR MUNDY: I'm interested in how unfair contract terms could stifle innovation.

MR COCKBURN: It's simply, as we said previously – we don't think that there has been a sufficient body of work that has been done by the Productivity Commission or by federal Treasury to examine what will be the ramifications of the unfair contract terms law. So whether in fact this will create moral hazard on a substantial scale, we suspect it will. We're not aware of any - - -

DR MUNDY: In what way?

MR COCKBURN: Well, the Productivity Commission, for example, has not done a body of work or we've certainly not seen a published body of work.

MS CILENTO: Based on your experience or evidence, what are you seeing or what's your experience been that would – because we'd like to hear evidence that would suggest that that's going to be the case.

MR COCKBURN: We don't have the evidence simply because, as I said, there's been no, as far as we're aware, inquiry as to what are the ramifications of this law. We think it's probably quite likely that it will create moral hazard on a very widespread scale in the sense that there will be a belief amongst a lot of retailers now, a lot of small retailers now, to say, "I don't really have to sort of do the due diligence around my lease around my contract. If I get into trouble, I've got an avenue now to appeal the terms of the contract were unfair."

MS CILENTO: Is it your sense that – I mean, I would have thought that this whole process of having to appeal and go into some sort of administrative process or legal process against a large shopping centre is not something that most small retailers would - - -

MR COCKBURN: Well, except that there's a reverse onus of proof applies. So I'm the landlord, you're the tenant and you challenge a contract that you freely entered into and down the track you suddenly decide that a particular term of that contract is unfair. I'm the one that has to, firstly, demonstrate to the court that it is not a standard form contract. You don't have to do that. I'm the one who has to then demonstrate that the term is fair.

MS CILENTO: But wouldn't you be the one who has the information about whether it's a standard form contract because - - -

MR COCKBURN: For a start, we don't know what is a standard form contract. The legislation actually doesn't define what is a standard form contract. The regulation impact statement and the explanatory memorandum keep referring to take it or leave it contracts.

MS CILENTO: Just to help me understand this, because I've never signed a lease at a shopping centre. So if a lease is being negotiated, are you saying that if I'm a franchisee or a

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small business that you would negotiate a completely new individual lease arrangement with me based on my needs and circumstances or would you pull one out of the drawer that you've handed to - - -

MR COCKBURN: We're required by law to pull one out of the drawer because retail tenancy legislation says the moment I as a landlord start to deal with you as a prospective tenant, I have to supply you with a range of material, including disclosure statements and a proof pro forma copy of the lease. The only way I can do that is by bringing one out of the drawer. The standard company lease is given - - -

MS CILENTO: But presumably in doing that you would have a standard contract which you have had legalled, according to its terms and conditions, and presumably that would include whether they're onerous.

MR COCKBURN: When you say "whether they're onerous", there's no definition in the Bill that's just been introduced to Parliament as to what is unfair. There are a number of indicia that currently apply in the Australian consumer law as to what a judge may take into account in deciding whether a term is unfair. But no lawyer can go to me and say, "By the way, your draft lease here, clause 76 is unfair." There's no body of law that that person can draw upon. There's no definition in the Act or what will be the Act that that lawyer can draw upon. We're in the realms here – we've adopted a – we're about to adopt an incredibly radical piece of legislation, one which I think no other Western country has done. Well, certainly no other country which we'd like to compare ourselves has done and we're doing it on the basis of absolutely no investigation as to what the likely ramification of this is going to be.

DR MUNDY: I just come back to where we started on this, and that's a question of innovation. What you're raising here is an issue that may be – I mean, that's not to say that I agree with your analysis. I think there is case law about unfair contracts and what are unfair provisions and what are onerous provisions in the common law.

MR COCKBURN: In a business consumer sense, yes.

DR MUNDY: Yes, but they may well travel. I'm sure that a case law will develop over time. The Australian consumer law seems to have got up without an awful lot of grief. There were some novel concepts in that which were recommended by this Commission many years ago.

MR COCKBURN: Look, I simply make the point and the only reason we made this point is - - -

DR MUNDY: What's the issue with innovation? That's what I'm - - -

MR COCKBURN: If I can just finish the previous one, because in your draft report you support the extension of the unfair contract terms legislation to business contracts. I just query on what basis does the Productivity Commission make that judgment.

MS CILENTO: Your biggest concern is that individuals looking to take out a lease will no longer read their contracts.

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MR COCKBURN: I think that's one concern. The moral hazard issue is one concern. The other concern, as Kristin said in her opening statement, is as a landlord, I am more inclined to play safe and I'm more inclined to say look, the Just Group is a big group. We've negotiated with them on many occasions. They understand what lease terms are. They're not covered by the unfair contract terms legislation. We're not likely to find ourselves in substantial litigation with the Just Group in relation to a lease in a shopping centre. Mary Bloggs, who's a young fashion retailer, very keen to get started, got an exciting concept but it's going to be a hell of a risk to actually enter into a contract with her because her business plan is unproven, untested. "Gee, if it goes wrong, we could find ourselves in the Federal Court arguing over unfair contract terms. Let's play safe."

MS CILENTO: So this whole new basement innovation isn't going to happen.

MR COCKBURN: Well, I'm not saying it's not going to happen. All I'm saying is that there will be a significant risk that landlords will play safe and will bet against the start-up.

DR MUNDY: But Mary has got a small start-up business. The cost of going to the Federal Court is several thousand dollars to lodge.

MR COCKBURN: She goes off to the ACCC, she doesn't go to the Federal Court.

DR MUNDY: Your member would presumably seek a guarantee of orders for costs. She wouldn't be able to proceed and the matter falls over. She would be a highly unresourced litigant against the major publically listed company. That sort of litigation doesn't - - -

MR COCKBURN: Are you saying the unfair contract terms law will fail because people aren't resourced to - - -

DR MUNDY: Well, we know that there are precious few private matters brought in respect to the competition law and they can be broad. So you were about to make the point that these matters would be brought by the Commission.

MR COCKBURN: Yes. My understanding is that only two people could bring actions under the Bill that was introduced last week. One is the complainant, obviously, the litigant, and the other is the - - -

DR MUNDY: Who you concede would – the complainant that you characterise would be highly unlikely to bring action in the Federal Court.

MR COCKBURN: Well, given I'm the one who's the landlord who has to – there's a reverse onus of proof applied, I'm not sure that the bar has been set substantially high for you to bring a challenge against me.

DR MUNDY: She's going to have to meet an order of costs if she loses and that could bankrupt her.

MR COCKBURN: Well, if she loses, sure. But she can also – she may well do that, by the way. Bruce Billson hasn't said that his Bill is actually going to prevent people bringing these

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sorts of actions.

DR MUNDY: No, but this Commission spent 15 months looking at cost incentives for bringing litigation and there are precious few examples - - -

MR COCKBURN: But you do concede that she does have an avenue to going off to the ACCC?

DR MUNDY: Yes, she does, but the ACCC also tends to try and resolve – its regulatory strategy is stated – enforcement strategy would seem that the court was a very long way down the path and what would usually happen would be some sort of mediated action.

MR COCKBURN: The point is you and I are in the realms of the hypothetical here, aren't we, because there is no body of work done by the Productivity Commission, done by the federal Treasury or done by anybody else.

DR MUNDY: With the greatest of respect, we can only do the work that the government asks us to do.

MR COCKBURN: I'm referring to the comment you made in the draft report about supporting evidence.

MS CILENTO: What evidence would be sufficient?

MR COCKBURN: Well, I don't know because the work hasn't been done. All I'm saying is we're taking a huge leap into the unknown here, a huge leap.

MS CILENTO: I'm just interested in the argument for why you think it's a huge leap.

MR COCKBURN: Simply because no other country in the world has done this before Australia that we're aware of. So there's no jurisdiction that you can look at – if there is, I'm happy to be corrected. I've said that actually publicly on several occasions and I haven't been corrected. So if there is a country, I'm very happy to hear about it.

DR MUNDY: I think that no other country has done it would be an argument about why we shouldn't have had universal franchise in 1901. I mean, the fact that no country's ever done it is not an argument in public policy.

MR COCKBURN: No, hold on a moment. The fact that no other country has ever done it is surely an argument as to why, therefore, there should be a very rigorous piece of analysis done before we embarked on such - - -

DR MUNDY: Well, I guess now is your opportunity to put the evidence to us.

MR COCKBURN: It's too late. This is about to become law. We have accepted from the moment the now government adopted this as one of its central planks of its law business policy and from the moment that government was elected, we've accepted that this is going to become law.

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MS CILENTO: Did you put evidence to them as part of this process?

MR COCKBURN: Well, we made a submission when the discussion paper came out last year.

DR MUNDY: Could you provide us with that?

MR COCKBURN: Sure. Now, as I said, because I want to continue this, we're not fighting against the law, the unfair contract terms law. We accept that that's going to become law. Our argument has always been our contracts are already regulated by governments. The retail lease is probably the most highly regulated contract in Australia. So in addition to the regulation of contract terms that we currently have in state and territory tenants legislation, over and above that for a certain proportion of our leases – not all of them because it would only be for those that fall within the threshold – they will now be subject to double regulation. That's the argument - - -

DR MUNDY: And there's no provision – and that may well be the case. I mean, it's not unusual, for example, the national access law sits on top of state access law. But if the Commonwealth considers the state access law to be adequate for the Commonwealth's purposes, then you can have the state access law.

