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Response to Consultation Paper on reforms to the Fair Entitlements Guarantee scheme

June 2017

Australian
Chamber of Commerce
and Industry

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Australian Chamber of Commerce and Industry

1 Introduction

1. The Australian Chamber welcomes the opportunity to make this submission in response to the Government consultation paper on reforms to address corporate misuse of the Fair Entitlements Guarantee Scheme (Consultation Paper).

2. The Australian Chamber's position in relation to the Fair Entitlements Guarantee scheme (FEG Scheme) is that:

    a. it should be a safety net and scheme of last resort;

    b. any remedy relating to the non-payment of employee entitlements on insolvency should balance the interests of employees, employers, creditors, taxpayers and the economy as a whole; and

    c. the most effective measure to ensure the payment of employee entitlements is a solvent and profitable business community operating within a strong economy. Government cannot eliminate each and every risk.

3. The Consultation Paper raises concerns about the increasing costs of the FEG Scheme which it attributes to "sharp corporate practices".[1] The Consultation Paper broadly defines these "sharp corporate practices" as the "range of methods and approaches adopted by certain company representatives, company owners or other parties involved in corporate restructures and insolvencies, which seek to prevent, avoid or reduce the payment of obligations to creditors".[2] Of note, the Consultation Paper is less concerned with reforms to the *Fair Entitlements Guarantee Act 2012* (Cth)(FEG Act) itself and is instead focused more heavily on reforms to the *Corporations Act 2001* (Cth)(Corporations Act).

4. The Australian Chamber is also concerned about the increasing costs associated with the FEG scheme, noting the observation in the Consultation Paper that costs under the scheme have increased by 75% over the last four years. However with the number of business insolvencies remaining stable in recent times, there is evidence to suggest that there may be other factors at play that are driving up the costs of the scheme. In particular, the Consultation Paper identifies that higher redundancy payments are negotiated during bargaining with the knowledge that the FEG scheme will cover this in the event of employer insolvency.[3] The fact that the cost of payments per person has escalated well beyond the level of private sector wage growth and inflation across the nine year period examined in the Consultation Paper and that a clear financial impact can be seen after the widening the redundancy pay formula suggests that higher negotiated severance payments may indeed be a significant factor contributing to the increase in costs. The Australian Chamber had previously cautioned about the moral hazard

[1] Consultation Paper, p. 1.
[2] Consultation Paper, p. 1, see footnote 2.
[3] Consultation Paper, p. 2.

associated with the scheme paying for negotiated redundancy, rather than redundancy in line with the National Employment Standards.[4]

5. Given the current fiscal context and to address distortions in bargaining it is the Australian Chamber's position that taxpayer funded assistance to guarantee redundancy payments should not exceed the maximum redundancy entitlements prescribed in the National Employment Standards.

Table 1: Cost of GEERS and FEG Scheme Payments

Financial year	Cases paid	Persons paid	Costs ($ millions)	Average cost per person ($)
2007-08	983	7808	60.8	7786.88
2008-09	1346	11027	99.8	9050.51
2009-10	1869	15565	154.1	9900.41
2010-11	1623	15413	151.3	9816.39
2011-12	1737	13929	195.5	14035.47
2012-13	1755	16019	261.7	16336.85
2013-14	1113	11255	197.2	17521.10
2014-15	2060	19074	312.5	16383.56
2015-16	1746	14341	284.1	19810.33

Source: Consultation Paper, p. 3 – Data from Department of Employment

6. A strong, well-functioning economy and policy settings that encourage and support business success and recovery will also help to reduce business failures that result in outstanding obligations to creditors, including employees. The Australian Chamber has previously made a Submission to the Productivity Commission's Inquiry into Business Set-up, Transfer and Closure.[5] The Australian Chamber's recommendations in Part 4 of that submission, which address the issue of insolvency, are of note. The Australian Chamber submitted that:

    a. the current insolvency regime focusses more on the rights and responsibilities of various stakeholders in a business and less on the need to restructure the business with a view to maintaining financially sustainable operations and long term shareholder value;

    b. some elements of the United States Bankruptcy Code's Chapter 11 insolvency framework could be introduced in Australia to allow the directors and management of a business facing financial difficulties, to control operations while a restructuring plan is worked out, with close oversight by the entity's creditors;

    c. the current framework's emphasis on the rights of creditors may not always work to their advantage in that they may not always benefit from company administration and liquidation;

[4] See for example Australian Chamber of Commerce and Industry submission to the inquiry into the *Fair Entitlements Guarantee Amendment Bill 2014* (Cth), September 2014.
[5] Australian Chamber, Submission to Productivity Commission Inquiry – Business Set-up, Transfer and Closure , February 2015.

d. the introduction of 'safe harbour' provisions into the insolvency regime would allow firms facing temporary financial difficulties to restructure their operations without the directors facing any insolvent trading; and

e. there could be a moratorium on the application of 'ipso facto' clauses in commercial contracts when a business entity seeks to restructure its operations.

