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TRANSCRIPT OF PROCEEDINGS 5

OWEN J

DAY 113: MONDAY, 15 JULY 2002 10

HIH ROYAL COMMISSION

(9.30 am) 15

MR BEECH-JONES: This is a summons for one of the witnesses who may be called in this section of the inquiry. I ask that the summons stand over to a date to be fixed administratively. 20

THE COMMISSIONER: The witness summons addressed to Mr MacAdie will be stood over to a date to be fixed. The date on which Mr MacAdie is required to attend will be advised to him through administrative means. 25

Just before I call on Mr Martin, can I indicate a further change in sitting times. The idea of sitting only Friday mornings has proved virtually unattainable. To put some certainty into the matter, that idea is officially abandoned. So Fridays from here on in will be normal sitting days. To preserve my own sanity, without extending that to anyone else in the hearing room, I do propose to take some Fridays off completely. I will give you as much notice as possible of when that is to occur. 30 35

Today we will sit until 1 pm rather than 12.45. We will recommence at 2 pm and sit through to 5.15. It is likely that the same sitting hours will apply tomorrow. From Wednesday we will return to the normal advertised sitting times. 40

MR MARTIN: Your Honour, before returning to opening some general matters relating to HIH, I would like now to provide some opening observations in relation to that section of the inquiry that has been described variously, but most commonly as the HSI/Cooper section of the inquiry. 45

The section of the inquiry that goes under that heading concerns a series of transactions involving HIH during the two years following its takeover of FAI from about February 1999 until appointment of the provisional liquidators in March 2001. 50

The general description given to this section of the inquiry is not entirely accurate, as not all the transactions to be investigated involved HSI or 55

Mr Cooper. The transactions to be investigated do, however, have a number of common threads.

The dominant theme that arguably unites the various transactions that will be investigated is that they have been undertaken in circumstances in which there was, at the very least, the appearance, and in many cases the fact, of a conflict between the interests of HIH and the interests or duties of one or more of those who were instrumental in procuring HIH's participation in the transaction and who owed fiduciary duties to HIH, which were arguably breached by reason of their participation in those transactions.

Another consistent theme which runs through the transactions under consideration is that they resulted in substantial losses being incurred by HIH, although often the transactions were to the benefit of those who were supposed to be protecting the interests of HIH and its shareholders and creditors or the associates of those persons. In some instances, the loss flowing from the individual transaction is not that great when placed in the context of the losses we have been accustomed to dealing with in this inquiry. However, collectively the amounts involved are very substantial, exceeding more than \$100 million when the funds invested in the various entities associated with HSI are taken into account. Your Honour, a sum of that magnitude is significant, even to those who have had their sensitivities reduced by their involvement with the figures that have been the subject of this inquiry.

Another significant aspect of the transactions is that they reveal a veritable flood of cash pouring out of HIH during the last six months before the appointment of the provisional liquidators. This occurred at a time when HIH was having difficulty finding the cash to fund its normal operations. Of course, last Friday your Honour received a significant amount of evidence concerning the cash flow constraints that HIH was under during the period between December 2000 and March 2001.

Of course, as your Honour heard, that cash flow crisis meant that payments were delayed to many persons whose entitlement to payment couldn't be disputed. That included injured claimants, policyholders, suppliers and other general creditors of HIH. Their nonpayment, no doubt, resulted in the occasion of real hardship.

By contrast, the evidence will show that during this period, a substantial amount of cash flowed unimpaired in the direction of the less deserving Mr Bradley Cooper. I say "less deserving" in this context not in any personal or pejorative sense, but simply to reflect the fact that there seems to be a strong case, at least in the view of those assisting the Commission, to the effect that Mr Cooper was at this time significantly indebted to HIH, yet no substantial attempt appears to have been made to

set off any of the monies actually paid to Mr Cooper over this period against the amounts which he owed to HIH; and to reflect the further fact that despite Mr Cooper's claims for payment, in most if not all cases appearing, at least to those assisting the Commission, to have a dubious legal basis, no attempt appears to have been made to obtain legal advice with respect to the enforceability of these claims, or if that advice was obtained, it was ignored. 5

The timing of a number of the payments occurring as they did within the last days, a significant payment literally on the last day, prior to the appointment of provisional liquidators, and at a time when many ordinary policyholders were having difficulty getting small claims paid, strongly suggests that the monies actually received by Mr Cooper were received by him at the expense of other claimants. The circumstances in which Mr Cooper was, on one arguable view, given preference over other creditors merit investigation by this inquiry. 10 15 20

Another recurring aspect of the transactions which will be investigated is the role played by Mr Adler in soliciting investment funds from HIH, into ventures in which he had a significant personal interest. I told your Honour some time ago that those assisting the Commission had not found any document setting out the duties to be performed by Mr Adler to justify the payments of \$40,000 per month made to him after he joined the board of HIH and which he received over the same period covered by the pay in lieu of notice he received upon the termination of his executive position with FAI. 25 30

The pay in lieu provided to Mr Adler over the period in question, when added to the consultancy fees, totalled almost \$2 million and when added to the amount of \$3 million received by way of termination payment, totalled almost \$5 million over that period. 35

One of the issues which requires investigation is whether, as might appear from the transactions under consideration, in fact the major activity in which Mr Adler engaged himself was the solicitation of HIH's funds for ventures in which he had a personal interest and which invariably proved to be disastrous for HIH. Your Honour, another recurrent theme that runs through all the transactions is that it seems that all of them had their origin in investments that were, as it were, taken over by HIH as a result of its acquisition of FAI. That, of course, has an obvious link to the involvement of Mr Adler. 40 45 50

Another recurrent thread running through the transactions is the role of Mr Ray Williams, who was involved directly in many of them, without, it seems on the information currently available, appearing to derive any personal benefit from them, but who, on the information currently available, appears to have very readily acquiesced in proposals put to him by Mr Adler and Mr Cooper with 55

apparently only the most perfunctory consideration of the benefits of those transactions from the perspective of HIH. He also appears on occasions to have approved transactions by signing and authorising them as chief executive officer, at a time well after he had in fact resigned from that position. 5

Your Honour will see from the general remarks that I've already made that if after all the evidence is in, the transactions are ultimately found to be properly characterised in the way I've described, they bear many similarities to what I might describe as the Pacific Equities transaction which was the subject of proceedings brought by ASIC against Messrs Williams, Adler and Fodera and which were heard and determined by Justice Santow. Consistent with your Honour's terms of reference, those assisting your Honour do not propose to revisit that transaction and it will not be the specific subject of evidence before your Honour, save that I do propose to tender the judgment of Justice Santow in due course, noting of course that the judgment is under appeal. 10 15 20

One common feature of the evidence presented in that case and the evidence presently available to those assisting the Commission, is that it seems that none of the transactions to be investigated were put to or considered by the board of HIH for its determination or resolution prior to being consummated and only one of the transactions appears to have come to the attention of the non-executive board and that was after it was completed. That transaction, your Honour, was the injection of \$2 million by way of equity capital into a company called Business Thinking Systems in October 2000. I will come back to that in due course. 25 30 35

Getting back to the ASIC proceedings, perhaps another way of putting the general question arising from the transactions to be reviewed is whether or not the matters that were found by Justice Santow were not in fact the tip of the proverbial iceberg. 40

Your Honour will also infer from the general remarks that I have already made that in many cases, attention will have to be directed to the question of whether or not the evidence reveals conduct falling within paragraph B of your Honour's terms of reference; that is to say, conduct which is a breach of the law. That is, of course, an important aspect of the public interest which is served by an inquiry of this kind. 45 50

The aggregation of the evidence relating to these various transactions and the possible finding that your Honour might find open after hearing the totality of the evidence, to the effect that there was a sustained and repetitious course of conduct over a course of years, might give rise to a more general and perhaps even more fundamental question; that is, whether that enduring course of conduct doesn't reveal that those responsible 55

for its perpetration were wholly unsuited to ever manage the affairs of a public company, because of their apparent inability to appreciate and implement fundamental principles of responsible stewardship, which of course require a clear and unmistakable distinction to be drawn between a personal interest or a competing duty owed to another entity and the interests of those who the directors are appointed to protect, which personal failings may have played a significant part in the ultimate collapse of HIH.

Another general question that arises for consideration from the evidence that is to be adduced in this section of the inquiry, is whether or not those responsible for these transactions have failed to appreciate that their duties were not being properly discharged by entering into related party transactions with the apparent intention of providing a superficial justification for the book values of underlying assets when those values could not be justified, the consequence of which transactions was quite literally the throwing of good money after bad. Put another way, perhaps your Honour, a general question which arises is whether, in fact, the driving force for a number of the transactions that will be investigated is the desire to ensure that the accounts presented a rosier picture of the state of affairs of HIH than was justified by the facts.

(9.45 am)

At the risk of being repetitious, I remind your Honour and those observing these proceedings, that of course what I am about to say is by way of opening and it is based only upon the documents that have been available to those assisting the Commission and in some cases, witness statements we have already received. As such, the purpose of the opening is to identify questions for your Honour's consideration and not to put final conclusions. Any drawing of conclusions must, of course, await the totality of the evidence, which will involve those about whom I have spoken being given the opportunity to put their version of the facts before your Honour.

That having been said, can I move now to the documents that will be relied upon. As in the past, can I perhaps apologise in advance for going through the documents somewhat laboriously. I do so in the hope that, ultimately, that course will save time rather than lose it, in the sense that it may avoid the need for detailed oral evidence in relation to many of the matters that appear non-controversially to appear from the documents.

I have also told your Honour that it is only our intention to investigate transactions that occurred during what I might call the HIH phase; that's to say, after HIH takeover FAI. It is certainly not our intention to revisit any of the transactions that were undertaken before HIH's takeover. But it is necessary, your Honour,

to put the HIH transactions into their context, to dip a little back into time to see the state of affairs at the time HIH acquired FAI.

A convenient starting point in that regard is the document which is [HARR.2003.030]. This is a memo from Mr Adler to the board. Your Honour may have seen this document before. It is apparently a response to a general inquiry about the company's dealings with Mr Cooper and it provides a convenient summary of the relevant corporate structure at that time. 5 10

The first paragraph points out that the main exposure was the 42 per cent shareholding in HSI. Can I remind your Honour that HSI is, of course, a reference to the company which was called Home Securities International and which had floated and listed on the American Stock Exchange in the latter part of 1997. The shares acquired by FAI Insurance were essentially acquired at the time of the float and were initially at around the mid-40 percentage in that company and were gradually been sold down. At this stage, they were 42 per cent, they went down eventually to somewhere in the mid to high 30s and then went back up in the latter part of 1999, when HIH bought another 10 per cent of the company, to about 47 per cent. The first engagement was FAI's interest in the shares of HSI, which was substantial but not a majority, although the size of the parcel was probably significant in terms of control. 15 20 25 30

HSI was a company that traded in various countries, including Australia. When it traded in Australia, it traded under the name FAI Home Security. Its core business was the sale of home security alarm systems that were sold essentially through a system of distributorship or franchises, the ultimate result of which was a program of door-to-door sales and marketing. As we'll see during the year 2000, a number of allegations were made of an adverse kind about the techniques that were utilised in that program of direct sales and marketing. 35 40

Paragraph 2 refers to another company, FAI Finance Corporation, which I will probably, from time to time, call FFC - as did the parties. That company's association with HSI was that it provided the finance to many of the purchasers of the security alarm systems that were sold by HSI. So that commonly the salesman who procured a sale of the alarm system to the householder would offer the householder the opportunity to finance that purchase through the provision of finance by FAI Finance and would often in fact act as an agent for FAI Finance in procuring the application for finance, so FAI Finance would then essentially provide the funds to HSI on behalf of the ultimate consumer, which consumer would then owe an obligation to FAI Finance. 45 50 55

By April 1998, the ownership structure of FAI Finance was that it was 50 per cent owned by HSI, the American

publicly listed company, and 50 per cent owned by FAI. In addition, by paragraph 3 there is just a short reference to FAI Homecare Pty Ltd, described as the ironing board company. That company was 47.5 per cent Mr Cooper, 47.5 per cent FAI and 5 per cent a Mr Allan Herron. FAI's investment in that company was relatively modest, being a little under \$1 million. 5

That brief description is a useful corporate outline but it doesn't tell the entire story. It doesn't, in particular, tell of the debt relationships which were significant. For that we go to [HSII.0002.158]. Your Honour will see this is an e-mail from Mr Peiris to Mr Boulderstone setting out the debt arrangements. Your Honour will see that there were two significant advances by FAI to FAI Finance. The first was of \$8.25 million. Your Honour can see the working capital loan of \$31 million, so there was an advance of almost \$40 million from FAI to FFC. There was also a smaller advance to Homecare. 10 15 20

At the risk of going off on a tangent, there is another company I would like now to introduce. It is a company known as Olympic Cascade, which is an American company. We need to briefly look at FAI's involvement with that company. Document [HSII.0003.715] is a warrant issued by Olympic Cascade Financial Corporation for the purchase of shares at 2 cents par value per share. 25

Olympic Cascade was another American listed corporation. This warrant was granted to FAI. We will see the circumstances. It covered the purchase of 30,000 shares. "Warranty", of course, is American speak for "options". Olympic Cascade was a company associated with a Mr Rothstien; his significance is he was associated with the broking house which organised and I think underwrote the float of HSI. Mr Rothstien appears to have been an associate of Mr Cooper. 30 35

[HSII.0003.652], we can see this is a fax to Mr Boulderstone. This seems to be a handwritten fax from somebody at Olympic Cascade referring to the provision of AU\$1.2 million to Olympic Cascade. That was secured by - if "secured" is the right word - a promissory note, [HSII.0003.654] - if we go to that. At the first paragraph, your Honour will see it was a promissory note securing an amount of \$1.2 million from Olympic Cascade in favour of FAI General Insurance at an interest rate of 15 per cent per annum. 40 45 50

Now, that amount was repaid, but only briefly terminated the debtor relationship. [HSII.0003.676], your Honour will see is a memo to Mr Adler records the repayment of the amount of \$1.2 million and simultaneously the receipt of 30,000 warrants. So there was another investment or advance to Olympic Cascade. [HSII.0003.699], your Honour will see that this is another promissory note. This one is in respect of the sum of US\$500,000. Of course, with 55

the prevailing exchange rate, that was slightly less than the AU\$1.2 million, but the same order of magnitude. The interest rate had diminished. By this time, it is down to 8 per cent.

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[HSII.0003.691] is a fax from Mr Rothstien to Mr Adler on the letterhead of National Securities Corporation, providing information in relation to the wiring of the US\$500,000 which was the subject of the promissory note. Mr Rothstien was the person significantly involved in Olympic Cascade.

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[HSII.0003.618] is an internal accounting record confirming payment of US\$500,000 on 27 November. On 27 November 1997, that was an Australian dollar amount it seems of about 730,000. So the exchange rate was obviously more favourable at that time.

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There were difficulties that persevered right through HIH's time that started at this time relating to the collection of interest on the debt. [HSII.0003.640]. Wanda Guff was the person within FAI principally involved with this. This is a memo from her to Mr Adler, confirming the difficulty which had been obtained, which then prevailed in relation to procuring interest payments. That was the difficulty that persevered. There are many documents pertaining to it. I won't take your Honour through them. There was also controversy about whether the relevant interest rate was 8 per cent or alternatively whether it had been varied to 6 per cent by oral agreement with Mr Adler, but I don't think we need to go into that.

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Could we go to [HSII.0003.649]. If we scroll down the page and go to the next page, please, page 50, down the page, your Honour will see that this is confirmation from Olympic Cascade that no interest had been paid. If we go back to the top of the page, your Honour will see the date of this was 30 October 1998. So that over the period, by this time, of course the bid had been launched, no interest was incoming.

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I would like to leave Olympic Cascade at the moment, just to introduce what I hope is not confusion and go to another entity known as Pacific Mentor. That was a company which commenced as a wholly owned subsidiary of FAI. It, in turn, had an interest in a company known as Business Thinking Systems, which I will sometimes refer to as BTS, by its acronym. The interest Pacific Mentor held in Business Thinking Systems was 50 per cent; the other 50 per cent being held by Mr Vamos, who was chief executive of the business.

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In addition to the shareholding of Pacific Mentor in Business Thinking Systems, FAI provided financial support for Business Thinking Systems by the provision of a guarantee to Westpac in respect of indebtedness to BTS. That document is [SBB.018.273_001].

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(10.00 am)

Your Honour can see this is essentially the guarantee provided to Westpac. If we go back up to the top of the page, it is dated May of 1998 and then if we go, please, to the next page, scroll down the page, it is in standard terms and it is signed at the bottom of the page by FAI. So that FAI provided a guarantee.

Just in relation to Pacific Mentor generally, if we go, please, to the document which is [ADLE.0009.016], this is the balance sheet of Pacific Mentor at about the time the bid for FAI was launched by HIH. Your Honour will see that it held a diverse range of investments in a variety of other entities, many of them being unlisted, including Business Thinking Systems. Your Honour will see also Pacific Mentor was a vehicle through which an investment was made in FAI Homecare - the ironing board business, and then further down if we go through the loans, there were advances to Business Thinking Systems, so that in addition to the equity investment, there was a \$500,000 advance. Total assets were some \$6.5 million in investments as at October.

If we go, please, back to the HSI subject, for the purpose of staying in chronological order, [AARA.164.0010], there is another entity which your Honour needs to be reminded about in the HSI context. I say "reminded", because your Honour has already heard about this entity, that's the entity called Ness. Ness Security Products Pty Ltd was the company that undertook the manufacture of the security alarm systems sold by HSI.

Your Honour heard evidence during the FAI phase of the inquiry about the transaction whereby the FAI board was consulted in relation to HSI's acquisition of approximately 75 per cent of Ness from a Mr Paul Brown of Monaco. This document relates to the acquisition of the balance of the shares in Ness from a Mr Circosta, who was the chief executive of Ness Security Products.

It sets out the terms under which HSI acquired the balance of the shareholding in Ness, the consequence of which is this Ness became a fully owned subsidiary of HSI. That occurred in about November 1998. Sorry, it was under consideration in November 1998. There was an issue about when it was actually consummated, but it was around that time.

If we go, please, to [ADLE.0009.017] this is a memo from Mr Baulderstone to Mr Peiris in November asking for some amounts to be written off in the books of Pacific Mentor, fairly significant amounts: two loans of \$1.4 million and an investment of \$300,000, reducing to that extent the assets that I previously showed your Honour.

Now, at about this time, the ownership arrangement of

Pacific Mentor was altered. If we go, please, to the document which is [ADLE.0009.018], this is a letter from a company called Katdan Investments Pty Ltd, a company associated with a Mr David Baffsky, who wrote this letter. Your Honour will see from the opening paragraph, by this letter, Mr Baffsky confirms his agreement for the acquisition of a 30 per cent interest in Pacific Mentor. As I say, prior to this time, it was a wholly owned subsidiary of FAI. I remind your Honour this occurred at a time whilst the bid by HIH for FAI was on foot.

If we go, please, to [ADLE.0009.019], this is the response from Mr Adler, confirming the agreement to purchase the 30 per cent interest for \$1.25 million. If we go, please, to [ADLE.0009.020], your Honour will see this is a letter from FAI, from Mr Adler as chief executive, to a Mr Green of Babcock & Brown confirming that company's purchase of a 30 per cent interest in Pacific Mentor for the same price, that is \$1.25.

Confirmation of that is found in [ADLE.0012.002]. Your Honour will see, this is the letter, you will see the handwriting, your Honour will see that it is agreed by Phillip Green for and on behalf of AIDC Limited. These transactions occurred, as your Honour has I think already heard, at a time when there was a question before the board of FAI as to the extent to which it ought to be undertaking disposition of assets because of the pendency of the HIH takeover.

One document on that subject is [HSII.0002.010]. This is a letter from Mr Landerer to Mr Adler concerning apparently a proposal from Mr Cooper to acquire part of the company's interest in HSI, its shareholding in HSI. Mr Landerer's position was that as a matter of principle, he didn't believe FAI should be selling the asset, specifically one of this size at this stage. That wasn't necessarily a universally held view in the board of FAI, but in the result, nothing happened by way of substantial alteration in the percentage interest which FAI held in Home Security.

If we go back to Pacific Mentor, to document [ADLE.0009.022], the next page, which is 023, your Honour will see again a list of investments. The nature of the business was split between investments and advances, but prominent amongst the investments was Business Thinking Systems' investment on \$200,000 and an advance of \$519,000.