MR COCKBURN: Yes, and there is a provision in the Bill last week.

DR MUNDY: So there is a provision for New South Wales say to apply to Commonwealth and say, "Our law with relation to retail tenancies does what your law was." If the Commonwealth says yes, then your problem goes away.

MR COCKBURN: No, it doesn't go away because, as we've made clear in our submission on the Bill, the exposure draft Bill, which I'm very happy to provide you as well, we believe the exemption process that's set out in the Bill sets the bar too high. It basically says that unless there is enforceable equivalence under a state law, then you can't be exempted. Our legal advice is that basically means that unless the particular law has an unfair contracts terms law provision in it, then it won't be accepted. And we made that argument in our submission to Treasury. We made suggestions to Treasury as to how that exemption clause should be rephrased in order to ensure that in fact an application could be made, whether it's by a state government, whether it's by the shopping centre council or whoever or the franchise council might want to do the same in relation to franchise agreements. We believe at the moment that the exemption clause that exists in the Bill will not permit us to be exempted from the legislation.

MS CILENTO: If you can provide the submission, that will be helpful.

MR COCKBURN: Yes, sure.

MS CILENTO: Can I just ask, what happens with pop-up shops these days in terms of the lease arrangements for those?

MR COCKBURN: They'll be usually on a short-term lease or a license. So it'll be for a term usually less than a year because if the term is longer than a year, normally what happens

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is retail tenancy legislation will then kick in and they're required in all states but one then to offer a five-year lease term.

MS CILENTO: What are the obligations in terms of fit-out and all those other sorts of things?

MR COCKBURN: Most of those obligations would not exist in terms of the agreement reached between you and I simply because we recognise that being a pop-up shop you're only going to be there for a short duration.

MS CILENTO: Is it the practice now – I mean, I know it's an evolution, if you like, to make use of space that would otherwise be empty, and you sort of talked about one arrangement with a whole floor being made available for sort of more dynamic new businesses. It does seem to me this is an avenue to encourage set-ups of new businesses in a way that hasn't existed before. Is it likely that shopping centres are making or have that space available all the time? Will there be dedicated pop-up space?

MR COCKBURN: In fact, this has been operating in shopping centres now for nearly two decades. We've had a practice of what we call casual mall licensing or casual licensing, which is, yes, I'd say at least now two decades old. This is basically a practice whereby portions of the common area of the shopping centre are in fact leased out on a very short-term basis, one week, two weeks, three weeks. It's now become actually quite a sophisticated form of leasing.

DR MUNDY: So that's the guy selling calendars at Christmas time.

MR COCKBURN: Yes, that's right. This is a way in which people can actually put their tail in the water in terms of retailing and seeing in fact whether they've got a concept that's attractive without actually having to commit themselves to a five-year lease.

MS CILENTO: Are pop-ups putting pressure on other retailers in your centres in terms of pressure to do things differently or to sell cheaper?

MR COCKBURN: I couldn't answer that because I'm not aware of any evidence that would support it. It did become an issue of controversy inside our shopping centres because some of the permanent retailers were saying, "Hey, hold on a moment. In my menswear shop I sell ties and you've brought Milton in to sell ties for the two weeks before Father's Day." So, as a result of that, we had to try and ensure that in fact we were able to still do this sort of casual leasing but in a way which didn't obviously offend those who are paying permanent rent inside the shopping centre and paying outgoings and such like. So we negotiated with the main retailer associations a thing called the Casual Mall Licensing Code of Practice. It had to be authorised by the ACCC because part provisions in it were clearly anticompetitive. It actually defines who you can bring into the centre, defines how far they must be away from a permanent retailer, et cetera.

In fact, that's been a very successful code. It's now been in operation – well, we have had it reauthorised a couple of years ago. So it's been in operation now for about seven years. We now have very, very few examples of disputes involving casual licensing. Sorry, just to finish that train of thought. So pop-up shops in a way are simply an extension of just the

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casual mall licensing. The pop-up shop of course occurs inside a retail tenancy, whereas the casual licensing usually occurs now in some fairly sophisticated well-designed carts inside in parts of the common area.

MS CILENTO: One of the issues that we talk about in the report is business failure. Do you become unsecured creditors as the shopping centre if a business fails? Is that an issue for you?

MR COCKBURN: Yes, I presume we do. Well, we do. There is a security deposit of course that we can draw upon.

MS CILENTO: Typically, how large is that?

MR COCKBURN: It usually would be no more than three months' rent. I think it's a standard would be between one and three months' rent.

MS CILENTO: Presumably that would usually cover you.

MR COCKBURN: It probably would. It depends on how far the retailer has gone into arrears.

MS CILENTO: What's the standard process for that? I would have thought once someone starts going into arrears you're pretty quick off the mark.

MR COCKBURN: To step in and take control of a retailer's business is a fairly big step and it can't be done under the Retail Leases Act under another piece of legislation. You're probably quite right, a good landlord probably would ensure that in fact the arrears aren't significant before action is taken. But it could be some time before we are actually able to take control of the business.

MS CILENTO: Sorry, I'm going to go back to a broad question. To what extent – and we hear a lot about online competition, the disruption, the growth in online purchasing and all the rest of it. You talked about the clicks and bricks sort of retail strategy. But, more generally, to what extent has the growth of online put pressure on shopping centres and is that being reflected in terms and conditions in leases in any way?

MR COCKBURN: I think probably what's happening more likely is the general state of the economy at the present time. That has been the most significant influence on leases, on lease terms. We stood up reasonably well for about a year or so after the GFC as a result of the fiscal stimulus that was provided. But once the stimulus had been cycled through, then obviously retail sales fell away quite substantially. Although we're now back to a situation where I think retail sales is growing at a level of around 3 or 4 per cent a year, that's a significant difference between what was occurring a decade ago obviously where in many cases it was going up by double figures.

It's still the case that in most of our major shopping centres currently they have negative rents on renewal. In other words, the rent on the new lease is less than the rent on the expiring lease. But that's more as a result of the economy. I wouldn't say that's as an impact of online retailing. But, nevertheless, online retailing is obviously one element, a significant

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element and a growing element within that retailing environment.

DR MUNDY: I'm mindful of the time. It would be helpful if – and you can – I expect you to take this on notice. It would be amazing if you could answer it. If you've got any data on – stats on rates of tenant default, how often you step in, how often tenants get in trouble, how much you tend to recover, those – anything on the sort of – any data on insolvency of tenants, I think that would help.

MR COCKBURN: We obviously don't as an organisation keep that. So we'd have to approach one of our members to see if that's occurring. Just a very minor point before I go. Unfortunately, we entered halfway through the API's address. Mr Sheehan was making a comment about options and leases and I think the general thrust of his argument was that the landlords generally don't grant option leases. There is basically a reason for that. It's a very risky thing to grant an options in a lease. And by the way, it's usually a difference – in the smaller shopping centres option leases are fairly common. But when you get to the large regional shopping centres it's quite uncommon for them to grant option leases.

One of the reasons for that is regulatory risk. We've had two graphic examples of it. In Victoria in 2003, they prohibited the recovery of land tax as an outgoing. That applied to new leases made after the date of the new Retail Leases Act, which was May 2003. But the government refused to exclude options leases from that. So it basically meant that someone had reached a commercial bargain with a tenant and then, all of a sudden, down the track the ground rules are changed by the government and obviously it significantly affected the commercial terms.

Incidentally, under the Bill introduced, the Unfair Contract Terms Bill introduced last week, again, that will apply to new contracts or renewed contracts six months after the date of royal ascent to the Bill. Again, they haven't excluded options leases from that as well. So that regulatory risk is obviously quite substantial and something that people have to take into account when they're deciding whether to grant an option.

DR MUNDY: Thank you very much for your time.

MR COCKBURN: Thank you.

DR MUNDY: This hearing is adjourned until 11 o'clock.

ADJOURNED **[1035]**

RESUMED **[1101]**

DR MUNDY: The next witness is on the phone from Melbourne. Could you just state your name and the capacity in which you appear? We are recording this, so I'll just make sure that the recorder can actually get you through the phone, into the mic and into the computer.

MR GILBERT: Okay. Perfect. I hope you can hear me clearly. My name is Ian Gilbert.

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I'm the Director of Banking Services Regulation with the Australian Bankers' Association.

DR MUNDY: Thanks, Ian. I'm pretty sure we're getting you through. You'll be aware, then, that a recording of this is being made and it will be transcribed and placed on the public record. Because you weren't here earlier on, I should also advise you that it's an offence to give any evidence to the Commission which is false or misleading and that anything you do say is not privileged, in the sense that you can be sued for defamation on the basis of the evidence you give us.

MR GILBERT: Okay. Thank you for that.

DR MUNDY: We've got about half an hour, so if you could make a brief opening statement and then we'll ask you some questions.

MR GILBERT: Thanks very much. I have to say that, first of all, I'd thank the Commission for facilitating this discussion so that I can participate from Melbourne. It was unfeasible for me to come to Sydney today and I appreciate the opportunity that you've created for me to speak for the association.

The first thing I'd say is that this is a very interesting inquiry that you've undertaken. I think I would describe it as a curtain-raiser in one sense to a range of issues that have been percolating around for some time. My interest particularly is in the exit aspects of the draft report that you've provided, and I hope I can provide some assistance to the Commission in relation to that. Given that we've a relatively short period of time, perhaps I could turn back to you.

Can I just say that the ABA will be responding to the draft report. Since I've had an opportunity to look at it - as I've said, I've been away for a period of time and only got back late last week to Australia. I hope that, with your indulgence, we can be given a few extra days beyond 3 July to provide an informed response to you. I hope that would suit the Commission, if we were able to do that.

DR MUNDY: Our Assistant Commissioner has acknowledged her consent. She's holding up fingers, which means, I think, you've got until the 10th.

MR GILBERT: That's very good, that's very generous; thank you. That's much appreciated.

DR MUNDY: There may be some items that we'd like you to come back on to us from this discussion today, so you'll have adequate time to put the material together.

MR GILBERT: Thank you for that. Perhaps I should say that there may be things that I may wish to take on notice as well, coming out of this discussion today, so that I can have discussions with member banks as well, but I'm happy to proceed from here as you wish.

DR MUNDY: Commissioner Cilento.

MS CILENTO: Hi, Ian. How are you?

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MR GILBERT: I'm very well, thank you - actually, I'm not very well; I've brought back a lurgy from Europe which I'm trying to shake off at the moment but otherwise very well, thank you.

MS CILENTO: Thank you for being in Melbourne, then.

MR GILBERT: It is sunny.

MS CILENTO: I'm not quite sure where to start, actually, but how about a general question, to kick off. One of the issues which we've obviously been exploring, which you've said is your area of focus, is business exit loosely defined. One of the things we're trying to sort of get to the bottom of is what the bank behaviour is at the moment - and I know it's a sort of general generic question but we've had presentations and conversations with some from the banking sector who are talking about their strategy now, having learnt the lessons of the GFC, being much more about informal workouts and trying to ensure that businesses that are viable remain in business and that they are supported by their secured creditor. We've also had evidence put that's contrary to that, so I guess perhaps it might be useful for you to give a perspective from the ABA about how banks are viewing this issue, how they see their responsibilities as secured creditor and what's the sort of common practice these days, if it's changed.

MR GILBERT: I think that's an interesting place to start. The first thing is - and I think this was written about by Treasury during an inquiry in the middle of or the post-GFC phase, and there was a clear recognition by Treasury at the time that banks had adopted a far more prevalent practice of informal workouts with financially-distressed business customers. I think that trend, from what I see and hear, has been continuing. We need to be a little bit careful about taking, often, some quite public criticism of banks in particular instances concerning a distressed business, compared with what is more the general way of approaching the problems of a financially-distressed customer, in terms of their credit facilities with the bank.

There's certainly been quite a bit of publicity. Some of these examples were quoted in submissions to Treasury last year, when looking at proposed regulatory intervention into the types of terms in contracts - lending contracts particularly - which are considered by some to be unfair. We obviously have concerns with that potential intervention and consideration needs to be given in all of these cases to what the consequential effect of intervention is in terms of the type of lending, the access and pricing of lending that needs to be provided to businesses in this country. If risk goes up, then price goes up and access can sometimes be affected as well.

I just make that as a general statement because there are a couple of aspects of the draft report where I think we need to be careful about balancing the opportunities for restructuring against the rights of creditors to recover what is effectively their investment in a business that may not be able to pay.

DR MUNDY: Are you talking there particularly about the extension of obligations on the part of receivers?

MR GILBERT: That's certainly an element of it but I think the - if there was any doubt

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about a business of which it is a creditor - in other words, if a creditor is at all concerned in the future about whether it's going to be able to recover its debt efficiently if the company that it's dealing with becomes financially distressed, one is more likely to see tighter credit conditions than the sorts of trade credit conditions that you would see now. It's this whole economic thing of pushing a balloon on one side and something popping out the other side. I guess that's an area that I think we need to think carefully about.

MS CILENTO: Ian, can I just ask a quick question? What's your sense about - there are various protections afforded to a creditor, obviously, legally and the rest of it, and I've heard your concern about and "If the system changes, then creditors respond accordingly," but the other side if that is that banks presumably undertake due diligence on a business and form a particular view about the viability of that business, or the likely viability of it. What's the balance in those things?

MR GILBERT: A business decision about lending to a business, which I'm sure everybody understands, is that there are probably five key elements that a bank needs to take into account. Three of those elements are absolutely critical in the lending decision. One is the character of the person who is running the business - are they any good at running the business, can they manage the business, can they do it adroitly and properly, is there sufficient capital in the business to enable the business to withstand shocks in economic or other trading conditions - and, secondly, has the business got the capacity to service the facility that the bank is going to provide it, that is, the cash flow.

It's really interesting in the draft report that some of the factors that were teased out in that, particularly 2, were the reasons that have been attributable to some of these business failures; lack of cash flow or high use of cash and poor management, inappropriate business strategies and so forth. They're two critical elements that a bank will focus on in its lending decisions and, of course, it's got to look prospectively. With a new start, for example, of course, a lot of this stuff is unknown; so, a track record of a business becomes a very important element in the lending decision as well.

MS CILENTO: Ian, this is probably a question on notice but one of the things that would be really useful for us is to actually have some data on the instances where banks are actually calling in loans and the circumstances of that. Is it a case where the business is not fulfilling its loan obligations, and which aspect of those loan obligations? I'll come back to that. Secondly, one of the things that we've heard a lot about that we've struggled to get a handle on in terms of facts, if you like, in data is this increasing number of informal workouts. I can leave that as a question on notice.

One of the issues that's been brought to our attention is circumstances in which - is the issue about the number of default conditions that apply to a business loan, which cover a broad range of matters, and the capacity of the bank as a secured creditor to call in a loan, even when all of the monetary obligations of the contract, and I'll be specific - there is no default or there is no problem with the track record of paying all interest as it falls due and any principal repayments that are required. So, from a monetary perspective, the loan is completely okay but the banks have been able to recall the loan based on other terms and conditions, including, for example, the loan-to-value ratio.

MR GILBERT: Which, of course, is an important measure in the future viability of the

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company and of the viability of the loan. I think it would be better, as you said, that we take that one on notice, and we can provide you with some better detail about those types of circumstances and how they play out. I should add that - and what I mentioned earlier, when I started to speak on these matters - we need to be careful about anecdotal aspects where the particular circumstances of the case may result in some of the conduct that you're referring to, and, secondly, what is more in the nature of the mainstream way that these things - - -

MS CILENTO: That's a point well made, Ian, and that's exactly why the data would be of assistance in that respect.

MR GILBERT: Yes. I looked at a number of submissions that were made to Treasury last year concerning the consultation on the unfair contract terms - proposals to extend unfair contract terms legislation to small business contracts, and I was - reading the examples that were quoted in some of the submissions - struck me as - with a need to know far more about the circumstances than what appeared to be selectively presented in those submissions. I think we've got to be very careful. The data is critically important in understanding what lending is all about, what a lending decision is all about and what a customer's performance is all about, as well.

DR MUNDY: Our principal interest here is in the business of foreclosure. On those unfair contract terms, could you just broadly outline to us what the ABA's concerns with them are?

MR GILBERT: The first is that there's a regulatory policy issue about whether in fact the case has been made out that bank lending - in fact, all financial purposes, not just bank lending but other-side-of-the-balance-sheet financial services should be regulated under this regime in respect of small businesses. The decision seems to be that it will. We don't believe a case has been made out till we've got a regulatory policy issue around that.

Secondly, where certain terms can be proscribed and able to be challenged in the Court, some of those terms may bear on what risk is presented to the lender in terms of its ability to rely on its contract and to ensure that the contract is performed according to its terms. If that equals in risk, then there are two potential implications for that: one is that the price of the facility might need to reflect that increased risk; and, secondly, it may mean that less rather than more is available to help manage that risk in terms of the loan.

There's a shopping list of provisions in the existing law which covers standard form consumer contracts, which will be extended to small business contracts as well; unilateral variation of contractual terms, a range of other provisions like that.

DR MUNDY: Has the ABA done any empirical or analytical work to estimate what the effects of the cost of capital for the banks will be on having to comply with these requirements or is it simply an ambit claim?

MR GILBERT: We haven't done any work such as that. The questions of risk and capital are associated, of course. We have estimated just what the upfront cost is going to be in terms of having to review every standard form contract with a small business, even the securities, like, mortgages debenture charges and other financing security instruments. To go through them all with lawyers and take out what we consider would be possibly able to be challenged in a Court, we're looking at around about $50 million across our members for

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that. It is a significant imposition but it's also significant in the sense that it creates a risk that is very difficult to measure, depending on where a Court might take the - - -

DR MUNDY: Are you able to provide us with a copy of that analysis that gets to 50 mil?

MR GILBERT: It had to be a guesstimate in one sense. It's based on experience in having to comply with the consumer unfair contract terms back in 2010-2011. It's a standard measure that would apply about identifying all the documents that need to be reviewed, conducting a review of those documents, engaging lawyers to advise on those documents and what changes need to be made, making the changes and, obviously, training and educating staff on the nature of the changes and why they've been made.