Now, if we go, please, to yet another company that is Data Advantage, your Honour, can I digress for a minute and say regrettably it is necessary to refer to all of these different corporate entities because threads will all be drawn together, but in many instances the threads don't emerge until the latter part of 2000, but it is necessary to trace them from the origins.

If we go, please, to Data Advantage, the document [SBA.024.943_007]. While this document is coming up, can I just tell your Honour that Data Advantage Limited was a company which was listed on the Australian Stock Exchange in September 1998 and it is the parent company, as your Honour sees in the first paragraph, of a company called Credit Reference Limited, which was the significant provider of credit reference reports to business throughout Australia.

Shares were allocated, as your Honour sees by this document, by reference to the business that had been written with Credit Reference Limited prior to its flotation, so that entitlement to shares was calculated by reference to the volume of business provided by particular entities. Both FAI Insurance and FAI Finance were customers of Credit Reference Limited, giving rise to an entitlement to shares. FAI had the entitlement, through a number of different entities, but FAI Finance also had a separate entitlement, based upon the business.

The shares were all issued, apparently, in the name of FAI Insurance; the proposition being advanced in this memo from Mr Jurd, who I can tell your Honour is the chief executive of FAI Finance, is that some 217,000 of the shares allocated to FAI Insurance should have been allocated to FAI Finance and that's out of the total allocation to FAI Insurance of 290,000 shares.

Now, regrettably it is necessary to bear in mind the numbers of shares we are talking about, because the numbers become relevant to the issue that arose in March 2001. If we go, please, to [ADLE.0009.025], this is a report from Mr Adler to Mr Baffsky and Mr Green who, as your Honour has seen, had by now become the owners, through their corporate entities, of 30 per cent each of Pacific Mentor.

It is dated 22 December 1998 and provides a useful general description of what Pacific Mentor was. It is described candidly by Mr Adler in the second sentence as being a venture finance vehicle for his own 'quirky' investments; otherwise described as a "greenhouse" for a number of his ideas and relationships. The purpose, it seems, was to enable the board to monitor and control the array of investments that Mr Adler was making and, for that purpose, to house them under one roof. And he refers then to the change of interests. Then in the second paragraph he refers to the nature of their investment.

If we scroll down the page, the last paragraph, Mr Adler refers to the philosophy, it is said to be a pure seed capital/venture finance company, only limited by

Mr Adler's imagination.

If we go, please, to the next page, you will see the top of the page there is reference to FAI's 40 per cent. It is said: If and when HIH takes FAI over, he will

endeavour to buy HIH's 40 per cent interest, because he didn't believe that HIH would be interested in the business of that kind. In fact that proved not to be the case.

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He then goes through the portfolio. If we scroll down the page, pausing at item 2, Business Thinking Systems, described as a business that Mr Adler commenced fifty/fifty with John Vamos four years ago from scratch, being a specialised software orientated business planner, which has 40 consultants around Australia advising businesses on how to create and implement a business plan; described by Mr Adler then to be growing and marginally profitable, although as we will see, that ceased to be the case during 1999 and 2000.

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If we go, please, to the next page and scroll down the page, your Honour will see that the nature of the business is described; then if we go to the next page 028, the paragraph headed "The Future", Mr Adler refers to debt which Pacific Mentor owes to FAI and then refers to the One.Tel investment. It seems that one significant aspect of Pacific Mentor was the parcel in One.Tel; that was obviously travelling well. He pointed out presciently, as it happens, in the last sentence of that page, the value of investments could nose dive, as could One.Tel.

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(10.15 am)

if we go, please, to the letter which is [HSII.0003.641], it is a letter from Olympic Cascade. By now we are 1999. We are almost to the stage where HIH took over, confirming difficulty in paying the interest on the Olympic Cascade debt.

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If we go, please, to [SBA.214.140_001], this is a letter from Mr Cooper to Mr Adler dated 12 January 1999 offering to purchase FAI's parcel of shares in HSI and indeed as we go down the page, it was an offer to purchase the entire shareholding which FAI held in HSI. If we go, please, to the next page, the second paragraph, Mr Cooper expresses the view that they would prefer HIH to hold the stake long term, but expressed a belief that: "HIH wouldn't back us, as FAI has in the past." That turned out to be an erroneous belief.

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If we go, please, to [HSII.0003.638], this is a letter from Olympic Cascade showing that interest was in fact paid in January 1999. If we go, please, to [SBA.214.139_001], this is 20 January 1999. It's a memo from Mr Adler to Mr Cooper referring to a meeting with Mr Davies of AA in order to discuss the problem between HSI and AA. If we go down the page your Honour will see under the heading "Corporate Governance":

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"Arthur Andersen believed the corporate governance of HSI is abysmal. The board approval is lacking for many major transactions ..." et cetera.

There was obviously an issue with respect to HSI corporate governance and in particular your Honour will see in the last paragraph on that page:

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"Too many related party transactions occur."

In the final portion of that page there is said to be not a proper division between Brad Cooper personal, and Brad Cooper the chief executive. That proved to be a recurrent issue.

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If we go, please, to [SBA.214.138_001], this is Mr Cooper's response. Basically he rejects the assertions and provides a detailed response. I needn't take your Honour through it in detail. If we go to the bottom of the page, your Honour can see that Mr Cooper's assertions that board approval was at all times sought before major transactions and related party transactions were undertaken, so there was an issue at that time about corporate governance.

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[SBA.202.368_001] is a document dated 10 February 1999 and, for that reason, is particularly significant because it is about the time HIH took over FAI and it may well be that this document was prepared because of that. But it provides a convenient summary of the relationships that existed between FAI and HSI. Now, if we go down the page, your Honour will see a list of the exposures. The first is FAI's investment in HSI. That's the estimated value of the shareholding of some just under \$40 million.

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Now, there is an issue about whether or not that's the proper value, because as your Honour may recall, I think there has been evidence on this, there was a spike in the price at which HSI shares traded on 30 June 1998. There was a momentary and significant increase. This valuation is presumably based upon the price at that date. However, by February 1999, the price had dropped significantly.

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Then there is a loan from FAI to Home Security, that's \$7.6 million. As your Honour will see, that advance was made by FAI to enable HSI to purchase its 50 per cent interest in FFC. Then there is FAI's investment in FFC, that's to say, the equity which it injected into FFC for \$12.25 million.

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Then there is an advance by FAI to FFC of some \$15.8 million, and another advance by an FAI subsidiary, that is FIA General Insurance, of \$15.8 million. That's a secured advance, and a further advance repayable on demand of \$1.4 million. There is another loan, undrawn at this stage, of \$2 million. Then a subordinated loan to FAI FFC of \$7.1 million and a loan to FAI Finance New Zealand. So the total was just over \$100 million. So that at the time HIH acquired FAI, FAI's exposure to the various organs of the HSI group was substantial and just in excess of \$100 million.

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If we go, please, to, back to the Data Advantage issue, [SBA.024.943_010], Mr Jurd of FAI Finance was pursuing the issue further in the light of the takeover. He is asking who he should pursue it with, in the light of the takeover, to ensure that FAI Finance received the allotment, rather than FAI Insurance. 5

Now, if we go, please, to [SBA.024.943_011], this is a fax from Mr Cooper to Mr Jurd saying that he wants to have the situation reversed. Now, why HSI would have a direct role is not immediately clear, because the dispute was between FFC and FAI. HSI's only interest was as a 50 per cent shareholding in FFC, but it is presumably in that capacity that Mr Cooper comes to be involved. 10 15

If we go back to Pacific Mentor [ADLE.0017.013], that is memo from Mr Adler to the other entities interested in Pacific Mentor, this is March 1999. The first paragraph Mr Adler reports that in conversation with HIH, that it had been indicated that, subject to a valuation, they may be interested in selling their 40 per cent interest and Mr Adler said he would first offer both of the other shareholders the opportunity to purchase the 40 per cent, or he would buy the 40 per cent himself, as he had moral obligations. Accordingly, he would organise an independent valuation of Pacific Mentor and place it before HIH for their analysis and final intention. 20 25

Scrolling down the page, the heading "Business Thinking Systems", your Honour will see the reference to Mr Adler being long term bullish, the company nevertheless had \$1 million worth of debt and would require close monitoring. 30

Now if we go back to the document [ROY.0150.0221] by now your Honour we are in March 1999, so that we are certainly well into the phase in which FAI has passed into the control of HIH. This is a cheque requisition form, authorising the payment of a cheque to Mr Cooper from FAI for \$166,000. If we scroll further down the page, your Honour will see that what it relates to is payment of a joint venture with B Cooper of 35 per cent of the profit and loss. 35 40

Now, what that appears to be a description of is an arrangement between Mr Cooper and Mr Adler, whereby Mr Cooper effectively underwrote 35 per cent of share trading undertaken by Mr Adler and of course received 35 per cent of the profit as well. This is the outcome of one such transaction, so it seems that Mr Adler was in this arrangement with Mr Cooper and that the arrangement was conducted by Mr Adler through FAI and continued to be conducted by him through FAI, notwithstanding its acquisition by HIH. 45 50

(10.30 am) 55

If we go, please, to [ADLE.0017.012] and back to the

subject of Pacific Mentor, Mr Adler's file note relating to the valuation of Pacific Mentor, where he observes in trying to value Pacific Mentor for the sale of FAI's 40 per cent interest, the following should be noted:

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"Firstly, it is a private company; secondly, it is basically stocked with Adler relationships; thirdly, investments are of a venture capital nature."

And he refers to a few adjustments being appropriately made. If we scroll down the page, reference to Business Thinking Systems, dynamic small business and Paragon Projects, all essentially write-downs in value. At this stage, Mr Adler is a prospective purchaser for the interest from FAI, which had of course by now become controlled by HIH. He hadn't as at March joined the board of HIH, he joined the board of HIH in mid-April 1999, but it had of course been agreed that he was to join the board and so that was just a question of the administrative steps being taken to enable that to occur.

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The question of possible conflict of interest raised its head fairly squarely and we will endeavour to see how that issue was dealt with, or perhaps not dealt with.

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If we go then please to [S00.112.494_003], this is the accounts as at 31 March 1999 for Pacific Mentor and if we scroll down the page, your Honour will see again its assets, leaving aside some small assets, were essentially loans and investments. And the most significant single item in the balance sheet was investments in One.Tel shares, providing some \$2.9 million at that stage.

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If we go, please, to the next page, scroll down the page after referring to borrowings and liabilities, your Honour will see that the balance sheet identified net assets of some \$10.3 million as at that stage.

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Now, if we go, please, to [SBA.21 0.019_001], this is an e-mail from Mr Ballhausen, who your Honour will be aware was involved in the asset management side of HIH, saying he doesn't know much about the Paragon Projects, beyond the bank guarantee he is arranging and says in February 1999, \$85,000 was advanced by Pacific Mentor to Paragon and then on 25 March, the \$200,000 was advanced by FAI to Paragon.

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Now, it seems, therefore that notwithstanding HIH's takeover, FAI's funds were still being advanced to what Mr Adler described as his "quirky" investments. And there is also reference in the last paragraph to a loan by FAI to Pacific Mentor of \$1.5 million, for "general capital purposes".

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Sorry, I said earlier this is an e-mail from Ballhausen; it is the other way around. It is an e-mail from Sewell to Ballhausen.

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If we go, please, to document [ADLE.0017.011], this is a fax from Mr Adler to Mr Fodera dated 7 April. If we scroll down the page, your Honour will see that in the second paragraph Mr Adler refers to specifically addressing the issue of Pacific Mentor, he describes it as the venture finance arm of FAI and he refers to the other two shareholders. 5

In the second paragraph he refers to Messrs Baffsky and Green having declined to acquire 40 per cent interest and then says in the third paragraph that he feels inclined, both morally and ethically, to purchase that 40 per cent and in that regard he has organised a valuation of Pacific Mentor. He said the current book value of the holding in Pacific Mentor is approximately \$2 million, according to Rob Baulderstone, therefore it would be fair and reasonable, he suggests that he purchase the 40 per cent for the current valuation price, which somebody has written in is \$2.997, thereby causing a book profit. So Mr Adler is proposing that he buy it at a valuation that he himself has procured. 10
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If we go to that valuation, it is [SOO.112.462_001]. The valuation covering sheet comes from Wolseley Corporate & Media. In fact, it procured another valuation from Horwarth's, to which we will shortly come. If we go down the page, your Honour will see that the valuation values FAI's 40 per cent share in Pacific Mentor at \$2.997. And there are some adjustments suggested, some factors that might give rise to adjustment at the bottom of that page. 25
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If we go to the next page, the second last paragraph Wolseley were saying in the light of those factors, if they were buying, they would seek a 15 per cent discount to Horwarth's valuation to 2.5 million. 35

Now, if we go, please, to the document which is [SOO.112.494_008], this is a memo from Mr Ballhausen to Mr Willia and seems to have gone on to Mr Howard. Mr Ballhausen has gone through the valuation, we have just seen and more particularly the Horwarth valuation upon which Wolseley relied and suggests various adjustments. And he then arrives at a value for the 40 per cent share after those various adjustments, the detail of which we needn't go through. 40
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Mr Ballhausen's valuation of the 40 per cent share, based on adjusting the valuation, is 3.4 million. As your Honour will see, somebody has written there "\$340,000, 10 per cent". Now, that's not right, because the 3.4 million is for the 40 per cent share. 50

Now, if we go then to [ADLE.0009.029], this is a memo from Mr Adler to Mr Baffsky advising that HIH said they weren't a willing seller and wished to retain all their interests, barring 10 per cent which they would sell to Mr Adler. Because of that, Mr Adler is now offering to buy Mr Baffsky's 30 per cent in Pacific Mentor, bearing in 55

mind that apart from One.Tel, all investments are yet to mature or produce profit.

If we go, please, the [ADLE.0009.030] your Honour will see that Mr Adler wrote to Mr Green in the same terms, 5
identical terms in fact, offering to purchase his
30 per cent. [ADLE.0009.031] is a memo from Mr Adler to
Mr Williams of 15 April 1999. If we go down the page, he
advises that he confirms what he will be purchasing 10
10 per cent from FAI and that he will endeavour to
purchase all or part of the other two shareholders's
interests, and inviting Mr Howard to advise Mr Adler what
he believes a fair value for the 10 per cent would equate
to.

If we go, please, to [ADLE.0009.032], this memo from 15
Mr Adler to Mr Storey, Two Gables. This is on Two Gables
letterhead from Mr Adler to Mr Storey, offering to
purchase 10 per cent of Pacific Mentor from FAI for
\$340,000. That is a repetition of the arithmetical error 20
that your Honour saw earlier, because of course 3.4
million for 40 per cent, means that 10 per cent should be
850,000, not 340,000.

Now, as we will see, that was corrected, but the lack of 25
independent scrutiny of this transaction jumps off the
page when an error of this kind can be made. Your Honour
will also note here Mr Adler refers in this memo to the
price having been approved by Mr Williams. So it seems
that two of them arrive at this price, both labouring 30
under the common arithmetical error, thus highlighting the
obvious risks that are attended with interparties'
transactions of this kind, Mr Adler by now having just
joined the board of HIH.

If we go, please, to [ADLE.0009.033] this is the fax that 35
we saw earlier. If we scroll down the page your Honour
will see the handwriting "Rodney, \$340,000 for
10 per cent, regards Ray."

Presumably that was endorsed by Mr Williams and sent 40
back. Now, your Honour, that, on the face of it appears
to be a somewhat cavalier way of undertaking a related
party transaction between two directors of the same
company. 45

If we go, please, to [ADLE.0009.034], a mistake has now 50
been appreciated and corrected by Mr Adler. He says, "The
correct figure to use is \$850,000." It is of course to
Mr Adler's credit that he spotted the problem and
corrected it, but what the correspondence would seem on
its face to reveal is that the price determination process
was essentially being driven by Mr Adler, the acquirer,
from HIH, of which he was a director.

If we go then please to [SBA.21 0.019_002], Mr Sewell 55
sends an e-mail to Mr Ballhausen relating to a guarantee
for Paragon, so the proposition seems to be that FAI

should provide a guarantee for Paragon, Paragon of course being an entity in which Pacific Mentor had an interest. The point being made apparently by Mr Ballhausen and Mr Fodera in the handwritten note is the fairly obvious one, that is, if Mr Adler is going to buy Pacific Mentor, why doesn't he provide the guarantee? That was an issue that was to surface again in relation to another of Pacific Mentor's investment entities, namely Business Thinking Systems.

(10.45 am)

Now, if we go, please, to [SOO.112.492_001], this is the share sale agreement relating to the 10 per cent of Pacific Mentor. If we go, please, to _003, the bottom of that page, your Honour will see the price ultimately was in fact \$850,000.

If we go, please, to [ADLE.0017.010], this is a memo from Mr Adler to Mr Baffsky dated 22 April 1999, offering to purchase the interest which Mr Baffsky held through corporate entity of 30 per cent, for \$1.35 million. That of course is a very different basis of valuation to that which has just governed Mr Adler's acquisition of 10 per cent. In this instance it is of course in HIH's interests, that is to say, HIH has been paid a significantly higher rate than that which Mr Adler is offering Mr Baffsky.

Indeed, as we will see, the transaction was consummated at this price, namely 1.35 million. One question that arises is whether or not Mr Adler should have alerted HIH to the possible availability of an increased interest in Pacific Mentor at significantly below valuation - the valuation Mr Adler had received.

If we go, please, to [ADLE.0017.0018], this is a fax from Mr Adler to Mr Green offering to purchase his 30 per cent. If we go to the second paragraph, "For a marginal increase of your original purchase price". If we go, please, at the risk of changing the subject and coming back to this, I am endeavouring to stick in strict chronological order - to introduce yet another subject [SBA.209.423_001]. This is an invoice to HIH from the Kindness Foundation.

If your Honour looks at the address, your Honour will see the reference to 77 Pacific Highway. 77 Pacific Highway was the building in which Mr Cooper was located and the Kindness Foundation was an entity associated with him. HIH was apparently being billed and it seems, paid, \$250,000 by way of sponsorship of National Kindness Week. That was to a Cooper associated entity. So it seems that the association between FAI and Mr Cooper continued after HIH's acquisition of FAI.

Now, if we go, please, to [SBA.214.134_001], this is a fax from Mr Adler to Mr Cooper of the same day as the

invoice. There is some dissatisfaction between the two. Just scroll to the last paragraph, the only purpose of it, Mr Adler observes to Mr Cooper:

"If I want to talk about the Kindness Foundation in the forthcoming photo shoot, then you are very available." 5

So the complaint is Mr Cooper is available to talk about the Kindness Foundation, but not about HSI. 10

If we go, please, back to the subject of Pacific Mentor, [ADLE.0017.007], your Honour will see from this fax that Mr Adler is confirming to Mr Green that he paid Mr Baffsky \$1.35 million for his 30 per cent interest, and he is prepared to give Mr Green another \$250,000, so he is paying \$1.6 million for Mr Green's interest. Again, that is significantly below the ratio of 10 per cent for \$850,000 that was suggested by the valuation obtained by Mr Adler and the question arises whether he did in fact advise HIH that these parcels were available at significantly below valuation and if not, why not, given that he was clearly by this time well established as a director of HIH? 15 20

Then if we go, please, back to the subject Data Advantage, [SBA.024.943_013], this is a fax from Mr Cooper to Mr Adler asking Mr Adler to get involved in relation to the transfer of the shares to FFC. If we scroll down the page, you see there is a handwritten note that somebody appears to have written, perhaps Mr Cooper: 25 30

"Phoned RA, he agreed 100 per cent and confirmed pro rata position, i.e., HSI owns 85 per cent of Data Advantage shares. He would action if not ..." something. 35

Quite how it could be said that HSI owns 85 per cent of Data Advantage shares is mysterious, because there is no suggestion that HSI had a direct entitlement to an allotment; the entitlement to allotment has always been said was that of FFC. If we go back to the top paragraph of the memo to see that, the shares were issued based on FFC's finance activity. 40

HSI's only interest in FFC was as a shareholder, that was as a 50 per cent shareholder, so how HSI could have any interest at all is not at all clear. The reason I am labouring this point, so your Honour understands where I am going, is in February 2001 HSI was paid \$1 million by HIH in respect of this claim - the mystery of how HSI has any claim at all is one that needs to be unraveled. 45 50

Of course, by March 2001, as your Honour will see, HSI had no interest in FFC at all; FFC was by then a wholly owned subsidiary of HIH through a transaction we will come to. 55

If we go, please, then please to [ADLE.0008.004], this is a fax from Mr Adler to Mr Williams relating to HSI. If we

scroll down the page, your Honour will see that the first paragraph Mr Adler refers to Mr Williams having expressed the desire that Mr Adler represent HIH on the board. He, Mr Adler, expresses concern about the operations of the company and if we go further down the page it is said then that the company's cash flow positive and net profit positive and even though the results would be flat: "...I believe they will be an acceptable set of figures", but he is not confident about next year.