DR MUNDY: It's my recollection, although I wasn't a Commissioner at the time, that the ACL largely reflects the work that was done by the Commission, and the Commission, at the time it did that work, felt that the benefits of the ACL and everything that's in it would outweigh the costs. Are you suggesting that the benefits that would flow to small businesses from these terms would be less than the cost that you're suggesting will be incurred by your members?

MR GILBERT: It's a difficult one to read in terms of going forward. I think we can say that, with the consumer ACL, that seems to have bedded down. I'm not hearing that there has been any concern but, of course, dealing with the consumer, particularly in the lending environment, is a relatively straightforward exercise, where risks are pretty well largely predictable. With a business there are far more variables in play, and changes and dynamics can be vastly significant to, say, a consumer environment.

DR MUNDY: I just want to move on to some issues not regarding cost of credit, and I started on this but we sort of got off track. We do make some recommendation with respect to receivers and widening the obligations of receivers. I suspect, on the basis of your previous observations, you would have a concern that that would increase the cost of capital. We're essentially going down a path that's probably a light version of what's happened in the United Kingdom. We'd be grateful - and I'm happy for you to take this on notice - of any estimates or analysis that the ABA might be able to provide, or indeed that your members may have as a result of changes in the United Kingdom - I used to have a mortgage with the Clydesdale - about the effects on the cost to capital of those reforms. We absolutely understand the theoretical arguments that this would only indicate the cost of capital would go up, not down, but we're not yet at all satisfied that it would be material.

MR GILBERT: Okay. Again, I don't know what our members' experience is with the Enterprise Act in the UK, but - - -

DR MUNDY: To be fair, it may well be that there hasn't been enough time but anything you can help us with on estimates or experience in other jurisdictions about such a reform we'd be grateful of.

MR GILBERT: Yes. I was intrigued by the table that you provided in your draft report, which included a comparison of four or five jurisdictions, including the UK, US, Canada, New Zealand and Australia, I think. In terms of the outcomes - and I think, under that table, you concluded that the system wasn't broken but there might be opportunities to cherry-pick

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from some regimes. I thought that table was quite instructive, that Australia really wasn't very far away from where some of the other jurisdictions were; maybe, exception, US, where the numbers were quite significantly different. I was surprised at those numbers. They were World Bank metrics, I think, that I was reading.

MS CILENTO: Ian, going to the issue of access to finance, it's clear that, for particularly a lot of small businesses, having security - i.e., owning a home - is seen as pretty important. At the same time, we expect to see growing competition from peer-to-peer lenders, who are not necessarily requiring that sort of asset-backing, if you like. It seems that there is a move away from the sort of commoditisation, if you like, of the provision of business finance. I'm wondering if you could just talk to the trends that you're seeing and also any sort of feedback you've got on how the banks are responding to that. Are they changing the manner in which they undertake their own lending?

We've talked about the sort of approach of the due diligence in assessing the viability of the business, which is what you see happening overseas, in the P2P space, where more lenders are focused on whether they think the business will succeed or fail, and, yes, there's a risk premium in there but it doesn't take it up to a credit-card-type interest rate. I'm just interested in where you think this is heading, based on your members, and what the approach of banks is going to be, particularly if there is a shift where we're seeing a reduction in home-ownership rates and the like and how that translates to business lending.

MR GILBERT: That's again something that's difficult to answer. Certainly, our industry is aware of the development of peer-to-peer lending in the small business or business market. Of course, peer-to-peer lenders aren't necessarily constrained in the same way banks are in terms of prudential regulation and the need to hold capital against business facilities, and some form of security to support that facility. It's often the case that a small business has only a home to offer by way of security.

The key elements of the lending decision for a bank, in order of priority, place collateral - that is, security - right at the end of the list of five factors, I mentioned three of them before, the character of the capital and the capacity or cash flow of the business to perform, but at the end of the day that's what we're on about. We're in the business of wanting to finance businesses, viable businesses, and to make sure that the loan stands up and performs, the business succeeds and the bank, in the same way, succeeds because it has a successful customer. Collateral is there for when the wheels fall off.

Often a small business - let me put it this way: a business could sell the home and put the money into the business or, almost as a proxy, provide the home as security for that capital injection into the business, leveraging that home for the business. That's very much been the case. The fact that peer-to-peer lenders may not feel the need to do this, given that they're not prudentially supervised either - there's a world of difference between what ADI banks have to do and the protection that they need to have in place.

It's an interesting dynamic. I'm sure that there will be a response from the mainstream industry on peer-to-peer lending. It's going to be competitive and it will be interesting to see what happens down the track. I don't have any window, in terms of how our industry will necessarily respond to this.

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DR MUNDY: Ian, you might take this on notice but, in the event that your members might decide they wanted to invest in peer-to-peer lenders, could you, perhaps on notice, give us your views about how APRA would treat that? Would they simply see it as an investment - if it was simply an equity investment in a company and there was no recourse, would APRA just treat it as an investment in another company, with no recourse to the bank's balance sheet, or would APRA see a systemic relationship that might need to be looked through to the bank's balance sheet?

MR GILBERT: It's a very interesting question. You're asking me what we think APRA might think?

DR MUNDY: I'm even suggesting that you might want to go away and think about it.

MR GILBERT: Yes. Right. Exactly, yes.

DR MUNDY: I'm just mindful that we're running out of time. And any thoughts that you might have around the broad regulatory approach to a peer-to-peer lending, too, and, if there is to be, to ensure that there are no competitive neutrality issues between different types of lenders, because we, the Commission, are always concerned with competitive neutrality.

MR GILBERT: Yes. That's certainly an emerging element in a number of spaces, for example, in payments, and the David Murray inquiry wrote something about that as well. I think that's very much the emerging feature in the financial services and lending market at the moment. There are new players and issues of competitive neutrality will be evident for some time.

DR MUNDY: That's been very helpful. I might suggest that, when it becomes available on our website in a few days' time, you have a look at some of the evidence we took earlier today because it might inform your response to us.

MR GILBERT: That would be useful. Thank you.

DR MUNDY: That should be available in three or four days, so probably by Monday next week. Seeing we've been generous with our extension, that shouldn't cause you any problems, and there's a weekend in there as well. Thanks for that, Ian. We look forward to the ABA's written submission on or before the close of business on 10 July.

MR GILBERT: Thank you very much. The questions you've asked me to take on notice, I've made some scribbled notes - - -

DR MUNDY: I will ensure that one of our very diligent officers sends you an email, so it's clear as to what we're after from you.

MR GILBERT: That would be perfect. Thank you.

DR MUNDY: His name will be Mark Bryant.

MS CILENTO: It might be a slightly longer list now.

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MR GILBERT: Yes. Right. Thank you.

DR MUNDY: We retain the right to augment the list.

MR GILBERT: As you wish. It helps us in meeting what you need to know from us. If you want to do that, that's fine; that helps us do it more effectively.

DR MUNDY: Thanks very much for your help.

MR GILBERT: Thank you ve
ry much for the opportunity.

DR MUNDY: Could we please have the next witness, the Australian Venture Capital Association Limited? When you're all settled, could you each please state your names and the capacity in which you appear, and then if you'd like to make a brief - that means single-digit number of minutes - opening statement.

MR EL-ANSARY: It's good to be clear.

DR MUNDY: I'm very clear. The reason why I'm not a regulator is I can never achieve the clients.

MR EL-ANSARY: We'll try and stick to it. Yasser El-Ansary. I'm Chief Executive of the Australian Private Equity and Venture Capital Association.

DR TANG: I'm Kar Mei Tang, Head of Policy and Research at AVCAL.

MR WALHQVIST: I'm Ingmar Wahlqvist. I'm an investment manager at Brandon Capital Partners, which is a venture capital firm.

MR EL-ANSARY: I'll ask my colleague, Kar Mei, to just give us a brief opening statement.

DR TANG: Members of the Commission, thanks for the opportunity for us to meet with you here today. AVCAL represents the VC and private equity industry here in Australia. Our members invest in high-growth businesses, ranging from start-ups, to SMEs, to large enterprises. As the industry body, we view VC as playing an important role in helping start-ups and research-driven ideas to transition from garages and labs to the global marketplace.

Australia has a young venture ecosystem and we've got a relatively short history of such business transitions. As a country, we understand SMEs and large business pretty well but start-ups operate in a less-well-understood space. They are, by necessity, businesses with a unique and globally-scalable product or service, set up to move very quickly along the trajectory from tiny to large in a relatively short span of time.

Take Seek as a case in point; founded in 1997, two years later the government see that AMWIN Fund invested 2.5 million as part of the start-ups first institutional fundraising. What's really interesting, though, is where the company is at today. Today Seek is a multibillion-dollar company that is the largest online jobs-listing business in the world. For a

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company founded in 1997, it's less than 20 years old, it's now more than twice the size of Fairfax Media, which is 174 years old, and is Australia's second-largest commercial and professional services company, after Brambles, which is 140 years old. It's by no means the only VC-backed growth story. There are many other, more-recent, ones, such as Sirtex, Pharmaxis, Nitro PDF, Shoes of Prey, and Spinifex Pharmaceuticals, which has just been acquired by Novartis in one of the biggest VC exits in Australian history.