If we go, please, to the next page, he refers to the share price facing downward pressure and in the second paragraph, describes HSI as having become somewhat tired and lethargic and needing a stronger board and a bit more discipline in the organisation.

If we go, please, to [AND.4086.0063], that's a calculation of the weighted price of the shares in HSI for the purposes of valuation. Your Honour can see - I don't know how well your Honour can read that - your Honour can see the July stock price, a steady decline from times when the shares went to 11, 13 and so forth, down to, by June of 1999, they are down to some \$5.95. So there has been a significant steady decline in the share price of HSI.

If we go, please, to the document which is [SBA.024.938_002], your Honour will see this is a letter dated 7 August. It is from Mr Adler. If we scroll back up the page, your Honour will see Mr Adler writes this letter, apparently as chief executive of FAI, which is a bit curious, given it is dated 2 August 1999. In any event, if we go down the page, your Honour will see in relation to the Data Advantage issue, he refers to what is said to be without question an oversight "on our part." He says:

"Understanding that this is a material issue to HSI, I am pleased once again to reconfirm that ...(reads)... to FAI, not redistributed back to FFC, as per the activity report from Data Advantage, which clearly confirms what the shares were the property of FFC, and based on pro rata activity, HSI should have immediately received the value of this asset."

Now, that's a very difficult proposition to understand, your Honour, because HSI was a shareholder in FFC, as was FAI. They were FFC's asset, if they were an asset at all, not HSI's. There was no question, one thinks, of the distribution of capital in specie to the shareholders of FFC. At that time obviously various approvals would have been required for that to occur.

Mr Adler goes on:

"Please feel free to include the above in the audit for end of year profit calculations. This should resolve the issue once and for all, as it previously, and still does have, my full approval."

This is Mr Adler in August 1999, a director in HIH, writing as chief executive of FAI, a position he doesn't hold at that stage, encouraging Mr Cooper to bring the value of the Data Advantage shares into HSI's accounts as an asset, on the face of it, without reference at all to the board of FAI or the board of HIH. 5

Now, this is a letter which was obviously designed to further Mr Cooper's desire to bring this asset to account in the books of HSI. HSI, as we will see, was of course a company which Mr Adler retained a personal interest by, through a personal shareholding. Again on the face of it, this seems to be a letter written to the advantage of HSI, in which Mr Adler has an interest; to the disadvantage of FFC, in which HIH had an interest and without reference, apparently, to the board of FAI or HIH. 10 15

(11.00 am)

If we go then please to [AND.1406.0011.0001], this is a memo to files, Andersen, dealing with a number of non-core assets. We can skip through the first page and go, please, to the second page, which is 002. If we scroll down the page to the paragraph headed "Home Security International", your Honour will see that an offer is on the table from Brad Cooper at \$8.80 per share. These shares have been marked to market at a value of \$18.3 million. "Cooper increases the offer by approximately 10 million. Management believe that the offer price is a more reasonable basis for valuation." 20 25 30

Without taking you to the accounts, in fact, the asset was booked at the increased price of some \$28 million, rather than \$18 million. On the basis of an offer, the capacity of Mr Cooper to complete the offer doesn't appear to have been investigated, nor indeed his continued willingness to complete at that price, given the failing market price that we saw earlier in the calculation done by Andersen. A proper valuation of the shares in the books of HIH as at 30 June 1999 is in issue. 35 40

Your Honour, the offer I should also address, the offer made by Mr Cooper was in fact at the end of the previous year, so the question was: was that offer current? That was obviously a question that needed to be investigated before you could use that value as a basis for booking the value of the asset, having regard to the plunge in the share price over the first six months for 1999, it seems at least an issue that required investigation as to whether the offer remained valid at that price. 45 50

Of course, the previous year as at 30 June 1998, in the books of FAI, the asset had been marked to market on the basis of a very temporary spike in the price that occurred on 30 June. This might be an unfair conclusion, but one sees that the choice between marking to market and not marking to market might be said to depend on the best 55

outcome.

If we go, please, to [SBA.214.132_001] this is a fax from Mr Adler to Mr Cooper of 13 August 1999, referring to a finance deal. In the second paragraph, your Honour, there is a reference to:

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"We do have substantial debt outstanding to Mr Brown."

That became a very significant characteristic of the transactions that we are about to look at. What it refers to is that at the time, as your Honour may recall from the

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evidence given on this subject in the course of the FAI phase of the inquiry, at the time HSI acquired Mr Brown's interest in Ness of approximately 75 per cent, it did so on terms. So that its obligation to complete the payment for that asset was deferred and there was a substantial obligation to pay Mr Brown that fell due in the middle of 2000. So HSI's obligation to meet that payment was increasingly of concern.

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Mr Adler then suggests that "we", that is presumably a reference to HSI "raise \$3 million from the market, convert Mr Brown's debt to equity..." et cetera.

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In the bottom of the previous page, in the middle of the paragraph, the last paragraph Mr Adler refers to the course he is recommending having the effect of creating a price for negotiation or comparison with HIH, "... so they will have more appreciation of the level at which you will eventually take them out."

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Mr Adler is a director of HIH at the time he wrote this. He appears to have been encouraging Mr Cooper to undertake a strategy that would have the effect of creating a price for negotiation or comparison with HIH. The precise meaning of just what that meant is something to be investigated, but again the scent of conflict of interest is certainly present.

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If we go, please, to [AND.1406.0012.0001], on the basis that a picture tells a thousand words, this is a graph of share price of HSI up to the period August 1999, and there has been a steady decline throughout 1999.

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If we go, please, to [ADLE.0017.006] this is a fax from Mr Adler to Mr Williams of 30 August. If we scroll down the page, we will see Mr Adler advising Mr Williams that he has purchased Baffsky's and Green's stake in Pacific Mentor, so that the relevant shareholding is 50 Adler and 30 HIH, and advised HIH to put somebody on the board. There is no evidence of the disclosure of Mr Adler for any price he paid for the Baffsky's interests, or any offer of those interests to HIH.

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If we go, please, to [SBB.018.293_001], this is a fax from Mr Howard to Mr Adler of 30 August referring to the loan facilities between Pacific Mentor and BTS; the first loan

of some \$500,000; the second loan for \$144,000 and then if we go down the page, your Honour will see that on 18 May 1998, FAI Insurances Limited issued to Westpac Banking a letter of unconditional continuing guarantee in relation to BTS overdraft. We saw that earlier, the overdraft was at \$350,000, and Mr Howard makes the obvious point that:

"As FAI/HIH now only holds a 40 per cent shareholding" - that was wrong it should be 30 per cent - "shareholding in Pacific Mentor, it is considered that FAI/HIH should be released from the guarantee. I would be obliged if you could telephone me to discuss."

If we go, then please back to the subject of FAI Finance and this is [HSII.0002.012]. For some reason, it is not clear what reason, but for some reason SG Australia undertook a due diligence report on FAI Finance in September 1999. Conveniently at page 17, that's 017, there is a structure of the ownership of FFC; if we scroll down the page to look at the diagram, your Honour will see that HIH owns 100 per cent of FAI Insurance, which owned at this stage, 35 per cent of HSI, which in turn owned 100 per cent of FAI Home Security, which in turn owned 50 per cent of FAI Finance. So that then FAI General held the other 50 per cent of FAI Finance. So that in a nutshell, FAI Finance was 50 per cent HIH, 50 per cent HSI and HSI was itself 35 per cent owned by HIH. Then if we scroll down the page your Honour will see various subsidiaries of FAI Finance are set out.

If we go, please, to [SBA.214.131_001], your Honour will see that Mr Adler is communicating again to Mr Cooper in relation to HSI, referring in the fourth paragraph to restructuring the relationship with HIH, and then asks for more information, including the cash flow, the profit budget. If we go over the page, some reference to the new monitoring division. Now, what that refers to is a shift in the nature of the business whereby instead of the alarms being stand alone sirens, they were monitored alarms, in the sense they had a capacity to communicate with a remote monitoring station.

Then paragraph 5 asks why and how Mr Cooper believes that business can continue to succeed using the same methods, presumably in America. In the end of that paragraph he expresses the fear that the American business is so cash flow negative "that you will wipe out HSI". So Mr Adler appears on the face of this letter to at least have apprehended the risk of destruction of HSI, in the last paragraph, expresses the view that they are at the crossroads, there will either be an US\$500 million company "or we loose a lot of money, pull back to Australia and have a moderately successful existence and never achieve what we want to or can at this time."

Go back to [SBB.018.330_001], this is a letter from Mr Adler to Mr Howard written on the letterhead of Adler Corporation, responding to Mr Howard's fax of 30 August,

saying he has reviewed the borrowings and status of the overdraft of BTS. In the fourth paragraph he says the removal of the FAI guarantee would affect the viability of BTS.

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"Could I suggest, as FAI is fully indemnified, that the current arrangements with Westpac be allowed to continued for a further 12 months and BTS pay a monthly fee for providing the guarantee?"

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The reference to FAI being fully indemnified is not at all clear. Those assisting the Commission are not aware of anything that would amount to a full indemnity of FAI. What Mr Adler is here proposing, stepping back from it, is that effectively HIH, a company of which he was a director, provide a guarantee for BTS, which was a company 50 per cent owned by Pacific Mentor, and 50 per cent owned by Mr Vamos; Pacific Mentor being a company 70 per cent owned by Mr Adler. So going back to the personals, Mr Adler is proposing that HIH provide a guarantee for BTS, a company in which it had a 15 per cent net equity; that is to say, 30 per cent of 50 per cent, that is 15 per cent.

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Now, the monthly fee equal to 1 per cent per annum, as you will see the amount of the overdraft was \$500,000; 1 per cent is \$5,000 a year. That seems very poor compensation for the risk being taken by continuing the guarantee when the guarantor only had a 15 per cent net equity in BTS. One has to go back and ask oneself what about Mr Howard's earlier observation, why shouldn't Mr Adler provide himself this guarantee, he having a greater interest in BTS?

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There appears to be a clear and obvious conflict between the personal interests of Mr Adler and the interests of HIH. Mr Adler nevertheless is acting, he is giving communications to Mr Howard, who one could reasonably apprehend might have been confused about whether those communications were coming from Mr Adler in his capacity as a director of HIH, on the one hand; or in some other capacity on the other hand.

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(11.15 am)

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If we go, please, to document [SBB.018.296_001], this is from Mr Howard to Mr Adler, he accepted Mr Adler's proposal. So that HIH agreed to provide the continuing guarantee for 1 per cent, with no apparent valuation of the level of risk, 1 per cent appearing to be an utterly noncommercial rate for the acceptance of such a risk and at least leaving open the question of whether or not the 1 per cent wasn't provided by way of an attempt to provide a superficial, but utterly artificial justification for HIH entering into the transaction which was ultimately for the benefit of other entities, notably Mr Adler and entities associated with him.

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Your Honour, I notice the time, would this be a convenient time to break?

THE COMMISSIONER: Yes, we will come back at 11.35.

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SHORT ADJOURNMENT

UPON RESUMPTION

MR MARTIN: If we go now to the document which is [SBB.018.294_001], this is a letter, returning to Business Thinking Systems issue, letter from Mr Howard to Westpac, confirming guarantee up to the level of \$400,000. As we will see, your Honour in fact that was increased to \$500,000.

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If we go, please, to the document which is [SBA.024.943_018], this is a letter from Mr Cooper to Mr Fodera of 8 October 1999 and bears detailed analysis. If we go down the page, the letter starts: "Dear Dominic". This is another letter from Mr Cooper on the subject of the Data Advantage issue. Again, it starts by referring to Mr Jurd, identifying the allocation of shares that would be FFC's entitlement and in the third paragraph, it said the shares were allocated to FAI. Then in the fourth paragraph, it says:

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"In December 1998, Geoff Jurd made Brad Cooper aware of the positive impact ...(reads)... and HSI."

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I digress to observe, of course, it would be enjoyed by them in their capacity as shareholders, not in their capacity as parties with direct entitlement to the allotment of shares, because as I have earlier suggested, there doesn't seem to be any basis on which it was ever suggested that there would be a distribution of capital by FFC to its shareholders.

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If we go further down the page, it's then said in the second last paragraph:

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"Geoff", that's a reference to Mr Jurd, "also raised the matter with Mr Adler ...(reads)... was forwarded to them."

That just couldn't have been done consistently with basic principles of corporations law. The entitlement was FFC's, not the entitlements of its shareholders.

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Then further down the page, there's a reference again in the last paragraph to the failure to issue shares to FFC and HSI. Again, it's just inexplicable how there could ever have been any consideration that the shares would be issued to HSI.

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If we go, please, to the next page, the top paragraph, again there is reference to the benefit to HSI being included in the financial year end for June of 1999. Again, that seems utterly inexplicable on the face of the

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documents. It's then said, in the third paragraph, somewhat inconsistently one might think, that the shares were certainly the property of FFC and that 50 per cent should have been transferred to the account of HSI. Why, one is forced to ask rhetorically? Why do the assets of a company get transferred to its shareholders? That can only happen, as your Honour is aware, in very special and limited circumstances. 5

Then the third last paragraph, the paragraph that starts "At listing", there are some figures that need to be borne into account. It's said that of the FAI's 290,000 shares, 217,000 were generated by the lending activities of FFC. Hence, FFC's shares mistakenly taken by FAI Insurance, had a value at listing of \$594,000 in December 1998. So that it's said that presumably, as at listing in December 1998, HSI's 50 per cent interest had a value of \$300,000. It's then said the shares today have risen to \$4.40 per share, valuing HSI's 50 per cent holding at \$477,000. 10 15 20

The reason I ask you to bear these figures in mind is that in February of 2001, HIH paid HSI \$1 million in satisfaction of this claim. You don't need to be a giant legal scholar to work out that, on no basis, could that \$1 million on the face of it ever be a reasonable measure of the value of any loss said to have been suffered by HSI because as at the date of this letter, if HSI thought that shares in Data Advantage were a good investment and were likely to rise so as to justify a claim for a greater amount in 2001, there was nothing to stop them going out and buying the shares and then claiming the \$477,000. 25 30

The same of course is true of the situation in December of 1998. So that conventional legal principle would, on the face of it, seem to limit the total of any claim to half of the value on listing, which is about \$300,000, but of course conventional legal principle would refute the claim in any event, because the nature of the claim is to equate the interest of a shareholder in the assets as being an interest in the assets of the company in which the shares are held, which is just fundamentally foreign to basic principles of corporate law. 35 40

Then Mr Fodera is encouraged to speak to Mr Adler to bring the matter to a close. 45

[HSII.0004.177] is notes of a meeting that it appears somebody had with Mr Cooper and Mr Whittaker. It's not clear who, but if we scroll down the page, your Honour will see that it appears to be somebody from HIH. There's a reference to poor share price, lack of success in the USA and then there's said to be HIH overhang. That presumably is said to be a consequence of HIH having too many shares in the market. 50 55

Then there's a reference under paragraph (b) to sale of shares by Hartford, looking to sell 10 per cent of HSI,

price expected to be US\$3 per share. "BC", that is Brad Cooper "has offered to buy the shares, but there's a certain logic in HIH buying the shares".

Then further down the page, the concept being discussed is said to be to expand FFC's operations into wider consumer finance, whilst driving the security business; possibility of including FAI Home Loans. That's another business being conducted under the FAI mantle. 5

If we go to the next page, there's reference at the top of that page to the introduction of the Kirby Group into FFC. That's an issue that we will need to look at, perhaps in not as much detail, but it did give rise to a claim in due course that was settled for some \$750,000. 10 15

If we go down to item 5, your Honour will see reference to the \$12 million debt to the vendor of Ness and HSI being obliged to pay \$12 million to the vendor of Ness, that's Mr Brown, on 30 June 2000, and it doesn't have the financial capacity, failure to repay will result in business being re-acquired and in addition, HSI has to pay FAI \$2 million as at 31 December 1999. So HSI had debt obligations of some \$14 million over the balance of the financial year. 20 25

(11.45 am)

Then there's a reference in paragraph 6 to a dispute about Mr Cooper's equity participation. We needn't dwell on that. Further down, the privatisation of HSI was discussed and then further down, item 8, it's said: 30

"The status quo is not an option. HIH has two choices: 1. Continue to support Mr Cooper, albeit with increased control and involvement; or 2. Move to control HSI and work out the situation, most likely in the absence of Mr Cooper." 35

If we go, please, to the next page, then there is at the top of this page a calculation of the current exposure to HSI. By this stage, your Honour will see that the debt to FFC/HSI has risen to just under \$51 million. Equity valued on the basis of Mr Cooper's offer at \$8.80, that being by this stage at least arguably a quite unreal basis for valuation, but it's shown there at 28 million and 50 per cent of FFC, valued at 13.37 million. Then there's effective guarantee of the Westpac securitisation program. That's a reference to Westpac's relationship with FFC. The total exposure of \$113.94 million. 40 45 50

Of course, what tables like this don't do - and this was to become a recurrent problem and indeed may well have been the source of some inappropriate assessment - the table doesn't distinguish between sunk costs, that is to say, money thrown away in future liabilities. Perhaps one of the reasons for failure to do so might be concentration upon the effect of particular transactions on the balance 55

sheet. But when determining, as we will see, HIH was called upon to do a number of times, when determining whether or not to keep throwing money into the hole, that differentiation between sunk costs, that is to say, money that is committed and lost, and future liabilities, is a very important one. But that doesn't seem to have been a process undertaken on any of the documents that we have seen anyway. 5

It's then said further down the page, HSI has an option to acquire the 50 per cent of FFC it doesn't own, on a deferred payment basis. That was part of the shareholders' agreement between HSI and FAI at the time FAI sold the 50 per cent interest in FFC to HSI. Then there's a consideration of a possible structure. If we scroll to the bottom of the page, and go the next page, you'll see there there's various proposals. The first is that HIH acquire the 10 per cent; reference then to Kirby coming in. Item 4, possibly bringing in an additional investor to provide some of the funds to pay the \$12 million. Then possibly revalue FFC and HIH's books, so as to offset any loss required to be recognised on the shares in HSI. It seems to be a recognition that there is a write-down coming up of the values of shares in HSI. I think that is the completion of the document. 10 15 20 25

It's not clear who prepared that document, but the inference from its terms is that it was somebody from HIH.

If we go, please, to [ADLE.0010.018], this is a fax from Mr Richardson to Mr Howard. If we go then to [ADLE.0010.019] - that may not be on the system - that is simply another copy of the notes of the meeting that we have looked at. The significance of them being attached to the fax from Mr Richardson suggests that the notes may have been made by Mr Richardson. That's just another copy. It's at least an open question as to whether those notes may not have been made by Mr Richardson. 30 35

If we go, please, to the document which is [SBB.152.891_001], this is a draft letter from Mr Williams to Mr Jurd dated 18 October 1999. It sets out the background to arrangements between Mr Cooper and FAI Finance. Those arrangements relate to the factoring of debt from FAI Finance and there's a company called FAI Home Distributors Pty Ltd involved; that company having the primary liability; it being indemnified in the third paragraph by a company called Cervale, and ultimate responsibility falling upon Mr Cooper if both of those companies defaulted; the amount being just under \$1 million. 40 45 50

The thrust of the letter, in the second last paragraph, Mr Williams is saying that, having reviewed the transaction, he believes the personal guarantee of Mr Cooper is sufficient. And the paragraph of the draft says: 55

"I hereby authorise FAFC to remove the second mortgage currently in place over Mr Cooper's residence."