With the VC industry maturing and new funds emerging after the GFC, more recent successes have helped Australian VC funds deliver an industry-wide return of over 18 per cent in 2014, outperforming the ASX 300 Index by over 13 per cent. Yes, there are also investment write-offs from time to time; this is part and parcel of early-stage investment. In any given year, between one to 10 investments in Australian VC portfolios, industry-wide, are written off. This isn't a bad rate, even for a relatively small industry that has around 250 investing companies at any point in time.

The Productivity Commission's draft report cites research which indicates that the US VC industry, despite its relative maturity, faces similar difficulties to Australia, where fund returns are highly skewed, and consequently the industry as a whole faces significant challenges in attracting sufficient private capital to invest in start-ups.

What's more interesting, though, is what the US Government is doing in response to this market failure. The US, as have other markets, has recognised the strategic need to supplement VC funding to nurture and retain the start-ups that they see as unique economic-value creators. In 2011, recognising that even in a country as rich in VC as the US, many start-ups still lacked access to capital. President Obama's Startup America initiative set up a $1 billion early-stage innovation fund to co-invest in promising start-ups, alongside VC funds. In fact, in most developed markets other than Australia, public and private sector VC co-investment programs are a core part of national economic policy. These programs are recognised as a particularly powerful lever in attracting both local and international institutional investments into early-stage ventures.

Other than the US, countries that have introduced these initiatives include New Zealand, the UK, Canada, the Netherlands, Germany, Denmark, Sweden, Singapore and Israel, amongst many others. In fact, Harvard professor Josh Lerner, who is also cited in the draft report, said, on his visit to Australia last year, that matching investment schemes is one of the most effective tools for governments to foster venture capital. This is because VC is, given the high-risk nature of its investments, still one of the most efficient models for funding start-ups. Research by Professor Lerner demonstrates that a dollar of VC investment is, on average, three to four times more effective in stimulating productive innovation in the manufacturing industry than $1 of traditional corporate R&D. This model works not just internationally but also in Australia.

The South Australian BioSA model has shown that, for every dollar of public funds that BioSA has invested in early-stage tech companies, these companies, on average, achieved $10 in further investment or revenue from sales. Independent research also shows that, for every dollar of assets owned, Australian VC-backed companies innovate at a much greater rate than other companies. They spend, on average, 200 times more on R&D per employee than other businesses. In 2011, businesses that had been backed by VC accounted for $4 billion in assets and nearly $3 billion in sales.

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If we need further evidence of why VC is important in Australia, let's consider the fact that over half of Australia's listed companies are in the financial services and mining sectors. This is versus the 5 per cent operating in healthcare and the very small number of listed companies in IT.

Where are the healthcare and technology businesses coming from? A substantial proportion of current listings come from VC portfolios. One in four ASX-listed healthcare companies has received VC backing. Of the top 50 healthcare and biotech stocks, a third were VC-backed. The clear message is this: if we want a more diverse and less-concentrated economy, we need to promote investment in innovation and new areas of growth.

I would like to also address briefly the feedback which has been reported in the PC's draft that VC funding is readily available and that good companies will always get funded. If funding were readily available to all good ideas and businesses, we wouldn't see the current critical need to have more funding go into commercialising the research coming out of our universities and research centres, which has been acknowledged by our government as a problem. Despite our healthy output of scientific and medical research, only one VC fund exists today that is dedicated to the life sciences industry, which has been raised in the last five years and its manager is sitting with us here today.

ABS stats show that VC managers in Australia review 6000 new investment proposals per annum and only invest in 1 per cent of them. In the last five years, while the number of start-ups receiving seed stage for rounds of under $2 million has increased by 22 per cent, investment in the 2 million to 20 million dollar range have actually gone backwards. It picks up again slightly for investment rounds of over $20 million. This is largely thanks to the inbound investment by international VCs, which usually come in at much larger valuations, but even then the number of Australian companies receiving funding from international VCs is small - fewer than 10, over five years - and these investments are very much confined to the technology sector.

Sam Chandler of Nitro PDF has been cited as saying that Australia is a good place for starting a business but not so much for growing it. Access to equity funding for start-ups is critical to their growth. In our view, there are a number of policy areas where we believe reforms can help better position us in the right direction, and, first and foremost, we need to address current roadblocks to early-stage funding.

We have seen some headway recently with the proposed introduction of equity-based crowd-funding. It's also important to recognise, though, that broadening the equity crowd-funding regime, while welcome, will complement but not fill the existing VC gap. Equity-based crowd funding typically facilitates fundraising at similar levels to angel or micro-VC investors at the very early start-up stages. Companies that crowd-fund usually raise a million dollars or less. The average successful fundraising on equity crowd-funding platforms is typically in the $1000-to-$2000 range. This is still a far cry from filling the $2-to-$20-million gap that I mentioned before.

The PC's draft report also mentions the recent employee share schemes reforms in the context of raising equity capital. It should be noted that employee share schemes, employee share option plans are designed to be incentives for employees to have skin in the game and

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for start-ups especially to compete more effectively with established businesses to attract and retain top talent. Start-ups use ESS and ESOPs to gain employee participation, not for equity-capital-raising; in fact, ASIC relief from onerous public-disclosure requirements, as part of an ESS offering, is only granted on the condition that the companies are not using the scheme for fundraising.

In summary, I would just like to say AVCAL supports the PC's work in identifying barriers to business entry, in our case, as well, business barriers to growth and reducing these barriers, where appropriate, to drive greater economic growth. We would be happy to expand on any of the issues raised in these opening remarks, or address any other questions by the commissioners. In the meantime, I'm happy to pass over to my colleague Ingmar or address any questions.

DR MUNDY: I don't want to cut this off but we have about 20 minutes and we do have an awful lot of things we want to ask, so perhaps if we can draw the opening statement to a close there. Off you go, Commissioner.

MS CILENTO: I'm going to start by just making a general statement, and it would be great if you can put a submission in, in response to the draft. I have to say, of all the areas that we're looking at in this report, this is one where we just get the most conflicting sort of feedback from people, depending on their circumstances. It really is as broad as, "We have no problems getting access to capital," whether it's seed or growth or whatever, to "We can't get access to capital. VC players in Australia are risk-averse, they don't fund early-stage; they wait for momentum in the business. VC funds in Australia try to pick winners; they don't take a portfolio approach." So, we've heard absolutely everything.

I guess the point that I'd like to start on is right back at the beginning, when you spoke about a market failure and you talk about the skewed nature of returns in VC. I would like to better understand where that market failure is, so, anything that you can provide that helps us with that, either by way of a question on notice or in a response now, would be really helpful for us.

DR TANG: Numbers don't lie and I think, when we are faced with a situation where we have a diversity of opinions and anecdotal evidence, we need to fall back on the numbers. It's quite clear that there has been a dip in access to capital in the 2-to-20-million-dollar range, and we're happy to also provide more detail on those numbers.

MS CILENTO: But, even there, is it - again, we hear different things, that there's a lack of supply of funds available or there's money there but there is a lack of investible ideas.

MR WAHLQVIST: Brandon Capital is a specialist life sciences fund manager, so we invest in biotech, pharmaceutical development, medical devices; so we have a particular view on this market because of the sector in which we play. I think the remarkable thing, as Kar Mei mentioned, is that we are the only dedicated life-sciences manager now investing in Australian science. I think that, from the point of view of market failure, it's actually a very uncomfortable to be, to be the sole funder of early-stage science in Australia.

There is certainly no shortage of opportunities to invest in. Through the medical research commercialisation fund, which we manage, we have links into about 50 medical research

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institutes and research organisations in Australia. So we have quite a good coverage of the medical research and science that's coming out of Australia. We see a lot of really, really good opportunities. But I think that an example of – and we get involved at the very, very early stages. We actually are very often involved in setting up the companies de novo based on a research paper or an early patent application.

I think the company that Kar Mei mentioned, Spinifex Pharmaceuticals, which was sold yesterday to Novartis, is a great case in point. That was seeded by Australian VCs, including us, and it was taken through to a certain stage of development, about phase 2. Needed about $40 million to do more phase 2 studies. That capital was not available in Australia. The VC firms which we've co-invested in largely don't invest any more. We needed to raise money from two large overseas funds to carry out that phase 2 program.

MS CILENTO: You've made two comments I just think are worth following up on. (1) is that I'm interested in why you're the only one in this area, and (2) why are other VC funds that you spoke about not investing any more? So what's the barrier to their being involved?

MR WAHLQVIST: The funding has dried up to venture capital, at least in live sciences in Australia. So, fortunately, we've just raised a large fund from superannuation funds without the – previously our funds had been contributed to substantially by the federal government through the IIF scheme. That's now been axed. We raise through superannuation funds. But that's the first time, I think I'm right in saying, Yasser, that that's the first time that the super industry has invested in VC for about six or seven years.