If we scroll down the page, your Honour will see the handwriting and that seems to be Mr Williams's handwriting. He says: 5

"In the circumstances, I feel it appropriate to remove the second mortgage in respect of Brad Cooper's residence." 10

So the direction is to FAFC to give up security that it held in respect of a substantial debt that it was ultimately owed by Mr Cooper. Of course, the question arises is: why? Why was it in the interests of HIH to give up security that one of its 50 per cent subsidiaries held over Mr Cooper's home? 15

If we go then to [SBA.214.129_001], this is a fax from Mr Adler to Mr Cooper. It's a bit oblique, but in the first paragraph Mr Adler refers to having read Mr Cooper's draft letter to Mr Williams and cautions him. And then in the third indent, the last one on the page: 20

"After reading, Ray would clearly ask the question 'Why did you sell all those businesses, if they were so good?' If he ever looked into these businesses ...(reads)... for the success of HSI." 25

What Mr Adler seems to be connoting by this correspondence is that he was privy to information which he believed Mr Williams would find relevant and indeed would cause Mr Williams to conclude that he would do no further business with Mr Cooper, but which Mr Adler was apparently counselling Mr Cooper to withhold from Mr Williams. Given that the business that Mr Williams was writing with Mr Cooper was HIH business and Mr Adler was a director of HIH, the whole tenor of this communication seems fundamentally inconsistent with Mr Adler's duty of disclosure to the board of HIH of relevant matters, of which he was aware, pertaining to its business dealings. 30 35 40

If we go then, please, to [HSII.0006.416], this is a fax from Mr Cooper to Mr Richardson. We need to go to the next page. This is dated 20 October 1999, draft heads of agreement being proposed by Mr Cooper. If we go to the recitals, it refers to the debt of 14 million in relation to the purchase of International Integrated Home Security Ltd. That's another way of referring to the Ness transaction. Then if we scroll down the page, the agreement is that HIH will advance the sum of \$14 million to HSI on or before 31 October and then as security for the loan, HSI will procure effectively Ness to grant to HIH a fixed and floating charge over the assets of Ness. Then the terms of repayment are set out, by paragraph 4, an interest rate of 6.5 per cent. 45 50 55

So the proposal is essentially that HIH will fund HSI's debt to Mr Brown. I remind your Honour, of course, that

at this stage, HIH was the holder of some 35 per cent only in HSI. So the question of why it should be providing those funds, is an open one.

If we go then, please, to [HSII.0004.176], we see that the percentage interest that I've just referred to altered very shortly after the document we have just looked at when HIH bought 10 per cent of HSI through the American Stock Exchange. This is a document from Robb Peck McCooley, who are brokers on the New York Stock Exchange to Mr Richardson, confirming the purchase of 580,000 shares of Home Security International at US\$2.02 and providing details for payment. 5 10

Your Honour has already heard a little of how that came about. If we could go to [SBA.206.417_002], this is a letter from Mr Adler that I suspect your Honour may have seen before, dated 21 October to Mr Williams, referring to Mr Adler having received a telephone call from a Mr Jeffrey Pokross, asking Mr Adler to confirm the HIH purchase order for 10 per cent. He'd had extensive discussions with Brad Cooper, but for reasons of legality, couldn't transact an order on Brad's request. He had also spoken with Mr Richardson, et cetera. 15 20

Mr Adler is essentially seeking confirmation from Mr Williams, so that he could in turn confirm to Mr Pokross. 25

If you go to the document which is [SBB.152.893_001], this is the handwritten fax from Mr Williams marked "Urgent", sent to Mr Adler at 9 o'clock in the evening, saying he'd just arrived in the office, just seen the letter and he would be most grateful if Mr Adler would confirm to Mr Pokross that "we wish to purchase 10 per cent of HSI". 30 35

One of the general remarks I made earlier at the very start of today was that it seems that none of these transactions were ever presented to the HIH board. This is another significant investment that was never, it seems, presented to the board, for its consideration or approval. I may forget to make that point in relation to a number of transactions. It is a universal point. The board was apparently never consulted, although of course Mr Adler and Mr Williams would both have been aware of it. 40 45

(12 noon)

[SBB.152.877_001] is a letter from Crabbe Capital. If we scroll down the page, your Honour will see this is a request from Mr Pokross for, effectively, a finder's fee, spotter's fee of about US\$100,000. 50

If we go then, please to [SBB.1522.887_001], this is a fax from Mr Richardson to Mr Williams. This seems to be the enclosure of a draft letter. Unfortunately it doesn't seem to be readily attached. We will find it later. If we go then to the document which is [SBB.152.905_001], 55

this may well be the draft letter to which Mr Richardson was referring. If we scroll through its terms, the matter that was then under consideration was a reference to HSI having the funding need of \$12 million to repay the Ness loan and a further \$2 million to repay FAI.

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Then in the second item is the cancellation of the option for HSI to acquire the balance of FFC. There's a reference to then a review of other agreements, the possible introduction of Kirby Group to take an equity stake in FFC; the bottom of that page, a dilution being suffered equally. Of course, the critical point was back in paragraph 1, was that HIH was to provide the finance to HSI.

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If we then go, please, to the next page, other points are considered. So, the proposal then under consideration was that HIH would assume the burden of advancing loan funds to HSI.

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[SBB.152.900] seems to be the second page of the letter from Crabbe Securities that we saw earlier. It seems to have been separated in the imaging process because it starts with the reference to the wire instructions for the payment of the success fee. It goes on to say that Mr Pokross has maintained a most cordial relationship with Heartland Fund, who still owned, post trade, about 16 per cent of HIH and they might be amenable to further proposals.

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If we go then to [SBB.152.882_001], your Honour will see that this is the final version of the letter to Mr Jurd from Mr Williams relating to the second mortgage over Mr Cooper's private resident. If your Honour goes down the page, you will see that the last paragraph is in the terms of the manuscript that we saw on the earlier draft. This letter has been signed by Mr Williams. It's dated 1 November.

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[SBB.152.870_001] is a fax from Mr Cooper to Mr Williams saying:

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"Thank you very much for the letter - it was greatly appreciated."

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It seems likely that Mr Williams sent a copy to Mr Jurd to Mr Cooper and this is his expression of appreciation. Again, just why it was in HIH's interests to give up security it held is not clear - or more correctly, its 50 per cent subsidiary held.

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[SBB.152.876] is a letter from Mr Pokross to Mr Richardson pursuing his claim for commission. Mr Richardson seems to be the instrument of communication.

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[HSII.006.412] is a letter from Mr Cooper to Mr Richardson. It seems to be a response to the earlier communication we saw. Your Honour will see in the second

last paragraph the proposal being advanced is said to alleviate a valuation problem for HIH in the coming months, as well as giving a significant interest in FFC. But he says there are three or four issues that are too open ended and he wants those resolved. I'm not sure they're identified in this letter, they're identified later. 5

If we go to the next page, it's then said at the top of paragraph, there's been a 30 per cent sales downturn, failure in the US, New Zealand sales are down 700 per cent, unprecedented competition from Chubb and Signature Security, business has been lost, morale is low, everyone is losing money and confidence and belief is certainly at an all time low. There's reference in the next paragraph to Mr Brown being on the warpath, demanding the debt be restructured, the sales network continues to shrink and serious questions are being asked from all angles about viability. This is the company in which HIH is considering making a very significant advance of some \$14 million. 10 15 20

Mr Cooper refers to HIH's 45 per cent interest in HSI and to him having apparently been instrumental in the purchase of 10 per cent of HSI at a price of \$2 when he had an open mandate to pay up to US\$3. At the next page, Mr Cooper refers to further discussions. 25

[HSII.0006.426] is a fax from Mr Adler to Mr Cooper dated 28 October asking Mr Cooper to review the draft which is attached. If we go to the next page, your Honour will see this appears to be a draft of a letter for Mr Cooper to send to HIH, presumably to Mr Williams at HIH. Therefore, it seems that Mr Adler has been providing - or at least on this occasion, provided - a draft of a letter for Mr Cooper to use in his negotiations with HIH at a time when Mr Adler was a director of HIH. Of course, that gives rise to a question that we will see posed a number of times throughout our review of this documentation; that is, just whose side was Mr Adler on? Was he on HSI's side or was he on HIH's side? 30 35 40

[ADLE.0005.007] is a fax from Mr Howard to Mr Vamos, your Honour will recall associated with BTS, confirming the guarantee arrangement. The guarantee has now gone up to \$500,000. The guarantee fee will be 1 per cent as previously discussed. There's reference to the capital injection being sought. Again, I remind your Honour that HIH effectively only had a 15 per cent interest in Business Thinking Systems. 45 50

[SBA.210.022_001] is a letter from Mr Adler to Mr Howard referring to Pacific Mentor. In the opening paragraph, your Honour will see the taxable income for the year ended 30 June 1999 is \$5.239 million. I remind your Honour that Mr Adler earlier in the year acquired 60 per cent of Pacific Mentor by payments to Messrs Green and Baffsky totalling just under \$3 million. The taxable profit alone for the year ending 30 June 1999 prorated to 60 per cent, 55

was equal to the consideration he paid. So the purchase price paid by Mr Adler to those two gentlemen late in the financial year of June 1999 was no more than the taxable profit to be derived from the shareholding.

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Again, the question is: was Mr Adler aware of the opportunity to buy those parcels apparently at less than the value he was paying HIH for its parcel? Obviously he was because he consummated those transactions. The question is: did he communicate that opportunity to HIH, given that it was a significant shareholder in Pacific Mentor? The rest of the letter is concerned with how the tax liability is to be funded. Essentially, Mr Adler is proposing a pro rata capital raising.

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[SBB.018.250_001] is a profit and loss statement for Business Thinking Systems. Your Honour will see the various items there set out. We need to go to the next page, the bottom of that page. Your Honour will see under "Operating profit", there was a loss of some \$87,000, to which other expenses were added. If we go to the third page, the operating loss for the month of October was \$100,000. This is the company that HIH is providing a guarantee for a mere 1 per cent of the amount guaranteed.

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[SBB.018.251_001], these are year to date figures for the period from July to October 1999. If we go to page 003, your Honour will see that the loss for the year to date of Business Thinking Systems was \$174,000. So it certainly wasn't cash flow or profit positive at this stage.

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(12.15 pm)

If we then go to the asset position of Business Thinking Systems to [SBB.018.252_001], this is the balance sheet for Business Thinking Systems as at October 1999. On the second page, your Honour will see that as at that time, liabilities exceeded assets by some \$865,000. If these accounts are to be taken at face value, the company was incurring significant losses and had a surplus of liabilities over assets so that the guarantee that was being provided would appear to have been attended with significant risk.

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[SBB.018.242_001] is the guarantee. If your Honour goes to the second paragraph, you will see that it's now guaranteed for \$500,000. As I say, just why HIH should be taking this risk instead of Mr Adler when he had a 70 per cent interest in Pacific Mentor as compared to HIH's 30 per cent interest, is a question that needs to be addressed.

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[ADLE.0012.003] is a fax from Mr Adler to Mr Williams relating to HSI, referring to Mr Adler's acceptance of a position on the board of HSI, which is said to probably lead to chairmanship in the fullness of time. He does in the third paragraph, however, say that he is not HIH's representative, but an individual director in his own

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right. That seems to be an attitude that changed later when Mr Adler sought an indemnity from HIH in respect of any liabilities incurred by him as a result of his membership of the board of HSI, but at least started out somewhat differently in December 1999. 5

[SBA.214.127] is a fax from Mr Cooper to Mr Adler confirming his welcome to the board of HSI, referring to many good times travelling to and from New York together as the global security group was built. [SBB.152.863_001] 10 is a fax from Mr Adler to Mr Richardson. It starts:

"Thank you very much for spending the time with Brad last night." 15

Then there's reference to further discussions with Brad. It's then said in the second paragraph:

"As Ray and yourself have already agreed that Paul Brown will be ...(reads)... relieves so much pressure ..." 20

This fax appears to presuppose a commitment having been given by HIH to fund HSI's obligation to pay out Mr Brown. Where and when that commitment was given, by whom and why is not at all clear. 25

[SBB.152.835_001] is a letter dated 29 December 1999 from Mr Cooper to Mr Williams, although, as we will see, it's signed by Mr Williams as accepted. We will go to that in due course. It seems not unlikely that the signature of Mr Williams was obtained a couple of days later, but 30 plainly from documents we will see, there were intense negotiations being conducted between Christmas and new year of 1999 in relation to provision of funds to HSI by HIH. 35

If we go down the points said by this document to have been agreed, the first is that the option per the FFC shareholders's agreement will be cancelled. That's a reference to the option to acquire the balance of the interest in FFC. The next page, your Honour will see in the second paragraph, it's said that HIH unconditionally guarantees to HSI that the US\$9 million will be paid on or before 30 June 2000, but HIH will supply the facility. The terms are set out. The security is said to be a first ranking charge over the assets and business of Ness. 40 45

Paragraph 3, the 2 million payment to FAI was to be deferred for one year. Then paragraph 4, HSI is said to assist HIH to get back early moneys that HIH has advanced to FFC. Quite how that was to be achieved is unclear. The next page, if HIH is repaid early, there was to be a commitment to further securitisation. Down the page, your Honour will see in the last paragraph that Mr Cooper expresses the hope that it reflects the essence of all things discussed with Mr Richardson. The next page, your Honour will see that it's signed by Mr Williams on 31 December. Again, there doesn't appear to have been the 50 55

slightest reference at all to the board or the investment committee or anybody in relation to this apparent commitment to advance US\$9 million to bail HSI out in relation to its debt to Mr Brown.

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[SBB.152.852] is a fax from Mr Williams to Mr Cooper said to enclose a note. That is the note at [SBB.152.853_001]. It seems to be a handwritten note from Mr Williams to Mr Cooper sent at 10.30 in the morning on 30 December and it says:

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"Despite your assurance that the one outstanding matter had ...(reads)... current precarious financial position."

If HSI's position was precarious, why was HIH committing a substantial amount of further loan funds to it or at least why wasn't that course presented to the board for its consideration?

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If we go back to the separate topic of Olympic Cascade at [HSII.0003.679], there were obviously continuing problems in procuring payment of interest. This is a fax from HIH to Olympic Cascade asking for payment under the promissory note of both principal and interest of some US\$31,000.

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Going back to the subject of the Brown debt, [SBB.152.812_001], this is a letter from Mr Cooper to Mr Williams of 19 January referring to the agreement to pay US\$8.698 million to Integral Investments Ltd. The proposal here is that there be a discount for early payment of some AU\$570,000. On the next page, your Honour will see the proposal was that Mr Williams sign. At least this version of it wasn't signed, so Mr Williams didn't accept as this stage.

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[SBA.203.656_001] is a letter from Atanaskovic Hartnell solicitors to SG Hambros enclosing the first draft of a facility agreement, paragraph 1 described as evidencing the provision of AU\$9 million. Somebody has written in there. Obviously that's an error. It should be US\$9 million. We needn't go through the terms of that because that didn't happen.

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[SBB.152.803_001] is a handwritten note from Mr Williams to Mr Cooper dated 21 January, expressing in the second paragraph optimism in relation to the future of HSI and associated entities. Quite the basis for that optimism is unclear.

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[ADLE.0012.001] your Honour will see is an application for the allotment of shares in Business Thinking Systems to Pacific Mentor, having a face value of approximately \$500,000. That seems to be a conversion of debt to equity in Business Thinking Systems. So Pacific Mentor in which Mr Adler had the majority interest is increasing its equity position in Business Thinking Systems, it seems.

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[SBA.214.148_002] is the quarterly report required for

listed companies under the relevant provisions of the United States. If we go to _004, your Honour will see this is an unaudited consolidated statement of income for HSI for the three months ended December 1999. The loss was US\$452,000. The six month figures are there set out. 5
The loss for the six month period was less; that's 166,370. Obviously, if six months is less than three months, that suggests the company's rate of loss has increased over the remaining three-month period - and significantly. 10

The position in relation to HSI seems to not reflect, at least at that stage, the optimism Mr Williams held. If we go to page _005, these are statements of cash flows for the two six-month periods. Your Honour will see that over 15
the six months to the end of December 1990, there was a decrease in cash. Indeed, there was over the same period of the preceding six months, and that cash at end of the financial period as at 1999 was 2.2 million, which is of course plainly insufficient to meet the debt due to 20
Mr Brown. That was the problem that needed to be addressed.

At about this time, HSI's position suffered a significant deterioration because of the publication of an item on the television program, A Current Affair. I'll ask 25
Mr Beech-Jones to try and find the transcript reference to that. I won't take your Honour through the transcript in detail. I will ask your Honour to note - it will be 30
tendered in due course - it was a program that was highly derogatory of Home Security and its methods of operation, criticising in a very direct and blunt way the sales methods that were used to procure sales on a door-to-door basis and also criticising in very strident terms the efficacy of the alarm system that was being sold by HSI. 35
That of course was a less than propitious development for a company that was already showing financial strain.

[ADLE.0006.020] is a letter prepared to be sent by Mr Adler, soliciting the support of a number of people for 40
Mr Cooper, referring to Mr Adler's relationship with Mr Cooper, describing his as a close friend and trusted business colleague for many years and that Mr Adler remained unwavering in his support for Mr Cooper. The proposal was that a letter of support be sent to a number 45
of people to correct the impression otherwise created by the A Current Affair program.

[ADLE.0006.021] appears to be a list of persons who were under consideration by Mr Adler for endorsement of this 50
letter. The one of interest is Mr Richardson of Hambros, who was apparently thought to be somebody who might lend his support to Mr Cooper's cause.

[ADLE.0006.022] is the text of the draft letter that 55
apparently Mr Adler prepared for circulation. I won't take your Honour through it, but it does go through and attempt to address in detail some of the allegations.

There seems to be an attempt to answer the various allegations. It would be something of a distraction to go into the particular issues. It's sufficient to say that the issues that were raised in the program struck at the very heart at the Home Security business.

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It seems that this proposal never went forward in the sense that the letter wasn't circulated, nor was there action brought by HSI against A Current Affair, although legal advice was sought. The matter was simply allowed to rest. So there was no, as it were, formal response by way of either litigation or public statement from HSI.

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[SBA.210.025_001] is a fax from the Adler Corporation. The next page, it's authorisation to sign a cheque, Pacific Mentor, any two directors. The directors were Messrs Adler, Baulderstone and Howard. Effectively, Pacific Mentor's chequebook was under the control of Messrs Adler and Baulderstone, if they chose to sign a cheque. Mr Baulderstone, of course, being an employee of Adler Corporation.

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[SBA.025.000_001] is an e-mail from Ms Campbell to Mr Howard. The attachment on the next page is a memo from Mr McDonnell to Mr Howard, cc Mr Fodera, purporting to provide a recollection of a meeting that is said to have taken place on Tuesday, 29 March, which seems improbable, given the memo is dated 6 March. It seems more likely that it was Tuesday, 29 February 2000.

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Down the page, your Honour will see running through the various dot points that were discussed, one of them included a term sheet for the refinancing of the Ness note. Then in the third point, there's a transaction relating to the acquisition by FFC of HIH's 66 per cent interest in FAI First Mortgage. Then at the very bottom, there's a reference to HIH expressing a desire to reacquire HSI's interest in FFC. On this basis, HIH/FFC would agree to write HSI's business volume on the proviso the business could be sold, et cetera. This seems to be the first reference of a proposal that HIH reacquire the 50 per cent interest in FFC held by HSI. No terms of the acquisition are referred to.

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[SBA.209.418_001] is a record of payment of \$250,000 to The Kindness Foundation. Your Honour will see that the invoice at least is close in date to the invoice we saw earlier, that is back in 1999, although the cheque is dated 4 March 2000. So \$250,000 has gone to a company associated with Mr Cooper in about March. Quite what services were provided - it seems probably none because it's referred to as a donation.

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[ADLE.0009.005] is a letter from Mr Brown to Mr Cooper relating to his retainer. Essentially - I won't take your Honour through it - it proposes a reduction in his retainer from US\$10,000 per month to US\$5,000 per month. It does seem there was some belt tightening going on. He

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expresses optimism for the future.

[SBA.203.675_001] is a memo from Mr Adler to Mr Williams confirming his acceptance of the position of chairman of HSI. He describes his willingness to accept that position, despite the very tenuous times the company is going through because of its potential and to ensure that HIH is kept up to date with the progress of the company because of HIH's over 105 million total exposure to the group. The third reason is his friendship with Mr Cooper. The fifth reason is that he did, after all, found the company with Brad some 12 years ago. He then says:

"... it is my belief that it is in HIH's best interest to purchase ...(reads)... as soon as possible ..."

Here is again Mr Adler, a director of HIH, about to become chairman of HSI, proposing a transaction between the two companies. Of course, the question of conflict is very evident. I mentioned earlier the transcript of the A Current Affair program. It is to be found attached to a fax from Mr Adler to Mr Williams. The reference is [SBB.152.818_001], commencing at page 011. I needn't take your Honour to it. The general characteristics are described.

[HSII.0002.039] is a fax from Mr MacDonnell to Mr Cooper - Mr MacDonnell being an employee of HSI. The discussion points are attached at [HSII.0002.040]. This seems to be a summary of the respective positions of the parties.

(12.45 pm)

The first point is, "Agreed - HIH gives up its option". That's presumably the option to acquire 50 per cent in FFC. Secondly:

"HIH unconditionally guarantee to lend 13 million to pay out the note to Paul Brown with security over Ness."