DR MUNDY: The challenge I've got is this: we accept that funding is an issue. The absence of funding for certain transactions is necessary but not sufficient to demonstrate market failure. It may simply be a reflection of investor preference. I'm not saying it is, but it may be. So it's not sufficient to say, "Well, these things aren't getting funded and therefore there's a market failure." So what we're trying to understand is are there – there's standard types of – is there an abuse of market power going on here? Don't think so. Are there regulatory barriers here that governments could remove? Tell us what they are. Are there unexpected spillovers? Well, if there is, then why are they there now and weren't they there before? So what we're really trying to get at is the – it's just not enough that there's a funding gap - - -

MR WAHLQVIST: Can I speak to you a little bit about that? I think that what you want is investors who are able to and have the sophistication to invest in long-run risky investments. In our sector the time to return is somewhere between five and ten years. That requires specialist managers and it requires patient capital. In general, Australian corporates are not geared to doing that. We have an ASX from which 50 per cent of the profits are generated by four banks and two miners. So it's a very concentrated economic structure overall in Australia.

Meanwhile, the retail or low end of the sector is not – let's say the small company sector and the individuals are not well-equipped to invest in these sorts of things either. In your draft report you pointed to funding for start-ups coming largely from personal finances, family and friends and credit card debt. That is not a sector that's going to contribute to innovation or long-run risky investments. So I think that there are some structural deficits in the Australian economy for who actually steps up to invest in this type of activity.

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MS CILENTO: Then my question would be, we've got one of the largest super industries certainly per capita in the world – it's a big pool of patient capital in theory.

MR WAHLQVIST: Yes.

MS CILENTO: Is it an issue of return? Is there an issue of how performances for funds being assessed?

MR WAHLQVIST: That's been a perception, but I think that certainly some of the more recent figures are that VC actually does return. I think that there might be a problem of scale here, a difference in the type of scale. So the $50 million that went into Spinifex – I'm sorry to use the anecdote again but it is relevant – is basically a rounding error for most super funds. So it's just infeasible for large super funds that manage in the tens of billions of dollars of assets to service a venture capital firm which is seeking to draw down hundreds of thousands of dollars on a quarterly basis.

DR MUNDY: And that problem exists for small infrastructure developments as well. The scale problem exists in lots of places, just not here.

MS CILENTO: Do you know if it's possible – one of the things that's been presented to us – and you may not be the right people to answer this question and we need to go and talk to someone else. But one of the issues that's been presented to us is it's difficult for a fund operating here to invest in Australian VC and overseas as a means of getting scale and diversifying.

DR MUNDY: That's got to do with the investment fund rules rather than - - -

MR WAHLQVIST: Under the IIF program you mean?

DR MUNDY: Not sure. I think it might be. I'm hoping - - -

MR EL-ANSARY: There were probably rules about where the money had to flow.

MS CILENTO: Is it something that your funds that you're familiar with have thought about doing or tried to do as a means of achieving scale and diversification so that they've got more funding opportunity and greater diversification?

DR TANG: Existing, yes, VCLP requirements do have certain restrictions on how much you can deploy overseas.

MR EL-ANSARY: And there certainly have been examples of VC, Australian VC funds investing offshore as a means of trying to address some of those challenges. But, ultimately, as has been said in a variety of fora over recent times, this industry, whether you're talking the venture capital side or indeed the private equity side, is operating in a global context. So whilst there is every reason to be concentrating on the opportunity set here in Australia, increasingly there's no question that opportunities will present domestically as well as offshore. The same applies in reverse also. We've seen examples of that last year. In fact, the single biggest VC investment last year came from a US-based venture firm into an

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Australian company. So I think increasingly we will see this move towards the opening up and the globalisation of this industry much like other industries. That's not something that we are concerned about or alarmed about. In fact, it's something which I think bodes well for the future.

DR MUNDY: In fact, a two-way flow of capital is optimal.

MR EL-ANSARY: Absolutely. So what this really comes to in the end for us is ensuring that we don't position ourselves as a market, as an economy, in a way that impedes our capacity to be able to operate in that global context. I think some of what we see at the moment – back to one of the observations from a moment ago that I think Ingmar picked up on also, we spent considerable amount of time last year in the financial systems inquiry context talking about some of these – perhaps it would be unfair to call them "barriers" but they certainly are handbrakes in the context of one of your handbrakes to your point, Melinda, about the superannuation sector and the scale and how is it that we find ourselves in this position – the answer to that is encapsulated in many of the arguments, some of which the PC has picked up on in the draft report and some of which you haven't. But they are encapsulated in the arguments that were put to the financial system inquiry about how do we address this current imbalance? Because we know one thing for sure. We don't know a lot about the future, but we know one thing for sure in the context of super, and that is, that we've got the fourth largest savings pool in the world today. We will have the second or third largest savings pool in another 10 years and then perhaps the world's largest in the 10 years after that. So we know which direction we're moving in.

MS CILENTO: I think where it would be really useful for us in terms of this inquiry would be to get insights that you can provide about if there is something that is acting as a blocker, either to investment or investment growth, we will struggle to be supportive of ideas that say, "Here is a big lick of money, some of it should automatically come here." But if it is becoming a genuinely global marketplace and there is an issue of scale, issues that relate to a fund's ability to diversify and invest overseas, whether it's regulation or just practicalities, would be really helpful. How funds flowing in to Australia – are there challenges that you observe from your relationships with US VC funds or whatever?

All of that stuff is really helpful to us because my inclination is that this is a rapidly evolving area. There are some cultural changes and shifts that have to happen I think in Australia. But the more we can encourage the free flow of capital for riskier investments and the deeper that pool is and the longer the track record, the more likely it is that these things are going to happen without a forced hand. Correct me if I'm wrong, but I think – and we've talked briefly in the report about match funding. That's what I've heard from you today as being what you think is an important program and the most important that you've seen overseas and think is replicable here. But if there are other issues or other programs that you think that are effective that go beyond this "we think a slice of this money should automatically be invested here", it would be really helpful to get that and to get the evidence as to what's delivering - - -

DR MUNDY: Because the challenge we have is this: what you've just outlined to us is no different to what I heard from the infrastructure sector 15 months ago. Infrastructure is really important, it's the backbone of the economy, we've got to have more money for it. We need to conscript super. We weren't overwhelmed by those arguments. The real challenge for us in this is – I mean, I'm inclined to accept your arguments about co-funding because it has

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some attraction. But around that we need a model. I am pretty certain that Commonwealth or state government bureaucrats will be less able to pick good projects than the three of you and probably the two of us, to be honest.

So governments are not set up to do this. As a very young treasury official in Western Australia, I cleaned up the mess that Brian Burke made when he thought he could. So we are really grappling to find a circumstance and a structure around which this money – not only whatever the amount of money is – and if Obama is right at a billion, then we're probably right at a hundred million or something like that. But it's the structure and the delivery of that within the context of what I accept are local characteristics of the markets in which we work, that we really need to be, because we will be very reluctant to say, "Just make X dollars available," without a structure.

MS CILENTO: We have talked about what are the practicalities of this. We've talked about the way I would characterise it, what are the inbuilt sort of learning by doing processes, recognising that this is a dynamic area, the businesses you're talking about investing in are very dynamic businesses. It's different to the sorts of mentality that's typically brought to a funding program. We're also very cognisant of the fact that these programs chop and change. So thinking about this in a practical sense about the types of program, how you can enhance its longevity by allowing it to evolve, all of those things are the types of things we've been discussing.

MR EL-ANSARY: Yes, absolutely. Can I just make two – and then, Ingmar, you might have some reflections – but just two or three points just in response to some of what we've canvassed there. So first point is I should put it on the record formally and say that whilst there are aspects of the analysis in the equity funding or equity finance section of the draft report that perhaps we feel could be bolstered and strengthened, particularly insofar as the area around comparing and contrasting what our counterparts around the world are doing – and that's something we will endeavour to add some more weight to when we put our written submission to you, because, to be brutally honest about it, I feel the weighting in this part of the report is far too skewed towards equity crowd funding and share schemes. Recognising also that share schemes is a work in progress and by the time that this report is finalised will be finished in the sense that it will be - - -

DR MUNDY: And that may reflect the quality and weight of evidence that's been put to us.

MR EL-ANSARY: So we need to do more work on that. Happy to take that point.

MS CILENTO: We are about to embark on a journey that will hopefully enlighten us a little bit more as well. But anyway.

MR EL-ANSARY: Good, excellent. So that's one point. The second point is that, despite that and notwithstanding that observation, we entirely agree with the recommendation, that is, that there be no mandating of superannuation fund allocations in the VC. We've never advocated for that position and I'm sure you both recall that.

DR MUNDY: We are aware.

MR EL-ANSARY: So I wanted to make that point. Then the third one is that there is very

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clearly here a need for us to work towards this longer-term agenda setting aspect of where we want to get to in the five or 10-year sense. That's something which we know is sort of less tangible from an economic viewpoint, but we know from a conceptual, from a policy architecture and certainly from a market viewpoint – and I know Ingmar can talk very directly to this – it is critically important for the private sector and for investors who are willing to put risk capital to work for five to ten years, that they be operating in a context that they know with a degree of certainty as best as any of us can. We're going to still find the same rules or largely the same rules in place. That hasn't been a feature of the landscape and the environment in the past decade. I think it's important that we acknowledge that as well.

MR WAHLQVIST: I simply echo what Yasser is saying about having some degree of stability in whatever regime is put forward. What we've seen in this sector particularly is the construction and dismantling of various mechanisms such as the innovation investment fund, the original commercial ready program which morphed into Commercialisation Australia which morphed into the infrastructure program. Each time it changes there's about at least one year of pause in these programs where nothing happens and there's absolute uncertainty. So I think, again, echoing Yasser's comments, having some stability - - -

MS CILENTO: It's a point well made and, again, anything that you can provide – I mean, we'd like hard evidence and data wherever possible. But every now and then a story is useful and having the experiences of people who've been kicked from one post to the other as things change can actually help crystallise people's minds a bit. So, again, anything that you can provide that's concrete in terms of how that's played out would be very handy.

MR WAHLQVIST: Thank you, and it's good guidance.

DR MUNDY: I'm just mindful of the time, but there was just one thing I wanted to ask you. We recently held some consultations in Western Australia and it appeared to us that the VC market is actually quite a geographic market. As long as you're digging in the ground there's plenty of VC in Western Australia and if you're doing anything else there's not much I think was the basic – but that was the proposition that was advanced to us. Certainly you can see – and this is me being sad old industrial geographer I guess. But you can see clustering in VC operations with certain industry characteristics around certain places. This is economic geography 101 almost.

I guess we're interested in any information that you might have about how – the characteristics of VC and the extent to which it has a sectoral dimension – your fund is essentially biotech – a sectoral dimension and essentially a geographic dimension. Because we're interested in making sure that whatever policies we recommend don't lead to a bias of one or the other or whatever the range is, whether we need to be aware of those issues. Clearly issues around – in the biotech issues around clinical trials and things like that are very different to some sort of app that you're going to put on someone's phone to help them buy a car. So we're interested in how we should think about those things in policy senses and also whether there should be any – which level of government should be doing what, if anything at all?

It may well be in incubator space that that issue is better dealt with by some national governments. It may be that VC is a matter that the national government should deal with and we should basically tell the states to butt out. So any views on that sort of general space,

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because we see – as my colleague mentioned, we're about to depart the country – that we are aware of things being done in New York and that are quite localised, the UK programs national – just how we might want to think through that and any views you might have on that because this is an area which every politician I hear talk about wants to get into and I don't necessarily think everything that they're saying, when I bundle it all up, is internally consistent, let alone value for money. So anything - - -

MR WAHLQVIST: That surprises me.

DR MUNDY: As we said, I mean, we're really keen to get a submission from you because this is an important area for this inquiry. We've struggled to get evidence. So anything – and if you want to continue to have a dialogue with our guys, we're more than happy for you to do that. While we're away, Bill is in charge of this bit.

MS CILENTO: Anyone that you – we are really keen – we know that everyone in the world is doing this stuff. Again, we hear mixed reviews on this. So anyone that you think is interesting to talk to that sort of has nailed it in terms of policy structure or even characteristics of the types of vehicles or businesses that are invested in, all that stuff is just good food for thought for us.

MR WAHLQVIST: Sure, okay.

DR MUNDY: Thank you very much for coming along today.

MR WAHLQVIST: Thank you for this opportunity.

DR MUNDY: We very much look forward to your submission. If you feel that you need a couple more days, I'm sure that my friends up the back will accommodate you. Thanks very much.

Could we have Professor Buchan, please? For the record, could you state your name and the capacity in which you appear and then if you had any opening comments to make, please do so.

ASSOCIATE PROFESSOR BUCHAN: Jenny Buchan, I'm a legal researcher out at UNSW and so I appear in the capacity of an academic. Thank you. I had some opening comments.

DR MUNDY: Off you go.

ASSOCIATE PROFESSOR BUCHAN: Associate Professor. You promoted me too quickly.

MS CILENTO: Take it while you can.

DR MUNDY: Any word stating with "A" that's attached to "professor" should be disposed of.

ASSOCIATE PROFESSOR BUCHAN: I couldn't agree more. Okay. So my area of

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research is franchising and that's what's brought me here today. For the purposes of this inquiry, my specific interest is how franchising intersects with business closure, mainly through insolvency. So I'll touch on franchise entry and transfer of ownership by franchisors as well. As noted at page 221 of the draft report, franchising is regulated by a mandatory franchising code of conduct which is administered by the ACCC. Insolvency law is regulated under the Corporations Act and that's administered, as you know, by ASIC. The relevant stakeholders for the ACCC's purposes are franchisees and franchisors, and the relevant stakeholders for ASIC are companies, their directors and shareholders. Franchisees are not shareholders and are not very significant creditors in the franchisor.

Some brief facts about franchising in Australia just to give you some context. There are about 1160 franchisors in Australia currently and an estimated 79,0000 franchisees. So by my crude maths, that may be around about 80 franchisees would be operating under each franchisee. Some have vastly more and some have significantly fewer. There are more than 460,000 people directly employed in franchising and the sales turnover of the franchising sector in 2014 was estimated at $144 billion. So I guess we're talking about quite a large sector of the economy. Franchising exists in pretty much every type of business operation today.

Now, franchising is promoted as a safer entry point for a new business owner than if they started business independently. Franchising certainly can deliver on that promise, but it doesn't always do so. It may not do so if the franchisee deviates from the formula, if the franchisor doesn't adapt the system to changing market conditions, if the franchisor is hopelessly inexperience. Interestingly enough, Griffith University does a biannual survey of franchising and in their 2014 survey they found that a quarter of franchisors began franchising in the same year that they started operating their business. So in my opinion, that doesn't represent a proven business.

There can also be problems if the original franchisor exists the investment via a sale to a public company. Right on the back of the previous submission, venture capital – venture capitalists are one way and increasingly prevalent way of franchisors exiting. Venture capitalists don't always understand the responsibilities that come with taking on a franchise network in the role of being a franchisor. A public company, which takes on a franchise, will run the franchise network as a division. Hopefully it will understand what it's bought and it will add value. A venture capitalist will typically want to extract value out of the franchise network rather than add value. This is certainly what is being observed by American lawyers who act on sales to venture capitalist groups. If you're interested, I can probably get you some more useful data on that.

DR MUNDY: That would be helpful.

ASSOCIATE PROFESSOR BUCHAN: Finally, the franchisor can exit by their business failing. That's where my predominant area of research has been most recently. So bad management can lead to franchisor failure. What I want to look at now is the consequences of franchisor failure. So because of this multiplying effect where one franchisor of some franchisor of sort 80 plus or minus franchisees – there's quite a strong multiply effect if one franchisor, the lynchpin of the system, fails or decides to embark on a strategic insolvency in order to reduce debt, reposition itself in the market or adopt a range of legitimate strategies, legally correct strategies, which then the franchisees with a very bad position sometimes.

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Now, there is a lot of asymmetry in the franchise regulation. For example, franchisors can get rid of franchisees, terminate them, if the franchisee becomes bankrupt, insolvent, under administration or if the franchisee is deregistered or if the franchisee is convicted of a serious offence or if the franchisee acts fraudulently. The franchisee doesn't have the opportunity to leave the franchise system to terminate its agreement if the franchisor does any of those things. So the franchisee is really the deer in the headlights if an administrator is appointed to the franchisor.

The franchisor also, because they draft the franchise agreement, always includes an ipso facto clause in the franchise agreement permitting themselves – giving themselves the right to boot the franchisee out and walk away from the agreement in certain circumstances.

DR MUNDY: Can I stop you there. Are those circumstances purely insolvency related?

ASSOCIATE PROFESSOR BUCHAN: Predominantly, yes. It's an insolvency issue ipso facto clause. So the franchise agreement is at the single unit level, so the 79,000 operators really non-negotiable. It becomes negotiable if a franchisor is appointing a master licensee say for Australia or for a state. So at that point, of course, there is a robust negotiation and a renegotiation if things are not going well. So even though franchisees do have already entrenched a seven-day cooling off right, the honeymoon is rarely over within seven days. So that right is a right which occasionally is exercised but usually the rose-coloured glasses are still firmly in place.

Franchisor advisers have enormous difficulty advising franchisees independent of the disclosure document because it's incredibly difficult to access data about franchisors and about the broader environment in which they are nested because the franchisor provides very little information about the franchise network; they provide information about the franchisor in the disclosure documents. There's nothing in the ASIC records which indicates that a company is a franchise and there is no public database of franchisors or franchisees in Australia.

MS CILENTO: Jenny, can I just ask a question about that. To what extent – I mean, it is interesting to think about the amount of information that is available to a franchisee, particularly if the franchisor has a complex business - - -

ASSOCIATE PROFESSOR BUCHAN: Or a trust.

MS CILENTO: Or a trust. I was also interested in the sort of change of control provisions, if you like, that where there is a change of control that a franchisee may not necessarily be aware of. To what extent do you think that there are changes that could be made regarding the provision of information or the need for greater transparency, including, off the top of my head, sort of pro forma documentation, requirements to advise franchisees of a change of control and those types of things? Is that practical or able to be done in a way which would assist franchisees not to be sort of lured by the honey and not realising what the other side of the coin is?

ASSOCIATE PROFESSOR BUCHAN: I think the most useful things that can be done for franchisees are before they make their final commitment and I think in that case the most

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useful thing really that could be done is to make a requirement that franchise agreements are on a public database or that franchise disclosure documents are on a public database. That would enable people who are interested in buying in to compare offerings. Currently we understand people might compare three offerings. But because it costs a lot of investment effort, time and money to actually investigate different offerings, people tend to, first of all, decide, "Well, I don't want to buy an independent business. Okay, I'll buy a franchise. Okay. What kind of franchise?" and they narrow down their thinking quite quickly. Then they look very deep into what they think they want to buy. "Do I want to work in a shopping centre? Do I want to work in fast food?"