That's the agreement we saw documented between Christmas and new year. Then further to defer repayment of 2 million for 12 months. It's then said to have been proposed on 29 February by Dominic Fodera that HSI sell back the 50 per cent interest in FFC in consideration for Paul Brown, note residual FFC debt of 7.5 million to be secured by the charge over Ness. Then the counterproposal on 7 March was to sell the interest in FFC for sufficient to pay out Paul Brown and the FFC note; i.e. 20 million.

What's significant about that description of the negotiations is the price at which the 50 per cent interest in FFC is to change hands doesn't seem to be driven at all by the value of the asset, but rather by the funds required by HSI to equip its obligations. Then another proposal under "They proposed", that HSI should consider defaulting on Ness - presuming that means

defaulting on the payment to Mr Brown - with the result that HIH wouldn't then have to lend \$13 million.

Then it's said, further down the page - this is presumably Mr MacDonnell's suggestion to Mr Cooper - HIH have inside information, then HIH have to lend 13 million for Brown. That's the apparent consequence of Mr Williams's execution of the document between Christmas and new year 1999. If there's a dispute in operating FFC, a deadlock arises and HSI has the option to acquire HIH's interest in FFC at 12 million vendor financed.

That appears to have been another Damoclean sword hanging over the head of HIH. If there's a deadlock, HSI get the right to acquire the interest in FFC, but on vendor financed terms, so HIH loses its interest in return for a debt due from HSI. At the time these negotiations are under way, HSI is in a very advantageous position because it is armed with what appears to be an unconditional guarantee or unconditional commitment to lend \$13 million and the capacity to threaten exercise of the option to acquire the remaining interest in FFC on vendor terms. There's also reference to HIH's exposure to the Westpac program of securitisation for FFC's debt.

It's then said that if sales dry up and HIH don't support, \$150 million disaster. The thrust of the negotiations, at least in this proposal from Mr MacDonnell to Mr Cooper, was essentially to threaten HIH that unless its continuing support was provided, there would be an ultimate disaster and collapse of the entire group.

On the next page, Mr MacDonnell's counsel to Mr Cooper was to sell the 50 per cent interest in FFC for \$20 million to clear up the Paul Brown and FFC note.

[HSII.0006.390] is a letter from Mr Cooper to Mr Fodera relating to the proposal to acquire 50 per cent in FFC. We will ignore the manuscript. If we go through it, you will see in the first dot point there's reference to the debt to Paul Brown, equating to AU\$13.5 million. It's then said there's no dispute that HIH have agreed to lend HSI the full amount required to retire the debt.

In the second dot point, it is said it has been proposed by HIH that HSI agree to sell back its 50 per cent investment.

"I propose to sell this shareholding for 14 million, payable ...(reads)... FFC is AU\$13 million."

That, of course, is a reference to the effect on the accounting treatment in HSI if there was a purchase at less than that price because that would mean a write-down of the asset carried in the books of HSI. That's the point made in the second dot point, that HSI would thus be able to book a small profit.

At the next page, the next dot point is:

"The board of HSI have agreed to support a sale of our interest ...(reads)... price will be \$14 million."

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Significantly missing from any of the six dot points that we have just looked at is any reference to the core value

of the asset being sold. The only matters that it seemed appropriate to Mr Cooper to raise in his communication to Mr Fodera going to value were matters all pertaining to accounting treatment or leverage in negotiations arising from prior dealings between HSI and HIH.

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One of the questions for inquiry is whether or not the price that was set for this transaction, which ultimately went ahead, was driven entirely by accounting consideration and HSI's need for cash to fund the repayment to Mr Brown, without apparent regard to the true value of the asset being transferred. There's then reference to other conditions. At page 3:

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"Ideally we would also like to explore any opportunities to structure ...(reads)... from Chubb and Newscorp."

Just what was meant by that is entirely opaque. It does again, however, lend support to the proposition that a considerable focus of attention at this stage was upon the accounts of the various entities.

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[HSII.0006.395] is a memo from Mr Cooper to Mr Williams. It says:

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"Just wanted to let you know that the price of the shares that we had ...(reads)... when we last spoke."

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Those assisting the Commission have no real idea what that relates to and whether it relates to some personal arrangement between Mr Williams and Mr Cooper or some arrangement involving HIH. We just don't know. That's a matter for inquiry.

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[HSII.0002.057] is a due diligence prepared by Andersen during April 2000. There was a report to HIH Insurance. At page 060, your Honour will see an executive summary:

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"Our findings can be summarised as follows. The latest 10Q for the six ...(reads)... applied to the model."

I won't take you through the sensitivities, but they reveal that very fact at different assumptions. It goes, predictably enough, from significant gains to some significant losses. There is a general description of the business and its structure, but I needn't take your Honour through that at this stage.

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[SBA.188.699_001] is the share transfer form for the shares in FFC transferred from HSI back to FAI Insurance and therefore HIH. Your Honour will see the consideration

specified is 13,257,500. Again, that is almost exactly equal to the amounts at which the asset was being carried in the books of HSI.

(1.00 pm)

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I notice the time. There will be some more aspects of that negotiation we need to look at after lunch, perhaps.

THE COMMISSIONER: 2 pm.

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LUNCHEON ADJOURNMENT

UPON RESUMPTION

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MR MARTIN: Before the break I had taken your Honour to the share transfer form which I should have pointed out was dated 26 April. It is necessary to go back a little in time to see how that point is arrived at. By "share transfer form", I mean the transfer of the per cent of the shares in FAI Finance.

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[HSII.0006.001] is a memo from Mr Cooper to Mr Williams dated 17 March, referring to discussions apparently then under way with Chubb and with the proposed discussions with Newscorp, in an attempt to attract their participation in the Home Security International enterprise. Although the discussions with Chubb persisted for some time, they didn't eventuate in anything.

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[HSII.0006.399] is another fax from Mr Cooper to Mr Williams dated 19 March, referring to the matter being very close to resolving all loose ends. In the third paragraph, he refers to Mr Colin Waters being brought into HSI - presumably that is a reference to Mr Greg Waters. There is also reference to Mr Williams going on in what is described as the road to visit the operations.

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[HSII.0002.482] is a fax from Mr Richardson to Mr Cooper copied to Messrs Williams and Fodera. It seems to be the fax that was regarded by the parties as setting out the terms of the agreement between them. Your Honour will see that item 1 is for HIH to acquire HSI's 50 per cent shareholding in FFC for AU\$12 million. Your Honour will note that's a reduction from the \$14 million that Mr Cooper had requested in his earlier facsimile.

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It is then said by item 2 that the money is to be used in full and final settlement of the debt owing to Mr Brown, so that the purpose of the acquisition appears relatively clearly from the terms of the document itself. There is then a business writing agreement between the three entities to be agreed.

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Then by item 5, the residual debt is to be secured by a second ranking charge over the assets and business of Ness and first ranking charge over those assets is to be given to Westpac. The balance of the FFC note is to be repaid

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over five years. It is said to be, by item 7, subject to the approval of the board of HSI. Interestingly, there is no provision requiring the approval of the board of HIH.

Then there is a reference to draft documentation. If we go to the next page, there is a separate matter. HIH has agreed to sponsor the forthcoming seminar to be produced by Vision in an amount of \$1.2 million. Details of this sponsorship will need to be finalised directly with HIH.

Vision Publishing is a company in which the beneficial interest is held entirely by Mr Cooper. It was a company engaged in the conduct of what I might call motivational seminars. This clause is described by Mr Richardson as being a separate matter. Nevertheless, it is the fact that this term appears to have been negotiated at precisely the same time and in the context of the negotiations between HIH and HSI for the acquisition of HSI's 50 per cent interest in FFC.

It is also a clause that finds its way into the agreement at a time when on the face of this document, there has been a reduction in the asking price being demanded by HSI for the sale of that interest from \$14 million to \$12 million - so the price has gone down. In addition, HIH has agreed to pay \$1.2 million to a company associated, indeed a company beneficially owned by Mr Cooper for "sponsorship", the terms of which were not at that point defined. Whether in fact there is any connection between that so-called sponsorship deal and the other transaction is a matter that will require investigation.

[HSII.0006.219] appears to be an agenda for a meeting. If we scroll down the page, your Honour will see there is a reference to a meeting with Mr Adler. Your Honour will see that the meeting which Mr Adler was to attend, included reference to the offshore markets. If we go further down the page, you'll see item 9:

"Vision and the potential deal with sales pursuit, or going it alone with just you and I."

Then item 10:

"Explain and present legends of leadership. Mentor/big voice ..."

The remaining items appear to be business interests of Mr Cooper's that were unassociated with HSI.

On the next page, reference to involvement of other individuals in the business. Your Honour will see in item 18 the potential change:

"Our name now and in return secure HIH's safe future by removing their brand name from any unnecessary risk. I recommend this would be a good strategy to consider."

Then item 19 is the recommendation that selling back the name be considered - three considerations which would be worth around \$20 million.

"... waiving the 7.7 that we owe for the remaining purchase of FFC; converting the loan to equity ..." et cetera. 5

So the proposal is that money be obtained from HIH by effectively selling its own name, FAI, back to it. 10

Further down, another item, "Capital raising", and further down again, there is reference to other items. It seems that was a meeting between Mr Cooper and Mr Adler at which a miscellany of matters were discussed, including a possible name change. 15

[ADLE.0016.078] is a fax from Mr Adler to Mr Williams. As your Honour will see, it is 27 April, which is the day after the share transfer form to which I referred before lunch. Your Honour will see that Mr Adler is writing in his capacity as chairman of Home Security International to express his concerns. It is then said that HIH, apart from being the largest shareholder, has considerable monetary exposure which has grown recently for three reasons: 20 25

"Firstly, the additional 10 per cent purchase, that of course being a purchase in which Mr Adler played some role by referring Mr Pokross to Mr Williams; secondly, the purchase of FFC; thirdly, because of the purchase of FFC, the implied and apparent liability of HIH has grown dramatically in case of liquidation." 30

Your Honour, that is a very interesting observation that doesn't seem to have been taken into account at all during the process for negotiation and purchase of the interest in FFC. It is a question to be inquired into as to whether it is merely coincidental that this fact was communicated by Mr Adler to Mr Williams the day after the share transfer was executed and the deal consummated. 35 40

The reference to the increase of exposure appears to lie in FFC's status as a linked credit provider, with the consequence that under various statutory provisions, notably Credit Act provisions, a linked credit provider has a liability to consumers in respect of goods and services sold by the party, in respect of whom credit is provided for the sale of the goods or service. 45 50

Again, your Honour, curiously omitted apparently from any deliberations relating to the acquisition of FFC is the prospect of that liability. Having regard in particular to something that I haven't yet told your Honour about, that's the commencement of a class action against HSI and FFC by various disgruntled consumers making the same sorts of allegations as were aired in the A Current Affair program. 55

In any event, in the third paragraph, Mr Adler goes on to refer to the change in the business aspect, as a result of the company monitoring the company. Then in the third line, reference to:

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"... a cash crisis of some magnitude over the next two months may preclude us reaching the good times, unless a reasonable cash injection of several million dollars is received. The reality is that this should come from HIH or significantly dilute the HIH Group shareholding if we are to pursue other means of equity finance."

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It is again of interest that the day after the share transfer is signed, Mr Adler says, "Oh, well, that 12 or 14 or 13 million, whatever it turned out to be, is all right for now, but now we are going to need more money over the next two months."

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Then in the last paragraph, he observes that his own advice would be:

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"HIH should use the opportunity to take a much greater interest in the company."

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And he hopes that the forthcoming roadshow with Brad will give "you the confidence to go further." Again, it seems relatively clear that Mr Adler, as he said in the first paragraph, is writing this letter in his capacity as chairman of HSI, not in any sense in his capacity as director of HIH. Just how it was apparently thought by all concerned that Mr Adler could properly fulfill both functions at the same time is a question that requires attention.

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(2.15 pm)

[HSII.0002.514] is a letter dated 12 May from Mr Cooper to Mr Howard, requesting payment of the \$1.2 million sponsorship for the Vision Publishing seminars and relying on the letter from Colin Richardson dated 21 March as the basis of the claim. Your Honour will recall that letter referred to further details of the sponsorship being communicated between HIH and Vision. Those assisting are not aware of any correspondence on that subject at all and are not aware of any delineation of the services that were to be provided by Vision to HIH in return for the amount of \$1.2 million claimed by Mr Cooper. What, of course, is relatively clear is that those services could not have been provided by the time this letter was written and therefore the request was for payment in advance of provision of the services.

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[ROY.0150.0256] is a bit of a difficult document to read, but it's an advice of bank account details for what is described as the HIH deposit. The account name is FAI Home Security Pty Ltd. That's the Australian subsidiary of the American parent. Then your Honour will see that

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the manuscript with apparently Mr Howard's signature is, "Please transfer AU\$5 million", and the date on this document is 29 May. So that in addition to the 14 million injected to enable HSI to pay off Mr Brown, this appears to be the injection of a further \$5 million to HSI from HIH. There is no indication on the documents available to those assisting of the provision of any security relating to this advance. 5

[HSII.0006.388] is a memo from Mr Cooper to Mr Williams, although there appears to be reference to Mr Fodera on it. The subject raised is the question of hold back. The reason for that is because of transition to a monitoring alarm product which carries with it a service obligation for a five-year period. FFC, as a limited credit provider, had the liability to provide that service in the event that HSI defaults - for that reason, proposing to hold back funds by way of security for the performance of that obligation. 10 15

The extent of the hold back by FFC became a very significant issue and the subject of quite heated negotiations over the remaining six months. It is, of course, an issue in which there was a direct conflict between the interests of HIH as the 100 per cent owner of FFC on the one hand and the interests of HSI on the other, HSI having an interest in obtaining release of as much cash from FFC as possible. I don't think I need to take your Honour through the rest of this document. 20 25

[ADLE.0016.161] is a memo from Mr Cooper to the board, copied to the management team, being apparently a monthly report to the board in respect of the month of April 2000. Mr Cooper reports that the group incurred a before tax operating loss of US\$1.2 million on sales revenue of US\$1.7 million. That's a very high ratio of loss to revenue. It's then said: 30 35

"After taking up the tax benefit there is a net loss of just over US\$700,000, but it is then said on a year to date basis, the group has incurred an after tax loss of US\$1.8 million ..." 40

There is then other financial information provided. At page 162, there is reference to unit sales. If we go down the page to "Cash position", your Honour will see at the end of April the group's cash position was US\$644,000. It is then said further down that as at 4 June 2000, the group's cash position was approximately US\$1.8 million, following the receipt of approximately US\$2.8 million of further loan funds from HIH. That would correspond with the AU\$5 million that we saw transferred in late May. 45 50

What of course is of interest is that within apparently five days of the US\$2.8 million being injected, the cash position is down to US\$1.8 million, so there is US\$1 million less than the amount of the advance within five days of it having been made. Plainly there were very 55

immediate cash demands at the time of the HIH advance.

[ADLE.0016.159] is a fax from Mr Adler to Mr Cooper, apparently responsive to the management report we have just seen. The first question posed by Mr Adler is: 5

"Is it fair to say that April 2000 was the worst month in the history of the company?"

Then he proposes a series of questions relating to financial matters, including item 6, "Whether the company had sufficient cash to last the calendar year." He then proposes that in light of April being such a disastrous month, the cash flows had to be reviewed and that the board should be receiving a weekly summary. 10 15

[ADLE.0016.141] is a memo from Mr MacDonnell to the board and others referring to capital raising options. It is dated 19 June. It is clear, notwithstanding the injection of substantial funds from HIH, consideration was being given to raising further capital to meet cash deficiencies. Various options are considered by Mr MacDonnell. If we go to the top of the next page, the paragraph at the top of the page, Mr MacDonnell concurs with Rodney's view that: 20 25

"... we need to do an urgent private raising of approximately US\$2 million to provide adequate reserves, such that a larger public raising can be properly planned." 30

So the immediate focus was US\$2 million, but that was only seen as temporary relief; there had to be further funds raised. Then a series of questions posed and Mr MacDonnell then goes through the various options that existed and the various constraints upon those options in relation to various forms of capital raising. 35

If we go to the next page, the bottom of that page, Mr MacDonnell expresses the view that the conclusion is to raise capital, being less than 20 per cent of the company's existing issued capital at market value. 40

[ADLE.0016.145] is Mr Cooper's report to the board for operations for the month of May 2000. Under the heading, "Profitability", it is said in the month of May, the loss was US\$1.7 million on sales revenue of US\$2.4 million. The after tax loss was US\$1.5 million, after tax loss of US\$3.3 million for the year to date. Of course, you have to add the tax back into that to get the real loss. 45 50

At page 148, under the heading, "Cash position", your Honour can see in the first paragraph there is a reference to the injection of US\$2.8 million from HIH and then by 13 June, the cash position had deteriorated further to US\$1.6 million. 55

[ADLE.0016.138] is a memo from Mr MacDonnell of 23 June

2000 to the board members, referring to the urgent capital raising of \$US2 million to be completed. Shareholders' approval was ruled out because of delays. There was

forecast of discussions to occur by teleconference.

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[ADLE.0016.139]. At this time, it seems to have been the commencement of a deterioration in the relationship between Mr Adler and Mr Cooper. You'll see on the page there was a claim advanced by Mr Cooper for reimbursement of expenses, forwarded on by Mr Wittaker within HSI to Mr Adler for his consideration. Those expenses included some \$10,000 for telephone expenses said to have been incurred during the month of January 2000 from the Peninsula Hotel in Los Angeles and also reimbursement for Mr Cooper's personal assistant for a particular period. Your Honour will see from the manuscript that Mr Adler appears to be requesting Mr Cooper to telephone him.

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[ADLE.0016.140] is a memo, which is a response to the previous memo about expenses. You will see Mr Adler is essentially declining to authorise the expenses claimed by Mr Cooper - no doubt in recognition of the cash problems that were confronting the company, inter alia.

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[HSII.0002.216]. What happened at about late June 2000, was that a possible investor in the form of Rokonet Electronics Limited came into the picture and negotiations were pursued over a number of months as to whether that company, which was apparently based in Israel, would take an equity position in either HSI or Ness. There were quite protracted negotiations. I won't take your Honour through the detail of them, but there is some significance for the matters of this inquiry arising from them that I will need to address.

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Could I skim through it. The background is set out. There is a convenient overview of the history of the company: its flotation in July of 1997; the joint venture in 1989 with FAI; distributor networks; servicing residential security markets in Australia, New Zealand, UK, Nertherlands, South Africa and the US; and the recent focus on monitoring accounts. I won't take your Honour through the detail. It is a convenient document for anybody wanting a potted history of the pre-development of the business enterprise.

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[ADLE.0016.089] was a briefing to Mr Adler from Mr MacDonnell relating to the financial relationships between Mr Cooper and HSI and the Distributors Association. You can see Mr MacDonnell has been effectively apparently commissioned to produce a report on the subject to Mr Adler.

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(2.30 pm)

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[ADLE.0016.091] is apparently the executive summary. Mr MacDonnell's view, communicated to Mr Adler, was the present contractual arrangements between FHS - which is

FAI Home Security - Distributors Association and Cervale cannot continue. Mr MacDonnell's view, to leave the situation as it was, would involve the board and the officers of FAI Home Security in breach of the Corporations Law. 5

The problem was that the Distributors Association was not fulfilling its obligations to FAI Home Security. The reason for that is further down the page, where at the second dot point, your Honour will see the Distributors Association being in a parlous financial state, having a deficit of shareholders funds of over \$3 million and having an outstanding loan account liability of \$1.5 million. 10 15

Then further down, Brad Cooper has entered into a deed of guarantee and indemnity with respect to the obligation of the Distributors Association with respect to past and future bad debts. Subject to a more detailed analysis, Mr MacDonnell's view was that Mr Cooper's liability was a minimum of 1.5 million and a maximum of 2 million, although there was some difficulty with the drafting of the deeds. 20

The next page, the first dot point on the top of that page, your Honour will see that the auditors have advised that there should be full provision for the loan account, with the Distributors Association. Of course, that would give rise to the question of why the guarantee hadn't been called up, the ultimate consequence of which would be vesting a liability upon Mr Cooper. 25 30

If we scroll down the page, there is more detail. The last dot point there, Mr MacDonnell says: 35

"The matter must be resolved urgently ...(reads)... debts in the group audited financial statements."