But when they eventually take the chosen one to their advisers, their advisers really struggle to contextualise that offering against other offerings that might be out there that their client should be perhaps comparing.

MS CILENTO: That's because they can't get access to those?

ASSOCIATE PROFESSOR BUCHAN: They can't get access to the documents without going through all the hoops that a would-be buyer would go through. Now, some of the states in the US have public filings. For example, apparently you can get hold of the Subway agreement, which is almost impossible to get hold of, by looking on the Minnesota filings. So those filings of franchise disclosure documents, which also includes a copy of the pro forma franchise agreement, are very useful.

MS CILENTO: Aside from that, are there other jurisdictions that you think have got a better answer for this in terms of the provision of information before a franchisee makes a decision?

ASSOCIATE PROFESSOR BUCHAN: Quite a number of jurisdictions globally now do require either – they require one of two things: either one or two year sort of franchisor in the market as a retailer before they are allowed to offer a franchise, which I think is not a bad idea, given that 25 per cent of them do it in their first year before they've even gotten through one business cycle. Or they have a public filing. Some of the Asian jurisdictions – off the top of my head I can't tell you – but some of them certainly do require - - -

MS CILENTO: If you could provide us with examples on what you think are sort of practical solutions around particularly that disclosure of information, that would be useful.

ASSOCIATE PROFESSOR BUCHAN: I can do that.

MS CILENTO: As a question I noticed too I think – whether you think there is merit in requiring the notification of franchisees on a change of control.

ASSOCIATE PROFESSOR BUCHAN: I think there's only merit in such an idea if the franchisees have the opportunity to respond to it. But if they have got no opportunity to respond by renegotiating their situation or even requesting a new franchise agreement for a longer period or bailing with the right to sell their franchise, then it's really not – it wouldn't help them. It would be a bit of a Pyrrhic, in my view. They need to be able to respond to the change. Can I just finish off and then Warren, do you have any - - -

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DR MUNDY: No. Go on. I'm just mindful of the time.

ASSOCIATE PROFESSOR BUCHAN: So even though the franchising code purports to address the imbalance and to increase the level of certainty for all participants, the code doesn't give the franchisees any sort of reciprocal rights a lot of the time to end their relationship with the franchisor if the franchisor sort of does anything appalling. So some of the specific problems that franchisor failure causes for franchisees, the franchisees can't cut loose during the administration. Until the liquidator disclaims their contracts as onerous contracts and/or the head leases of the premises they occupy as onerous, the franchisees have to stick with it and they're bound to continue with their performing their obligations.

The administrator can get an extension of time for filing the second report to creditors. Administrators in the franchise context often seek and receive that from the court because that enables them to, of course, look for a buyer for the whole network. But the bad thing it enables them to do is to use the franchisees as a retail outlet to get rid of all the drossy stock that the franchisor has accumulated in a warehouse somewhere and hasn't been able to move itself. So franchisees can be caught for up to nine months stuck, unable to bail on their agreements.

Now, none of the contracts that the franchisees sign are contingent – to support their own business is contingent on the franchisor remaining solvent. So franchisees can sign supplier agreements that are arranged with the franchisor, employment agreements with their employees, leases, licenses. None of these – if the franchisor then just disappears out of the equation, the franchisee is still committed to all of these sort of third party situations but they haven't got supply coming in. So that's a problem.

Some landlords – and most of the shopping centres would be in this category – require the franchisor to be the head tenant. So as soon as the – and the franchisor then licenses or subleases to the franchisee. The franchisor requires the franchisee to guarantee the head lease. So as soon as the franchisor starts to perform badly and falls behind on the head lease payments, the landlord goes straight to the franchisee, they call in the guarantee and they potentially terminate the head lease, because, of course, if the franchisor has had an administrator appointed that could likely be an event which permits the landlord to terminate. That leaves the franchisee without premises.

DR MUNDY: And the franchisee can't normally step into the lease in place of a franchisor.

ASSOCIATE PROFESSOR BUCHAN: That's correct. I think it would be – in Toronto subtenants have the right to negotiate with the landlord to step into the head lease if the head tenant goes belly up. I think that would be something that would be very interesting to consider for Australia. A lot of franchisees claim that they would be viable as a business absent the franchisor.

DR MUNDY: Your view would be that the appropriate place for such legislation would be in the franchising code? Because I'm just mindful that we're now talking about dealing with commercial leases, which are normally constructed under state law.

ASSOCIATE PROFESSOR BUCHAN: Indeed. In Toronto I think it's in leasing legislation, but ideally, if it could be found to be – if a spot could be found for it in federal

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legislation, that would be ideal. I think it would be all subleases. Subtenants aren't always the problem. So I don't think this is a problem unique to franchisees but it's large in franchising. Some sleeper issues. So if the franchisor decides that the franchisee is failing, it can pre-empt the failure by deciding to act on any sort of breach and it can terminate the franchise agreement before the franchisee's creditors step in. The franchisor can then resell that territory. That deprives the franchisee's creditors of funds, which should be able to be used to pay the franchisee's creditors. So the banks really ought to be a bit more wide awake to the dynamics of franchising. The banks cover their position by taking security over the franchisee's house but in fact the franchise business – the proceeds or sale of the franchise business should flow to the franchisee's creditors, not into the franchisor's pocket.

DR MUNDY: Because there's no payment being made, the ability of the franchisee's creditors to somehow turn this over on the basis of some – its preferential is just not there because there is no payment.

ASSOCIATE PROFESSOR BUCHAN: Realistically it's not possible. It's really I would describe it in legal terms as unjust enrichment of the franchisor. And it happens. What can be done? Maybe the lease business – I mean, if the franchisor in the situation I just outlined had to wait until the franchisee failed, the franchisor would, of course, have to line up with all the other creditors. But they don't want to do that. So registration and leasing, subleasing, giving sub-lessees rights I think are probably the two suggestions that I would make.

DR MUNDY: Melinda, did you have anything else?

MS CILENTO: No, that was what I was interested in is – I was reading through some of the challenges and trying to figure out what the best approach would be. My inclination is that greater disclosure and transparency is the least thorny way to try to get to a better result.

ASSOCIATE PROFESSOR BUCHAN: I also think that franchisors don't exist in isolation. They typically operate within very sophisticated networks of companies. I do think it would be beneficial for the franchisor's adviser to know the name and role of all of the companies that the franchisor – the whole context. I mean, some of them operate – simply receive the franchise fees and pass them straight over to a related group of companies.

MS CILENTO: I think any further information about what should be – what information needs to be provided as part of that registration process would be useful, because you want it to be a valuable source of information, not something that's a tick a box. So the types of information that franchisees need to have to be able to understand better, and ideally more fully, the risks associated in their relationship would be helpful.

ASSOCIATE PROFESSOR BUCHAN: Would somebody send me an email?

DR MUNDY: One of our colleagues, our able colleagues down the back, will give you a business card on your way out I'm sure.

ASSOCIATE PROFESSOR BUCHAN: Thank you.

DR MUNDY: Otherwise you've got mine.

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ASSOCIATE PROFESSOR BUCHAN: Yes, I do.

DR MUNDY: Thanks very much.

ASSOCIATE PROFESSOR BUCHAN: Thanks for the opportunity.

MR McNAMEE: Excuse me, can I make a couple of brief statements?

DR MUNDY: Yes, all right. . But brief, Peter.

MR McNAMEE: Sure.

DR MUNDY: And it's not a debating forum.

MR McNAMEE: No, sure. Just a couple of observations.

DR MUNDY: Please state your name and the capacity in which you appear for the record.

MR McNAMEE: Peter McNamee, private citizen. In relation to the comments from the Law Society earlier on, just they spoke about issues but mainly related to larger public companies and they mentioned Fortescue and Centro and independent directors in relation to insolvent trading terms. So I'm just wondering whether it might be worthwhile having – considering different sets of rules for public companies and SMEs, because they are substantially different creatures and they may need to be treated differently.

Secondly is that your report does refer to the responsibility of directors of companies that become insolvent and also generally – but can I suggest that we may need to consider also the responsibilities of the other side of the equation, that is, the lenders, the secured creditors and their behaviour. To this end, it may be worthwhile reviewing the submissions made to the Senate Inquiry into the effects of the GFC on Australian banking. So a lot of valuable submissions were made to that and it might be to better understanding from that point of view.

Finally, with any insolvent event there are two sides. There's those who do the insolving, if you like, and there's the banks, there's the accountants, there's the liquidation people, the lawyers, and they're all on one side. A lot of them get paid. The other side to the people who have the insolvency visited on them – and I haven't heard or I haven't read a lot in your report about evidence that you have obtained from the people who've had this impost upon them. So I think all I could suggest is to get a balanced view on it, again reference to any submissions perhaps made to the Senate Inquiry would be helpful to understand the other side of the operation. That's all. Thank you.

DR MUNDY: Thank you. All right. These proceedings of the Commission are closed.

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