So the accounting requirement imposed a temporal obligation on resolution of the issue. 40

[ADLE.0016.061] is fax from Mr Adler to Mr Williams, dated 3 July 2000. If we go to the first paragraph, you'll see that Mr Adler's status and his obligations must have been at least the subject of some attention, because it is the subject of the opening sentence of the memo where he refers to himself as chairman of FAI representing interests of all the shareholders - obviously very cognisant of the fact that he is responsible for the largest shareholder and thought he would jot down his feelings. 45 50

In the second paragraph he advises Mr Williams HSI ended the fiscal year in very bad shape, probably losing between US\$3 and US\$4 million in an operating sense and much more when write-offs are taken into account. In the third paragraph he makes the point sales had not taken off in accordance with management budgets and therefore cash 55

anticipated to last until the end of the year is probably only available until the end of August.

So he is forecasting - illiquidity is perhaps the most benign expression to use. Then he refers to possible capital raising in the penultimate paragraph and in the final paragraph, the repayment of loans to HIH and recapitalisation or some form of restructuring. On the next page, once again, he says:

"We loath to trouble HIH for more money, but necessity may enforce ...(reads)... in the future. Chubb continues to hover around, nothing is confirmed."

On the balance of probability he says something would be done and refers to Rokonet. In the second last paragraph, he says:

"It is not a pretty picture ...(reads)... recruitment of agents to get out there and sell the alarm systems."

[HSII.0002.232] is a fax from Mr Adler to Mr MacDonnell of the same day, re Rokonet, expressing the view in the second paragraph, that it would be a very bad move for HSI if Rokonet were to invest directly in Ness. That's an interesting observation, because a couple of months later, that's of course exactly what HIH did; that's to say, invest directly in Ness.

[SBA.072.931_001], ignoring as best we can the manuscript, is a fax from Mr Adler to Mr MacDonnell of 4 July, referring to the reduction of expenses in paragraph 3 by restricting credit card and travel outside the country, using frequent flyer points to pay wherever possible. In the final paragraph, he says:

"I believe you should inform all directors formally about our cash position as it is a most serious matter."

[ADLE.0012.007] is a letter from Mr Adler to Mr Richardson expressing concern to hear, assuming it is correct, that Mr Richardson had approached Chubb directly, indicating HIH's desire to sell out. Mr Adler then says:

"If HIH is interested in selling then a planned, orderly exit is essential and we will work with you to achieve that goal. Please don't risk the Chubb deal for us, because that would be most unproductive."

Then:

"We would appreciate that no appointments be made with Chubb unless an HSI employee is represented, if you must have a meeting."

What seems to have happened is Mr Richardson, if there is substance in what lies behind it - it doesn't really matter whether there was or wasn't. More correctly,

Mr Adler seems to report that Mr Richardson had approached Chubb with a view to selling HIH's interests to Chubb. He has complained about that course and attempted to prevent it because of the adverse effect on HSI. Again, it seems a relatively clear inference from this document that Mr Adler saw his obligation as being to protect the interests of HSI, albeit to the possible detriment of HIH. I remind your Honour that Mr Adler had a personal interest in HSI, but of course he was also a chairman of the company.

[ADLE.0016.116] is a memo from Mr Adler to Mr MacDonnell relating to the financial arrangements between HSI and Mr Cooper. In paragraphs 3 and 4, reference is made to the termination of the convertible note/nonrecourse loan and, fourthly, the Distributors Association issue. Item 3 we have not come across before; I need to explain that a little.

What happened was at the time of the float of HSI, Mr Cooper's acquisition of shares in the company was part in cash and part by way of a nonrecourse loan by the company to him - nonrecourse in the sense that there was no obligation beyond forfeiture of the shares to repay principal, but there was an obligation to pay interest, as we will see.

So there was a substantial debt owed by Mr Cooper to HSI in respect of some of the shares he held in that company. In addition, there was his guarantee obligation to HSI via the Distributors Association. This fax indicates both those matters need to be resolved.

[HSII.0002.377] is a difficult document to read for anybody without particularly acute eyesight, but it is basically a summary as at 13 July of various debt exposures to FAI FC. Running down the page, your Honour can see the numbers there: 18 million, 13 million, 7 million, and go over to the next page, further figures. Fortunately someone has added it up, 51 million. So through the various entities, a debt exposure of some 51 million as at 30 July 2000.

[HSII.0002.262] is a fax from Mr Cooper to Mr Nachmully of Rokonet, referring to the purchase by Rokonet of 50 per cent of Ness Security Manufacturing for an agreed figure in the range of US\$5 to US\$7 million. The significance of these negotiations is their ascertainment of a price arrived at by third party negotiations when compared to the related party transaction that took place a few months later between HIH and HSI.

(2.45 pm)

Your Honour will see this price in fact came down and was ultimately very much below the price that HIH paid HSI for 50 per cent of Ness.

If we go to the next page, there are other terms that were suggested, including Rokonet's purchase of shareholding in HSI and then joint development of business and so forth.

[ADLE.0016.053] is a fax from Mr Adler to Mr Williams of 5
24 July referring to the preparation of the accounts by
the auditors of HSI. It is observed in the first
paragraph that it is very clear to the auditors and to the
board that without HIH's support, the company would not
have made it through last fiscal year. 10

Then he refers to his own predicament and, in particular,
the obligation to sign a statement to the effect that the
company is solvent. He observes that the reality is that
he can only make that statement if HIH will agree to 15
capitalise the debt into equity - we've seen the size of
some of that debt. Or, secondly, subordinate the loan,
roll the loan over or a combination of the above. Then
the final paragraph refers to his need to receive from HIH
some form of indemnity letter protecting him as there is 20
considerable personal risk and "one can't forget this is
an American listed company."

So it had gone from a situation in which Mr Adler
expressly asserted that he was not representing the 25
interests of HIH on the board of HSI, to a situation where
he is now seeking indemnity from HIH in respect of any
personal liability and he is also asking HIH effectively
to subordinate its interests, so that HSI can continue.
Again, Mr Adler's conflict of interest is palpable 30

[SBA.072.938_001] is a draft fax from Mr Cooper to
Mr Williams. It may not have been sent, but it does
provide some guidance as to Mr Cooper's thoughts at this
time. If we go to the third paragraph of the draft, 35
Mr Cooper advises Mr Williams that HSI is in severe
difficulties and there is a way out through Rokonet and
Chubb and he needed, he thought at least, to resolve the
following. He didn't want to deal with Richardson. He
needed Mr Williams to make the decision. 40

Firstly, he needed release of HIH's charge over Ness in
order to enable Rokonet to purchase. Secondly, he raised
the question of his own equity and the proposition being
that there was a previous commitment to give him equity. 45
He is then offering to buy HIH's shares on the basis of
10 per cent deposit, the balance over two years, with no
interest. We don't seem to have the second page of that
document. 50

[SBA.072.937_001] seems to be a memo that was sent by
Mr Adler to Mr Williams referring to the meeting. Five
items are raised: firstly, the release of the security;
secondly, capital raising; thirdly, Mr Cooper's
shareholding in HSI; fourthly, the confirmation of 55
sponsorship of Vision Publishing. Why Mr Adler considered
that was a matter that needed to be addressed at this
meeting that seems to be to do with HSI, is a question

that needs to be addressed. On the face of it, it had nothing to do with either him or HSI or HIH, but had only to do with Mr Cooper personally. If your Honour goes down the page, there is some handwritten manuscript there, but it would be only speculation to try and assess what that might have meant or who wrote it. 5

[ADLE.0018.001] is a fax from Mr Cooper to Mr Williams dated 31 July, copied to various others, including Mr Adler, Mr Richardson and Mr Fodera, referring in the first paragraph to the possible completion of transactions with Chubb and Rokonet, then the bottom paragraph referring to an MOU, for the sale of 50 per cent to 51 per cent of Ness. 10 15

If we go, please, to the next page, the first paragraph refers to the release of HIH's security over Ness to enable that transaction to proceed, and then there is a reference to the discussions with Chubb. Then if we can scroll down the page to the paragraph that commences "Ray", he says: 20

"I'm sorry we are both frustrated, but I can assure you we are working unbelievably hard to avoid being insolvent and having seriously considered filing for Chapter 11 on Wednesday of this week, as we are unable to meet payroll." 25

So collapse was imminent, as at the end of July. In the next paragraph, he says that he believes the point has been made clearly to him, by himself and Mr Adler and says: "We are on the precipice of financial ruin, but one of the two negotiations should complete". In fact, neither of them did. 30

[HSII.0006.133], this is another summary of exposure and this is HIH monetary exposure to HSI. This is effectively a direct exposure. Leaving out FFC, your Honour will see at the top some \$21 million by way of promissory notes and receivables, purchase agreement. And there is a breakdown of those that we needn't go through. There are some other smaller amounts on the next page that we needn't concern ourselves with. 35 40

As I say, your Honour, that excludes FFC, where there was a significantly greater exposure on the part of HIH. 45

[SBA.337.004_005] is a letter from Mr Brown of Alliance Investments agreeing to lend US\$500,000, obviously in recognition of the cash crisis, he being a member of the board of HSI, and of course, the recipient of the funds earlier in the year, that had been provided to HSI by HIH to purchase the FFC interests and which had in turn gone on to Mr Brown. 50

[SBA.188.493_001] is a document dated 2 August from Mr Richardson, an employee of HIH, to Mr Fodera relating to Hemsway Investment. Your Honour can read the terms, but can I summarise it by saying Hemsway Investments, the 55

company associated with Mr Cooper, borrowed AU\$1.375 million from FAI New Zealand, a subsidiary of FAI and therefore a subsidiary of HIH, secured by guarantee by Mr Cooper. No interest has been paid on the loan since 1999, the loan was therefore in default. 5

Now, your Honour, this document is one of the sources of the reference I made at the commencement of proceedings this morning, to Mr Cooper's indebtedness to HIH. Here is a loan in default, with guarantee 1.3 million, plus interest. As we will see, your Honour, money was paid, and paid, and paid again to Mr Cooper on his personal account over the next six or eight months from the time this memo was written, without there being any attempt to set those monies off against this outstanding liability. How that came to pass is a matter that needs to be investigated. 10 15

[HIH.0264.0289] is a fax from Mr Adler to Mr Williams of 3 August. In the second paragraph, Mr Adler is now writing in both capacities, as chairman of HSI and as director of HIH. Then he refers in a curious way to his responsibilities as a director. Now, what he doesn't seem to acknowledge is the fairly obvious conflict between the two duties that he owed to the various companies. It is then said in the third paragraph: 20 25

"It is only in this last week that I have concluded that without HIH's continued support, which to date has been given, HSI and all its subsidiaries could well be considered insolvent and if I would not take the appropriate action, based on that fact, then I would become legally responsible and accountable." 30

And he said says that: 35

"You should be cognisant that in view of HSI's ownership of FSC...(reads)... extent of many millions of dollars."

That, presumably, is a reference to the credit provider obligations of FFC. 40

If we go up to the next page, he then refers to the loss of the collectibility of the consumer debt, and the potential continuing class action issue which would flow through HSI to HIH, due to its ownership of FSC, and then there's the goodwill of the FAI brand name and its importance to HIH: 45

"... how would it look if a 46 per cent owned subsidiary is placed in Chapter 11?" 50

So he has provided a catalogue of all the down sides to HIH, in the event of the collapse of HIH, no doubt as a springboard for requesting further financial support. He refers in the second paragraph to the removal of Mr Cooper as managing director, and placement into the role of president of sales, to enable the Rokonet and Chubb deals 55

to proceed and that Mr Cooper should leave the board as a director.

Then he refers to his friendship with Mr Cooper in that second paragraph from the top that's on the screen now. 5
Further down the paragraph he commences with the security package and says:

"If you would like me to stay on as chairman, I would need a letter from HIH confirming financial support and in the first instance, subordinating the loans that are shortly due and payable...(reads)... all shareholders. It has come to the stage where I believe I am taking on personal responsibilities which I feel is unjustified." 10
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And:

"To date I have taken on no director's fees or any salary or financial disbursements I was just there to protect HIH's interests." 20

Mr Adler leaves out of account his own personal interest as a shareholder of HSI and of course leaves out of account there his express assertion at the time that he took on the role that he wasn't there simply to protect the interests of HIH. 25

At the bottom of the page, in the postscript he adds that he only pointed out problems, not solutions so: 30

"... here goes with HIH's pre-approval on my return I will become caretaker managing director until a suitable replacement is found, I will decimate the overheads of HSI and effectively move all the operations into Ness." 35

If we go please to the next page:

"I will conclude the Chubb deals ..." et cetera. And then in the second paragraph in regard to short term finance: 40

"As you know, I manage some funds for HIH, I would be prepared to use some of these funds to help HSI through their 'dark period'." 45

It seems a possible inference that that's a reference to the Pacific Equities money. It is just a possible inference. It is of some significance, in the light of later documentation, to note that the suggestion that Mr Adler assumed the role of chief executive is his. 50

(3.05 pm)

Document [HSII.0002.327] is a fax from Mr Cooper to Mr Williams of 3 August, indicating there was a short term requirement for \$750,000 for HSI and then in the last paragraph, referring to additional funding being required for Ness. 55

[HSII.0002.376] is an accounting record showing the transfer of \$750,000, scrolling down the page and to the right, from HIH to HSI on 3 August, so that's the very day the fax from Mr Cooper came in, across went the money. If we go further down, you'll see there is a note apparently prepared by Mr Howard as general manager of finance, saying:

"As per instructions from Dr R Williams, prior to lunch on 3 August, I transferred funds to HSI to tide them over for the next month until HIH reviews the strategic situation."

And further down:

"Code to \$5 million", so the balance has now gone out to \$5.75 million. Mr Cooper asks, and receives, no assessment of capacity to repay, at the same time Mr Adler is pointing out to Mr Williams the company is on the brink of insolvency, so the prospect of recovery is at least uncertain.

[HSII.0006.121] is a difficult document to read. We see that it's apparently a cash flow for 12 weeks for HSI, period commencing 8 August. If we scroll to the right-hand side, it is an accumulating balance, going to the closing balance for week ended 30 October. Your Honour can see the forecast in the second bottom line, a forecast balance of minus US\$4.6 million. So the proposition that AU\$750,000 would tide HSI over for a month or so, seems quite belied by this document. The needs were significantly greater.

[HSII.006.123] is a similar sort of document for Ness on a stand alone basis, showing a cash flow forecast requirement for the same 12 month period to the bottom line of just under \$4 million. If we scroll across to the right, this is Australian dollars. Now, it seems to those assisting that those two amounts are cumulative, the previous one was HSI alone and this is Ness alone, there may be some overlap, but we think not. If that's right, then the cash demands were immediate and substantial.

If we go, please, to [HSII.0002.336], this is a precis from Mr MacDonnell to the board of directors as to the current state of negotiations with Rokonet deal. If we scroll down the page, relevant for present purposes, the second dot point refers to Rokonet acquiring 51 per cent of Ness and assuming management control for a purchase price of between US\$5.25 million and US\$6 million, with an option to acquire further capital, up to 76 per cent. That provides some yardstick. The price gets negotiated further, but these provide a yardstick for the transaction that ultimately occurred between HIH and HSI.

[HSII.002.338] is a memo summarising the position in relation to Mr Cooper's promissory note. It was for purchase of 250,000 shares in the common stock of HSI at

\$10 per share. Obviously, the maths produces a figure of US\$2.5 million which, by this time, given the change in the exchange rate was close to AU\$5 million. Further down the page it is said that security for the note is recourse to the 250,000 shares, which was of course a significant part of Mr Cooper's shareholding in HSI, but the obligation interest was with recourse to Mr Cooper. 5

Further down the page, under the heading "Legal advice", being what one might have thought is the blindingly obvious is pointed out and that is that the company can't just afford to throw that debt away, because it wouldn't do that with an unaffiliated third party, there must be a benefit to the legal advisors recommend against cancellation. Obviously, what was under consideration at this stage was some way of getting Mr Cooper off the hook. 10 15

If we go, please, to the next page, by this stage of course the shares are valued much less than the US\$10 they were purchased for. Then there are a number of options are considered, including pre-payment of interest to cancel the note and the possibility of shareholder approval is canvassed in the last paragraph. 20

The difficulty of that course being that an interested shareholder mightn't be able to vote, because it might result in an oppression suit. 25

[HSII.0006.117], your Honour will see is a memo from Mr MacDonnell to the board of 9 August attaching the cash flows, some of which we have seen earlier. \$4.6 million of funds is required to maintain operations to 30 October 2000, and on the current cash, the group can only last until the end of September, if it is not required to fund Ness's working capital requirements. But those working capital requirements are some \$4 million before taking into account, that's a \$1 million overdraft facility, if it is to maintain operations to 30 October. 30 35

Down the page there is a budget and there is a reference in the second last paragraph to the financial controller of Ness indicating that share requires 1.5 million of urgent funding and the last paragraph it is said: 40

"The critical aspects to achieving this projection are the achievement of 1,000 sales units in Australia between now and December and approximately 350 units a month internationally." 45

That presumably is 1,000 sales per month and: 50

"... during June and July ...(reads)... running to this forecast."

As we will see later, there was an expectation that sales would finish during the Olympic period, which was imminent. 55

Back up the page, annexure E refers to the Home Security Group, excluding Ness, forecasting cash running out by the end of September 2000. Then under the details further down there are details of the group's liability. There is a reference to the future liability to pay monitoring costs of 8,000 lines for a five-year period. And then there is the class action liability that's not reflected in group balance sheet. There is then reference to HIH's financial support to the group, the bottom of that page, \$21 million, loan facility agreements and receivables factoring agreement. That leaves out the FFC exposure.

On the next page there are various matters dealt with that we needn't go through. On the last page, under the heading "Forecast Profitability for 2001 Financial Year", the second paragraph, the annexures are there, I won't take your Honour to them:

"Based on current sales forecast the group will lose... to the 2001 financial year."

So there was no hope of an imminent turnaround.

(3.15 pm)

[HIH.0264.0285] is a fax from Mr Adler to Mr Williams, by now it is 10 August. In the second paragraph he refers to the situation in relation to HSI being dire, the mood being one of desperation. The sales are in fact continuing to deteriorate. He refers to Chubb and Rokonet deals being progressed, but negotiations are lengthening. Then in the second last paragraph he refers to having sought legal advice, presumably with respect to imminent insolvency. In the last paragraph he says:

"The company is short of funds and has relied on HIH's financial support these last two months to survive. The real question is: can the company survive? Is it worthwhile to keep it in existence, or would everyone be best served by Chapter 11/liquidation/closing shop."

If we go then, please, to the next page, the second paragraph, he expresses the view it is in HIH's best interests to keep the company afloat. Then he expresses the view that the end result would be a significant loss to HIH, probably in the order of \$50 to \$60 million due to the ownership of FFC and various other outstanding guarantees. As I pointed out earlier, there doesn't appear to be any distinction being drawn here between sunk costs and future liabilities, which is of course what one would have thought would have been the key focus, if the question one were being asked to determine is whether to keep throwing more good money after bad.

He then refers further down the page to Ness and if we scroll down, the bottom half of the page he says:

"This can only be done, with a new managing director. As

I said to you in a previous letter, I am happy to undertake that task if you agree to two provisos."

Firstly, the caretaker; secondly:

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"HIH provides the financial support in order to change the financial 'smell' of HSI."

Then he refers to liquidation in the last paragraph. Ness is a valuable company, but a wholly owned subsidiary. He then refers in the last line to the proposition that HIH put in another \$5 million. Now, whether HIH were getting the cash flow forecasts or profit forecasts at this time is not clear.

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On the next page Mr Adler says, on his analysis of the information, says:

"Ness needs between 2.5 and 3 million next week, HSI needs about 1.5."

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He has added in another 0.5 for comfort. Then there is a reference to other funds being injected. That, presumably, is a reference to Mr Brown's advance of \$500,000. Then somebody has written "\$1 million", it seems. It would be speculation to know who wrote that, or try and guess who wrote that and what it means.

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[HSII.0002.343] is Rokonet's offer, at least an MOU, and deals with the subject of due diligence. If we go down the page, the proposal in paragraph 1 was Rokonet will pay US\$5.25 million for 50 per cent of Ness, including management control and US\$1.1 million for 10 per cent of HSI. That was with an option to acquire a further 25 per cent.

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Your Honour, as a yardstick, that amount is a little under AU\$10 million for 51 per cent, and control. In the result, as we will see, a month or two later, HIH paid AU\$17.5 million for 49 per cent of Ness, but lacked control. Of course, the other aspect for HIH was that HIH wasn't in the same position as Rokonet, in that Ness was a wholly owned subsidiary of HSI, in which HIH had an interest of approximately 47 per cent. So why HIH would want to pay directly for Ness when it had an indirect interest through HSI, presumably would be realised in the event of insolvency of HSI, it is unclear.

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In the event of insolvency, HIH would have been one of the main creditors of HSI and therefore presumably would have had access to Ness not at least of course through the securities it had over Ness. So when we come to evaluate the Ness transaction, we have to look at the fact that HIH had a charge over the assets of Ness, had an indirect equitable interest in Ness through the shareholding it had in HSI, and nevertheless appears to have paid significantly over what was negotiated by an arm's length third party for the acquisition of an interest.

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I should also mention, your Honour, that in fact there will be tendered in due course a report from experts who have been engaged by the Commission to do an analysis of the value of Ness as at the time of the HIH transaction and the thrust of that report is to the effect that their estimated value of Ness is significantly below the amount offered by Rokonet prior to due diligence of US\$5.25. So that on the basis of that evidence, if it is ultimately accepted by your Honour, the gap between the true value of the 49 per cent interest in Ness and the \$17.5 million paid by HIH is a wider one.

There is just one aspect of this document that I should have drawn your Honour's attention to. This might explain the difference between this offer and the expert report to which I have referred; item 3 is of some significance, because it refers to an obligation of HSI to pay the debt of \$6.4 million to Ness, so the offer to buy the shares in Ness is contingent upon HSI kicking capital into Ness to the benefit, of course, of the shareholders of that company. "Kicking capital in" is the wrong way to put it; repaying debt is the correct way to put it.

[HIH.0264.0283] is a fax from Mr Adler to Mr Williams. In the second paragraph he states:

"We confirm that within the next 48 hours, we will be calling on you to send us AU\$2.5 million. All that remains is for us to work out where the money should be sent. We will revert. We understand that the money comes with some conditions."

Firstly: an independent chairman; secondly, that he becomes managing director after the Chubb deal is completed. Of course, that was Mr Adler's proposal and he is now proposing it as a condition upon the advance. And secondly, Mr Cooper remains a director and becomes president of sales and someone else be appointed to the board, overhead reduction, et cetera.

There is then reference further down the page to the FFC interest holding back charge to be reduced to 15 per cent. As I pointed out to your Honour, that is an issue in which HSI and HIH plainly had a direct and

immediate conflict of interest, because the more the hold back charge was reduced, the greater the exposure of FSC a wholly owned subsidiary of HIH, to the failure.

Then the second last paragraph, he refers to there being no forecast major changes in sales due to the umbrella of misery hanging over the company and the Olympics.

[HIH.0264.0284], this is the next day, it is a fax from Mr Adler to Mr Howard of 16 August:

"Dear Bill,

HIH has kindly agreed to contribute \$2.5 million to HSI. Could these funds please be sent today to the following account. It would be greatly appreciated if this money could be deposited this morning."

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Your Honour could easily understand Mr Howard's confusion about whether this was a direction to him coming from a member of the board of HIH on the one hand, or alternatively the chairman of HSI on the other.

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[HSII.0002.347] is a letter from Mr Cooper to Mr Nachmully of Rokonet. It is a response to the offer. If we scroll down the page, you'll see by paragraph 1, the offer of US\$5.25 million for 50 per cent of Ness, and US\$1.1 million for 10 per cent of HSI was acceptable, but he wouldn't agree to pass control of Ness.

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Now, your Honour, if HSI were prepared to take under \$10 million for 50 per cent of Ness, why, we ask rhetorically, did HIH have to pay \$17.5 million a couple of months later, when the situation had, if anything, deteriorated rather than improved?

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[HSII.0002.513] is another letter from Mr Cooper to Mr Howard complaining about nonpayment of the \$1.2 million sponsorship to Vision Publishing. [HSII.0003.627] is another subject we haven't addressed for a while, this is Olympic Cascade and in relation to the \$500,000 promissory note, there is a letter providing a tale of woe in relation to the incurring of losses. If we go to the next page, there is an offer of US\$50,000 in full and final settlement of the obligation under the promissory note which, as your Honour will recall, was an amount of US\$500,000, so Olympic is offering 10 per cent.

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[HIH.0264.0282] is a fax from Mr Adler to Mr Williams,

enclosing the e-mails, the loss being described by Mr Adler as "horrendous". That's 22 August. This is after the 2.5 million that in fact went across.

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(3.30 pm)

If we go, please, back to the Olympic Cascade issue, [HSII.0003.626], this is Mr Ballhausen's response refusing to accept that Olympic Cascade is incapable of meeting its

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obligations and refusing the offer and refusing to entertain any more offers until outstanding interest is paid.

If we go, please, to [HSII.0003.616] and scroll down the page, the offer has now increased to US\$100,000 in full and final settlement, payable at the time.

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In [HSII.0003.623] Mr Ballhausen maintained the line refusing to entertain any offer of settlement until the outstanding interest was paid. Your Honour, is this a convenient time?

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THE COMMISSIONER: Yes. We will resume at 3.45 pm.

SHORT ADJOURNMENT

UPON RESUMPTION

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MR MARTIN: [HSII.0006.443] is a fax from Mr Cooper to Mr Nachmully of Rokonet, encouraging him to commit to the transaction that they had previously negotiated.

Mr Cooper wasn't indifferent to the sale of 50 per cent at the price of US\$5.25 million; rather, he was actively promoting it. 10

[HIH.0264.0281] is a fax from Mr Adler to Mr Williams of 25 August. The second paragraph is rather interesting, because he says: 15

"Our results are so poor that we are prepared to prejudice our own company ...(reads)... our largest shareholder." 20

Mr Adler appears to be drawing a division between "us" and "them", but with himself apparently overlooking, at this stage, the fact that he's on both sides of the fence.

What he then says is that it's clear to him that to minimise the constant bleeding by HSI and therefore indirectly HIH, a dramatic restructure is necessary. In the third paragraph, he forecasts a more defined and direct relationship with HIH. Then in the penultimate paragraph, he expresses the view that if things continue the way they are, there could be serious loss to HIH. Then he refers to dealing with Mr Richardson. 25 30

[HSII.0003.564] is another document in the sequence of correspondence relating to Olympic Cascade. Mr Ballhausen again reiterates having received the interest money, that he doesn't accept that Olympic Cascade is incapable of making the full payment and therefore wouldn't be making a counteroffer until a realistic proposal was advanced. 35 40

The significance of all of this is that in about February 2001, as we will see, a completely different line was taken and a very significant discount on the Olympic Cascade debt was accepted in the form of final settlement. The circumstances of that will require investigation. 45

[ADLE.0021.169] is a letter from Mr Adler to Mr Williams, reiterating his request for a letter of indemnity from HIH. It's dated 28 August 2000. 50

Back to the subject of Olympic Cascade, [HSII.0003.772]. There's then a dispute about payment of the interest. In the last paragraph, repetition of the proposition that HIH considers Olympic Cascade is capable of meeting interest and amortising principal payments. 55

[SBA.071.427_001] is a memo from Mr Jurd, who I remind

your Honour is the chief executive of FFC, relaying on to Mr Howard legal advice that he had received about the implications for FAIFC of Home Security's insolvency and making the point that there may well be an exposure to FFC as a linked credit provider, but there are defences available under the various provisions of the act. At least at this stage, some consideration was being given to the precise consequences of the collapse of HSI on FFC. 5

[ADLE.0018.017] is a letter from Mr Lo to Mr Adler in relation to the letter of indemnity, advising that legal advice had been sought and that board approval was required and that there were limits under the Corporations Law as to the liabilities that could be indemnified. I needn't take your Honour to it, but [ADLE.0018.018] is the proposed letter of indemnity. 10 15

[HIH.0264.0275] is a letter from Mr Adler to Mr Williams, dated 31 August, dealing with FAI Home Loans. This is a name that had now been taken on by a company that's previously been referred to as FAI First Mortgage. It was a company in the business of, as its name suggests, providing home loan finance. 20

The letter attaches, curiously, a letter that Mr Williams had received from Mr Alistair Jeffery from Bluestone Mortgages. Obviously Mr Adler had a copy of that letter - presumably from Mr Jeffery from Bluestone. He refers in 25

the second paragraph to Mr Jeffery having created and Mr Adler having taken a small interest in Bluestone, which is a brand new company set up to do what is termed nonconforming mortgage origination loans. He's pushed Alistair to purchase FAI Home Loans, because he believes it gives Bluestone a platform and Mr Adler knows that HIH are keen to sell the asset. He goes on to give Mr Williams advice as to the terms upon which the transaction should be undertaken. 30 35

As Mr Adler acknowledges, he had an interest in Bluestone, as a director of HIH, and he is proposing to Mr Williams the terms upon which Mr Williams should undertake a transaction in which Mr Adler plainly had a conflict between his duty as a director of HIH and his interest as a shareholder in Bluestone. 40 45

The letter from Bluestone is [HIH.0264.0276]. Your Honour will see in the first paragraph that it's a letter of the same date to Mr Williams. Mr Adler's interest is specified as 10 per cent of Bluestone. Then the proposal for acquisition is outlined. It seems that that didn't go ahead, but the propounding of the transaction by Mr Adler in circumstances where he plainly had a conflict, seems consistent with much of what was happening at this time. 50

[SBA.188.488_001] is a draft, apparently prepared by Foster Stockbroking, relating to what's described as a pre-IPO opportunity. Presumably that's a solicitation of capital prior to a public raising; capital being solicited 55

is in BTS. This document is dated 31 August 2000. I needn't take your Honour through it in detail, but obviously a capital raising by BTS was under consideration.

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At page _004, your Honour will see that under the heading, "BTS Background", Mr Vamos founded Business Thinking Systems in the mid-1990s, with the support of Rodney Adler. Mr Adler is the chairman. Mr Vamos, Ms Fleming, Mr Lucas, Mr Sawyer and Mr Fletcher are the other directors of BTS.

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At [SBA.072.929_001] are the monthly management accounts for HSI. At page _004, your Honour can see that the net loss posted for the month is just under \$1 million; that presumably is US\$1 million. So the situation was not looking up.

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[ADLE.0003.133] is another fax from Mr Adler to Mr Williams dated 6 September. There's an interesting observation in the first paragraph:

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"In view of our meeting yesterday, I am much more concerned about the value at which HSI is valued in the HIH accounts."

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That, presumably, is a meeting which he attended in his capacity as a director of HIH:

"According to the information I saw yesterday, HSI is valued in HIH's books ...(reads)... is a going concern."

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As Mr Adler points out:

"This will not only put at risk your current valuation, requiring ...(reads)... plus \$15 million."

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This is obviously at a time when very serious consideration is being given to the extent to which the accounts of HIH for the period ended 30 June 2000 can be presented in a favourable way to the market and of course the Allianz transaction was a dominant feature of that aspect which was then under consideration.

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Mr Adler then proposes a series of transactions. The first one is:

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"HIH purchase Ness for \$36.5 million (the original cost of Ness thereby ensuring no write-down of that asset)."

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Pausing there, quite clearly and candidly expressed on the face of this memo is specification of price by reference to accounting considerations, rather than value:

"It is then proposed HSI and Ness enter into a five-year agreement ...(reads)... have a reliable income."

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The next page, paragraph 3:

"On receipt of 36.5 million, 15 million is to be repaid to HIH ...(reads)... making HSI financially strong ..."

Further down the page, it says, curiously: 5

"The above series of steps does not solve the problem, but it defers them all and gives all of the entities the time to develop and prosper."

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Again, this is a transaction being proposed by Mr Adler in his capacity as chairman of HSI, which is plainly a transaction very much in the interests of HSI and in which he is proposing that HIH, a company of which he is a director, buy an asset from HSI, the company of which he is chairman, by reference to considerations that appear to have nothing to do with value, but everything to do with accounting treatment and in a context, of course, in which, presumably, Mr Adler, as chairman of HSI, would have been aware that a third party was proposing to purchase, with the encouragement of Mr Cooper as chief executive of HSI, a 50 per cent interest in Ness for an amount significantly less than the amount which he was here proposing HIH pay for Ness.

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Of course, the proposal, as I've said earlier, overlooks HIH's existing interest in Ness as the beneficiary of a charge over its assets, so that in the event of the insolvency of HSI, HIH already has significant protection in relation to the assets of Ness.

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[HIH.0264.0201] is another fax from Mr Adler to Mr Williams. This is a complaint about the actions of Mr Jurd as chief executive of FFC. The complaint is that Mr Jurd and FFC are dealing with distributors who have left HSI. Can I remind your Honour that FFC is a 100 per cent owned subsidiary of HIH and therefore its profits flow dollar for dollar back to HIH; whereas HSI is an entity in which HIH had only at this stage an interest of about 46 per cent. Again, Mr Adler seems to be prevailing upon Mr Williams to take steps which, on one view, damage the interests of HIH for the benefit of HSI. Again, the conflict of interest is direct and obvious.

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[HIH.0264.0293] the same sentiments were expressed by Mr Cooper to Mr Williams in rather more detail. Paragraph (b) Mr Cooper asserts that there was an undertaking given that FFC would not harm the HSI business and would, at all times, act in HSI's best interests. Why that undertaking would be given is not clear.

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The next page, the second paragraph, Mr Cooper states:

"If action is not taken today, we will have no business to protect. The consequences of this will be devastating for the entire group."

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Further down:

"You have a \$70-\$100 million investment which is on the brink of collapse. I reiterate my previous statement that Geoff Jurd cannot ...(reads)... impartially towards HSI."

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In the last paragraph, Mr Cooper suggests that he will have Rod call Mr Williams to discuss the matter.

[HSII.0002.391] seems to be a letter from Mr Williams to Mr Adler of 12 September, referring to having had Colin Richardson and Bill Howard review the proposal, suggests the following in response. Again, HIH buys Ness for \$36 million, which is the amount which is carried in the books. The purchase price is to comprise cash of \$20 million, in exchange for a bond. HSI repays 18 million in loans to HIH and remaining 2 million left in HSI as working capital. That's a lot less in terms of working capital and cash component than that proposed by Mr Adler.

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You can immediately see that the transaction, structured in this way, is accounting driven, because at a purchase price of 36 million for Ness, there is no write-down of HSI's value of Ness in its accounts, so there's no reduction in HSI's assets and with the repayment, the use of that money to repay in full the loans from HSI to HIH, no provision needs to be made for those loans in the accounts of HIH, having regard to the going concern issue that Mr Adler has previously foreshadowed.

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On the face of it, it's a terrific solution from the perspective of the appearance of the accounts, but it overlooks the reality. The reality is that HIH's investment in Ness is not worth \$36 million and the reality of it is that HIH's advances to HSI should be provided for and written down, because of the doubts about HSI's capacity to continue as a going concern. So the effect of the transaction consummated in this way, would be to overstate the assets of each of HSI and HIH. The reason that comes about, of course, is the basis of the transaction is not the true value of Ness.

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Further down, your Honour will see in the penultimate paragraph, it says:

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"We believe that the above goes to solving the debt and carrying values of assets on both sides, with HSI receiving more working capital."

There's an express acknowledgment of the transaction being driven by the accounting considerations, rather than by an obligation to get good value for the asset acquired.

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[HIH.0264.0259] is a fax from Mr Adler to Mr Williams setting out the terms of the then agreement. It's interesting to note it seems clear that the negotiation is being conducted between Mr Williams on the one side and Mr Adler on the other side, but they are both directors of

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HIH. The terms are there set out. There's been an adjustment of the breakdown between cash and bond and an adjustment of the amount to be repaid of the HIH debt and therefore an increase in the cash available to HSI.

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It seems from the manuscript that not all of those terms were agreed. In the event, the transaction was restructured, so we needn't dwell on these terms, rather than note again the fact that there doesn't appear to be any reference at all to value, nor any attempt to assess value for the purchase price in any of these negotiations. Rather, the drivers seem to be the accounting treatment and the precise amount of cash that will be injected into HSI after set-off of debt to HIH.

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[HSII.0002.388] is a fax from Mr Adler to Mr Howard of 13 September. The second paragraph observes:

"I have the HIH auditors coming to see me tomorrow to discuss HSI valuations and I would like this brought to a head, for all the obvious reasons."

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That is apparent confirmation of the importance of the accounting treatment as a driver of this whole transaction. Then the handwritten manuscript appears to read:

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"Bill - I cannot sign the accounts until this is finalised."

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That appears to be Mr Adler's initials following that manuscript. Again, the question that no doubt occupied Mr Howard's mind was, in what capacity was Mr Adler writing? Was he writing in his capacity as a director of HIH or some other capacity?

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[ADLE.0003.129] purports to set out the terms of an agreement. As we will see in due course, it's a letter signed by Mr Adler. The terms of the agreement again are structured on the basis of the sale of the entirety of Ness for \$36.5 million. Again, that appears to be a price set by reference to book value. The breakdown between cash and loan is 25 and 11.5. Then to further terms over the next page:

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"Out of cash received by HSI it will repay all outstanding loans to HIH which are approximately AU\$15.75 million."

So again, there are various other detailed terms. Because this transaction didn't proceed, we won't go through them in detail.

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[HSII.0002.394] is a fax from Mr Adler to Mr Cooper of 14 September. "FAI Home Security" provides reference to \$1.3 million having been lost for the month of July. So things had not improved. There's a reference to the probable sale of Ness to HIH.

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[HIH.0264.0247] is a significant document. It's a fax from Mr Adler to Mr Williams of 15 September. It says:

"It is not an easy letter to write ..."

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For reasons that he describes. In the second paragraph, he talks about a conversation about the restructuring of HSI, referring to horrendous pressure on Mr Williams. He then says:

"I am in an invidious position as chairman of HSI, a group that you value in your books at \$3 per share ..."

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That's a reference to HIH as if Mr Adler is not connected with it. Then, however, the last sentence, there's an acknowledgment that in all truthfulness, as a director of HIH, he can't sign off accounts knowing there's a potential \$30 million plus difference in value. So this appears to be an assertion that he sees his responsibilities as a director of HIH now, including him signing off on the accounts. There is then a very significant paragraph, a significance that perhaps goes beyond the HSI transaction that we are concerned with:

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"As you know, one can shut one's eyes when talking about actuarial, property valuation et cetera, but as chairman of a company, my knowledge is so complete that I would be commercially irresponsible and maybe even personally liable if the HSI situation is not resolved."

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The assertion that one can shut one's eyes when talking about actuarial property valuation, et cetera, is chillingly reminiscent of the problems that beset HIH after its acquisition of FAI in relation to the under-reserving of that company, the overstatement of the value of its assets. It seems to connote an apparent acceptance - and, of course, we will wait with interest for Mr Adler's explanation of this paragraph - of the legitimacy of shutting one's eyes to actuarial and property valuations.

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THE COMMISSIONER: In terms of reserving, I don't think it's necessarily right to confine it to the situation after the FAI takeover, so far as HIH is concerned. One view of the evidence - and, of course, that evidence is yet to be completed - is that under-reserving may have been a problem before the FAI takeover.

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MR MARTIN: Indeed. It's difficult to know what the reference is to. Wherever it be, whether it be in FAI or HIH, it is, on the face of it, an extraordinary concession or proposition to advance. It then goes down the page to refer to the problem of competition between FFC and HSI. Again, referring to it "hurting you as much as it hurts us", which is an apparent return to the division of the fence between HSI and HIH.

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If we go to the next page, the first paragraph commences:

"... every week that goes by, the business is more and more and weak."

[HSII.0002.402] is a fax from Mr Cooper to Mr Howard under the heading, "HSI Audit Sign-off". The introductory paragraph is interesting: 5

"... as a means to help HIH, we put together a proposal to sell Ness Security Products Pty Ltd, an integral part of our business model, to HIH." 10

That's an interesting spin to put on the transaction when HSI is on the brink of insolvency: 15

"We have advised Arthur Andersen, our auditors, of the basic parameters of the deal ..."

Then in the paragraph further down: 20

"We need to urgently prove to the auditors that the Ness sale ...(reads)... adamant the auditors become ..."

Once again, this is quite demonstrable evidence that a significant driver of the transaction was the accounting treatment to be provided to, initially, the books of HSI and to a consequential extent, of HIH. Then that consequential effect was referred to in the final paragraph on that page. 25 30

On the next page, Mr Cooper then tries to provide a breakdown of the consequences for HIH. First is the write-down of the shares to zero; provision against outstanding loans of 16 million; provision for outstanding monitoring services, 10 million; provision for warranty and service liabilities, 5 million; provision for class action. At least on that sort of breakdown, one can distinguish between sunk costs and future costs. The existing shares and the loan are what I would call sunk costs, whereas the remaining three are future costs, 35 40

future liabilities, perhaps arising from the collapse. One can see on these estimates, that only some 18 million out of the 47 million would be future liabilities.

Of course, the significance of the sunk costs, the point being made by Mr Cooper is that even though the money is lost, what would happen from an accounting point of view is that it would have to be written off in the accounts. It's then said that the value of Ness would be critically depleted by a collapse of the HSI Group, thus affecting, presumably, the value of HSI's security over Ness. 45 50

He's prevailing upon Mr Howard to get the heads of agreement signed. [SBA.209.441] is again a fax from Mr Adler to Mr Williams. The second paragraph refers to Mr Jurd having to be directed. Again, this appears to be Mr Adler wearing his HSI hat, telling Mr Williams what HIH need to do. It's then said: 55

"In regard to funds, let me advise you of some facts:

1. We need to repay HIH \$16 million ...(reads)... little bit on marketing."

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There is the breakdown of the debts that's provided, no doubt, as a backdrop for the negotiations relating to the acquisition of Ness.

[ADLE.0021.290] is a fax from Mr Cooper to Mr Adler dated 20 September in response to an apparent question, to explain the reason for the downturn in sales and what has been to reverse the trend, Mr Cooper says:

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"The answer is simple. Since July of 1999, I have been unwinding ...(reads)... 75 per cent of my time."

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The bottom of the page:

"The downturn - during the last 18/24 months I estimate 75 per cent of my time ...(reads)... everything, but sales."

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The next page, he refers to problems overseas. If we go to the third paragraph:

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"The company, while created by me and mentored by me, has excellent day-to-day management ...(reads)... 428 seminars out of my office."

It's not hard to see that if Mr Cooper has been conducting 428 seminars, that he may not have been entirely focused on the activities of HSI. Because as your Honour may have seen from some of the earlier documents, Mr Cooper was being remunerated US\$700,000 a year for his work in relation to HSI. Yet, he seems to have found time to do these other activities, said to be justified by "enhancing the vibe and the positive view towards FAI, making it the place to be". Then he says that since July of last year, he's been on the back foot.

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Then if we go to the bottom of the page, your Honour will see in the penultimate paragraph recruiting difficulties are referred to:

"...A Current Affair having hurt us badly. Essentially we are in freefall ...(reads)... relaunch the new program ..."

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Mr Williams and HIH are plainly seen as the salvation to an otherwise dire situation. The next page, there is then a reference to recruitment of sales people and various management steps that need to be taken. The next page, the second paragraph, your Honour will see:

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"Insurance companies need adequate reserves and confidence ...(reads)... once every two months ..."

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Then there's reference to the restructure. In the last

paragraph:

"Our restructure will give us a whole new frontier of corporate growth and opportunity. Ray Williams' support to date has been invaluable ..."

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(4.30 pm)

[ADLE.0003.128] is another fax from Mr Adler to Mr Williams. This one is now 21 September. It refers to HIH not being able to put \$23 million worth of goodwill on to its balance sheet, so there could be another solution, since if HIH buys 49 per cent of Ness for \$17 million, with an option to buy the balance, HSI will be able to repay \$10 million of debt to HIH and the balance of the money will be repaid at a date five years out. In this way, HSI has \$6 million to place it in a position of substance.

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Brad will become president of sales; Mr Adler will become CEO. HIH won't have any additional goodwill on its balance sheet. It can show the auditors that loans have been repaid. You've got security for the outstanding loan. Then there are a couple of outstanding issues, like the issue of options. The significance of this is again the entire transaction is being driven by accounting and audit issues and the value of the asset being acquired appears to receive no consideration whatever in these communications.

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Of course, communications are being undertaken between Mr Adler and Mr Williams - Mr Adler in a position of hopeless conflict of interest.

[ADLE.0003.030] is a fax from Mr Cooper to Mr Howard, expressing his appreciation for the agreement to the purchase of 49 per cent of Ness - that enabling HSI to report a net asset position. That, of course, had an obvious knock-on effect in the books of HIH. He points out that full audit sign-off is being sought by 29 September. Therefore, there must be ability to show sufficient cash reserves as in the third paragraph and the thrust of the letter is then concerned with the breakdown between repayment of debt on the one hand and cash to be left over for HSI in the future.

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Again, the inference arguably arising from the document is, the driver of this transaction is accounting consideration and the need to find a means of injecting further funds into HSI at a time when the existing debt to HSI was very much in doubt, because of the doubts over HSI's capacity to continue as a going concern.

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[HIH.0264.0211] is the deal summary proposed at the time. It is the soul of brevity. The first term is that Mr Adler is to become CEO of HSI. As we have seen, the origin of that thought was Mr Adler. HIH buys 49 per cent of Ness for 17 million. HSI repays loans to the total of

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14 million, but then because of the cash needs of HSI under this proposal, there is a guarantee to provide HSI with a further 3 million of funds by 30 June 2001, contingent upon average market sales. There is then an issue of the manufacturing agreement to be assessed and the new RPA agreement is now in operation, therefore nothing new is required. 5

The arrangement is that there will be an immediate repayment of 14 million, but with an obligation to advance further funds from HIH prior to 30 June 2000. 10

[HIH.0264.0212] is a fax from Mr Howard to Mr Williams enclosing a copy of material that had been faxed to Rodney and Brad. As we will see from the documents, it seems that the negotiating teams were Mr Howard and Mr Williams, on the one side; and Mr Adler and Mr Cooper, on the other side. Of course, Mr Adler was a director of HIH, so what he was doing on the HSI side is a matter for inquiry. 15

[HIH.0264.0234] is Mr Cooper's response to the deal summary that we saw. The first one that your Honour will recall related to Mr Adler's position as CEO. Point 2 is HIH buys 49 per cent of Ness from HSI for 17.5 million - so there's an increment of half a million. Point 3, the debt repayment is said to be 10 million and 7.5 remained in cash. So the ambit of negotiation is how much goes off against debt and how much is to be retained by HSI in cash. The other points we needn't dwell on at this stage. 20

[HSII.0006.324] is also a fax of 25 September from Mr Cooper to Mr Williams, cc Messrs Adler and Howard. In the second paragraph, he refers to his pleasure at working with Mr Howard, apparently by contradistinction to others with whom he has negotiated. It seems the lines of communication with Howard and Cooper at one level and Williams and Adler at another level. 25

[SBB.023.149_001] is a fax from Mr Howard to Messrs Adler and Cooper. Again, the negotiating teams seem relatively clearly identified. We needn't go to the draft agreement, because it varied. 30

[SBB.023.152_001] is a fax from Mr Adler to Mr Howard asking him to try and finalise all the outstanding issues today, that is 25 September: 35

"... as we have audit and legal obligations on Wednesday and Paul Brown is flying out for an audit committee meeting arriving on Tuesday." 40

Referring to a request for a final term sheet. Again, there seems to be significant audit obligations, at least driving the timing of the transactions, if not more. 45

[SBB.023.153_001] is a handwritten fax from Mr Howard to Messrs Adler and Cooper: 50

"... attaching the draft deal summary which has been approved in principle by Dr Williams ...(reads)... would be greatly appreciated."

Obviously the proposal is that Mr Adler should sign on behalf of HSI. If we go to the deal summary on the next page, your Honour will see provision for signature, further down, the two signatures provided for are Mr Williams and Mr Adler - both directors of HIH.

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[HSII.0002.467] is a fax from Mr Cooper to Mr Adler attaching a draft reply to the letter. Again, it seems clear that Messrs Adler and Cooper were liaising between themselves as to terms of negotiation.

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[ADLE.0003.028] is a fax from Mr Adler to Mr Howard confirming execution of the deal summary and concluding:

"We would appreciate knowing when the 17.5 million can be paid, if possible, we would like to conclude that this week."

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The imminency of the cash obligations was obviously a significant factor.

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The deal summary that was signed is [ADLE.0003.029]. Your Honour will see that this is a slight variation to the one we looked at earlier, but this one does have Mr Adler's signature. In due course, we will see one in these terms that's signed by both Adler and Williams. Where the terms have ultimately been resolved is the price will be 17.5 million, there's to be a shareholders agreement, the breakdown between loan and cash is 13 million is to go off against loan funds, but there's an obligation to provide a further 2.5 million by 30 June. So 4.5 million is to go into HSI as working capital and 13 million to be written off against the loan. Then there's to be comfort given by HIH on meeting the costs of the solicitors engaged in relation to class action. There are two other agreements. Items 4 and 6 relate to other particular agreements that we needn't go into in detail.

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The deal was 17.5 million, 4.5 million in cash, 13 million written off in loans, but another 2.5 million of loan funds to be provided prior to 30 June. So a total obligation of 20 million. In addition, there's the costs of the class action. That turned out to involve a liability of up to \$3 million. That wasn't an insignificant obligation either. The total obligation being assumed for 49 per cent of Ness was a face value of some \$23 million. That's in a context where, as your Honour has seen, of the earlier transaction in which HSI was enthusiastic to try and sell 50 per cent of Ness for 5.25 million US.

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There's one document I missed out that preceded the execution of the agreement. [ADLE.0021.249] was, it seems, a last gasp in the negotiation. Again, it's from

Mr Adler to Mr Howard. Your Honour will see the terms were agreed, but in fact it was Mr Adler who proposed the term that ultimately went into the final agreement. Breaking down the cash, it's 13 million for loan funds, 4.5 million in cash, but a further 2.5 by 30 June. 5

[HSII.0006.323] is simply a version of a deal summary, signed this time by Mr Williams. That's the same deal summary also signed by Mr Adler. So consensus has been reached by execution of the counterparts by each of Mr Williams and Mr Adler. There is a document which has both signatures. I needn't take your Honour to it. It's [SBA.024.897_001]. It's in the same terms as the counterparts. 10

[SBB.018.220_001] is back to the issue of BTS. This is a guarantee from HIH to Westpac dated 27 September 2000. Your Honour will see that the amount guaranteed has gone down to 250,000, but it is the obligation of HIH to guarantee BTS's debts, even though its very much minority interest in that company is continuing. 15 20

[ADLE.0021.285] is a fax from Mr Adler to Mr Cooper of 28

September: 25

"Tomorrow at the board meeting you should propose my appointment and you should identify and define your new title."

That's obviously an appointment to Mr Adler as CEO. This became a bone of contention between Mr Adler and Mr Cooper as we will see. 30

[ADLE.0021.286] is the fax from Mr Adler to Mr Williams of 28 September, the day after the execution of the counterparts, asking for the 4.5 million net tomorrow. So by 29 September, he wants the cash component. Bill Howard has told him that cash is a bit tight. That seems to have been something of an understatement: 35

"... due to many payments being made, but we can't make any announcement to staff until the transaction is facilitated." 40

[ADLE.0021.287] is from Mr Howard to Mr Adler: 45

"I am organising the cash issues - but cash is a difficult issue at the moment ...(reads)... going concern changes."

Again, obviously the audit issue is regarded as a significant one. Nevertheless, Mr Howard was able to organise it. 50

[HSII.0002.472] is a receipt for \$4.5 million from HSI dated 28 September. So the money did go across as requested. 55

[HSII.0002.498] is the share transfer form. The transfer

was from a company called Frenhill, which was a nominee company that had been holding the shares. In the result, there was a considerable delay in obtaining registration of the transfer. In fact, it wasn't obtained until, I think, February of 2001. Of course, the money had changed hands without there being insistence upon proof of registerability of the transfer. 5

[HSII.0006.312] is a copy of the cheque of 28 September for 4.5 million that went from HIH to HSI. 10

[SBA.337.005_001] is the minutes of a special meeting of the board of HSI of 28 September. Your Honour can see the persons present include Rabinovici, Cooper, Adler, et cetera - many by telephone, of course. Down the page, the ratification of advances from HIH, 0.5 million and 1.5 million on 3 and 17 August 2000. Then in the last paragraph, there's reference to the sale of Ness Security Products for 17.5 million, agreement to repay 13 million to HIH and HIH agreeing to provide additional funds of 2.5 million by 30 June 2001. 15 20

On the next page, it's then said that Mr MacDonnell discussed that Mr Adler would become CEO of the company as a condition of the Ness sale. Then: 25

"So as to comply with the company's conflict policy, the board ...(reads)... effectively doubled that offer."

Your Honour can see why the minutes of HSI would record why that was a good thing because it provides a justification from its perspective of undertaking the transaction in an apparent circumstance of conflict because it's getting double arms-length. What about from HIH's perspective? It's paying double arms-length. Mr Adler had exactly the same conflict on the board of HIH as he did on the board of HSI. Where, one would ask rhetorically, is the minute of the board of HIH giving consideration to this question and recording considerations that enabled it to proceed notwithstanding the apparent conflict of interest. That rhetorical question, it seems, can be asked, but there is no answer to it. There is no consideration by the board of HIH of this transaction recorded in the minutes that have been disclosed. 30 35 40 45

It's then said in the third paragraph that Mr Adler abstained from the vote. That seems to be some recognition of his inability to participate. That recognition, of course, overlooks the fact that he was a significant architect of the transaction, so distinguishing between his role as a director voting on the transaction and his role as architect seems somewhat illusory. Then there's ratification of Mr Brown's advance. 50 55

[SBA.072.902_001] is simply the Westpac Bank statement providing confirmation of the receipt of the \$4.5

million.

The one document in which one might have expected to find some reference to this transaction was the report to the investment committee for the period ended 30 September 2000. That document is [BRD.064.109]. I needn't take

your Honour to it, but your Honour would search it in vain for any reference at all to this transaction in the investment committee. It was certainly not referred to in any of the minutes of the board of HIH at around this time. It seems that the standards of corporate governance within HSI were somewhat higher than those which appear to have prevailed within HIH.

[ADLE.0021.275]. Your Honour can see in this document - I won't go through it in detail - it's clear that relations between Mr Adler and Mr Cooper were becoming strained. In the penultimate paragraph, there's reference to three prior requests and a written request earlier today to Mr Cooper to announce Mr Adler's managing directorship. In the final paragraph, there's a reference to the need to resolve Mr Cooper's obligation to the distributors association.

[ADLE.0021.277] is a fax from Mr Adler to Mr Stephens referring to the restructure of HSI so that the risk of liquidation is now behind us. Incidentally, he says, it was that close. That's a reference to the imminence of insolvency. There's then a breakdown of the transaction. The third paragraph:

"Although the crisis is over, the reality is that we are still only selling 500 systems ...(reads)... to rectify that situation."

That in itself is an interesting observation because what it suggests is that Mr Adler has solicited and procured a significant financial commitment from HIH at a time when he appears to have been aware that sales were less than 50 per cent of what was required to reach breakeven point and there was no existing plan to rectify that situation. It's then said:

"As part of the arrangement with HIH they have asked me to become managing director ..."

Which puts something of a spin on the circumstance in which his rise to that position came about:

"Although the situation is not as yet profitable, we are certainly moving down a path that allows me to be quietly confident ..."

[ADLE.0021.279] is a fax from Mr Adler to Mr Whittaker, who was the financial controller at HSI, referring to the financial ramifications of the deal:

"It was a bleak period with little hope and now that we

have done a great deal with HIH, I am quietly confident about the future."

Whether that suggests that it was a great deal from HSI's perspective or from HIH's perspective remains to be seen. He again repeats that he's asking for a viable plan to turn the company around to be presented to him. 5

[ADLE.0021.280] is a fax from Mr Adler to Mr Circosta, who was the chief executive of Ness, referring again to the transaction, in terms whereby he describes HSI as last week having been dying a slow death, this week having little debt and 5 million cash on deposit. He doesn't believe it will have any real operational effect on the management a Ness, and referring to his forthcoming appointment as managing director. 10 15

[ADLE.0021.281] is another fax from Mr Adler to Mr Cooper, advising him of the letters that he has sent out, referring to the restructuring. The last two paragraphs, the same two issues are dealt with. There's the distributors fund issue that needed to be sorted out and also Mr Adler's need to be appointed managing director of HSI. That's a familiar refrain. 20

[ADLE.0021.282] is a fax from Mr Adler to Mr Cooper saying: 25

"When can I have the plan to shift sales from 500 to 2,000 per month?" 30

Again, I remind your Honour that he's procured HIH's solicitation, obviously without such a plan being in place. 35

(5.00 pm)

[ADLE.0016.036] is a letter from Mr Adler to Mr Williams where he pays detailed attention. He says he has two problems that are unrelated, but both are important that he would like to discuss with him. Firstly, he finds himself in a very awkward position because he's been approached by institutions giving him a proxy or discretion to overthrow Mr Williams and take over the role of chairman and chief executive. 40 45

He then says in the second paragraph that the market is looking for blood:

"There is little doubt it will be either yourself, the chairman or a combination of both." 50

From his own perspective, as a director of the company, every time he sells shares, it is another "thorn" in HIH's "armour". Then in the third paragraph: 55

"Likewise, I do not want to have any part in being in opposition ...(reads)... the company's best interests ..."

That's an intriguing sentence. It refers to a handshake in relation to the takeover and then connotes the sentiment that he believed moving against Mr Williams would have been in his and/or the company's best interests but he desisted, in part because of the HSI matter. He goes on: 5

"... however, probably one of my greater failings is that I cannot do something ...(reads)... myself in a quandary." 10

There is at least an inference arising from that that requires to be pursued as to whether Mr Adler believed that Mr Williams had supported his personal interests in relation to the takeover and HSI, as a result of which Mr Adler had provided loyalty to Mr Williams, notwithstanding the formation of a view that removal of Mr Williams would be in the best interests of HIH. Then he goes on in the second paragraph to say: 15

"Now that the investment company has been completely imploded ...(reads)... grow our mutual investment." 20

There's an interesting combination of sentiments in this letter. In the first portion of the letter, he deals with moves to unseat Mr Williams. In the second, he's attempting to solicit Mr Williams's commitment to contribute \$2 million to a company in which he has a significant personal interest. One of the questions that will have to be pursued is whether or not there was any inferred nexus between the two subjects. 25

Just to complete this aspect, if we go to a couple more documents. [ADLE.0005.002] is a letter from Foster Stockbroking to Mr Williams dated 5 October. Your Honour will see that it bears Mr Williams's signature, committing HIH to subscribe for 2.5 million shares at a price of 80 cents each in BTS. The letter is dated 5 October. We don't know when Mr Williams signed it, but it refers to funds being received by 11 October. So it was obviously very shortly after the request. In response to Mr Adler's request for \$2 million, Mr Williams seems to have signed off on it very promptly. 30

Again, the extent of the investigations undertaken by Mr Williams to satisfy himself in respect of the viability of this investment is not known. This was the one transaction that did make its way to the consideration of the board. I told your Honour this morning there was only one of these various matters we looked at ever minuted in a board meeting and this was it, but it wasn't until 29 November - almost two months after the funds had been committed. 45

Finally for this evening, could we go to the letter, which is [ADLE.0021.250]. This is a fax from Mr Adler to the board of HSI of 5 October commencing: 55

"As you know, for the agnostics among us, there is a God because the transaction that we did last week with HIH proves that point."

One possible inference from that paragraph is that it suggests that the transaction was very much to the benefit of HSI. If that's so, it's a bit hard to see how that can be reconciled with Mr Adler's obligation to HIH. He then refers to a number of matters that need to be cleaned up, including the distributors fund issue and the options package for the executive. What he's asking for is the authority of the board to resolve the distributors fund issue with Mr Cooper.

I notice the time. Before your Honour rises, it would be convenient for a number of reasons for me to now tender the documents in a number of indices that are on the parties' courtbook. If I could just read out the indices - they're all subsets of the HSI/Cooper index - there's the agreements index, the audit documents index, board meetings index, chronological documents index, an index headed "financials", an index headed "Williams property" and an index headed "BMW/Trivett motor vehicles". I tender those documents.

In addition, there are five documents which I have referred to today that fall outside those indices. They are: [HSII.0004.177], [SBA.214.148_002], [HSII.0002.040], [HSII.0002.057] and [ADLE.0016.091]. I will produce a note of those five documents. All the others are listed in the indices on courtbook.

THE COMMISSIONER: I note the tender of various documents that are in indices which are themselves subsets of the HSI/Cooper index. They are the agreements index, documents index, board meetings index, chronological documents index, financials index, Williams property index, BMW/Trivett index and the tender also of five individual documents that Mr Martin has just enumerated.

EXHIBIT #HSII.0004.177

EXHIBIT #SBA.214.148_002

EXHIBIT #HSII.0002.040

EXHIBIT #HSII.0002.057

EXHIBIT #ADLE.0016.091

THE COMMISSIONER: We will resume at 9.30 tomorrow.

FURTHER HEARING ADJOURNED UNTIL TUESDAY, 16 JULY 2002