7. In approaching this inquiry it is important to remember that corporations come in all shapes and sizes, including small and medium enterprises, family businesses and corporations in the non-for-profit sector as well as publicly listed companies. The owners and directors of these corporations come from diverse circumstances and will have varying levels of experience, skill educational attainment, language proficiency and financial position. Each corporation will face its own unique operational challenges.

8. The corporations law framework needs to balance the need to protect creditors, including employees, and the need to encourage innovation and risk taking by the diverse range of individuals operating businesses in Australia. The Australian Chamber submits that this balance will be better achieved through implementation of reforms of the nature identified in the Australian Chamber's Submission to the Productivity Commission's Inquiry into Business Set-up, Transfer and Closure (referred to above). Some of these recommended reforms are reflected in the *Treasury Laws Amendment (2017 Enterprise Incentives No. 2) Bill 2017* which will amend the Corporations Act to create 'safe harbours' protecting company directors from personal liability for insolvent trading if they are pursuing a restructure outside formal insolvency and render 'ipso facto' clauses unenforceable during and after certain formal insolvency procedures.

9. The policy direction of the *Treasury Laws Amendment (2017 Enterprise Incentives No. 2) Bill 2017* is welcome. As the Minister for Small Business acknowledging the following in the bill's second reading speech:

a. "the current insolvent trading laws put too much focus on stigmatising and penalising failure";

b. "[t]he threat of Australia's insolvent trading laws, combined with uncertainty over the precise moment a company becomes insolvent have long been criticised as driving directors to seek voluntary administration even in circumstances where the company may be viable in the longer term";

c. "[c]oncerns over inadvertent breaches of insolvent trading laws are frequently cited as a reason that early stage—angel—investors and professional directors are reluctant to become involved in a start-up";

d. "[b]roadly, the safe harbour and ipso facto measures encourage Australians to take a risk, leave behind the fear of failure and be more innovative and ambitious. **More often than not, entrepreneurs will fail several times before they experience**

success and will generally learn valuable lessons during the process. Helping these entrepreneurs to succeed requires a cultural shift" (emphasis added); and

e. the amendments "will promote the preservation of enterprise value for companies, their employees and creditors, reduce the stigma of failure associated with insolvency and encourage a culture of entrepreneurship and innovation".[6]

10. A number of the options traversed in the Consultation Paper are of concern to the Australian Chamber, particularly where they explore broadening the scope of liability for corporations and their directors, expanding on the grounds upon which directors can be disqualified, further piercing of the corporate veil and extending liability to for the actions of a company to others within a group and increasing liability and penalties for conduct in circumstances of business failure that results in access to the Fair Entitlements Guarantee scheme (FEG Scheme).

11. To be clear, the Australian Chamber opposes conduct involving an intention to prevent recovery of employee entitlements. However it is concerning that a number of the options for further regulatory reform go beyond intentional wrongdoing and even beyond addressing the "sharp corporate practices" identified as concerns within the Consultation Paper. Where this occurs there is a risk of regulation running contrary to the cultural shift necessary to encourage entrepreneurship and innovation and reduce the stigma associated with failure.

12. It should not be assumed that insolvency is ordinarily the result of deliberate malpractice by companies and the persons operating them. The Consultation Paper acknowledges that the majority of businesses do exercise appropriate behaviours in providing for their employees' entitlements.[7]

13. However the Consultation Paper suggests that without further law reform "the Australian Government will not be able to appropriately address certain behaviours which are exerting financial pressure on the FEG scheme and unfairly burdening taxpayers".[8]

14. The Australian Chamber urges caution in assuming that compliance problems always demand, or will be solved by higher penalties and the blunt force of further regulation. The concerns identified in the Consultation Paper relate largely to the behaviour of people and our experience of other areas of law and regulation is that wider efforts are required, and will secure improved, wider ranging and more sustained changes in behaviours.

15. The Australian Chamber also submits that capping redundancy payments to the level of the NES together with administrative measures aimed at ensuring better enforcement of the existing law should be considered before further changes to the Corporations Act, particularly given the risks that some of the reforms canvassed could present to entrepreneurship, risk taking and innovation in the Australian business landscape.

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[6] Second reading speech for the *Insolvency Law Reform Bill 2015* (Cth), Commonwealth, *Parliamentary Debates*, Senate, 1 June 2017, 9, The Hon. Mr McCormack, Minister for Small Business.
[7] Consultation Paper, p. 7.
[8] Consultation Paper, p. 7.

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2 "Sharp corporate practices"

16. The most effective measure to ensure the payment of employee entitlements in full and on time is a solvent and profitable business. Businesses and business operators lose, not gain, by being insolvent and insolvency is a circumstance that business operators seek to avoid. However, in a competitive and free market insolvency is an unfortunate reality for some proportion of businesses. Generally, it is not the consequence of a willingness or intention to avoid legal obligations where there is non-payment of employee entitlements in full or on time in circumstances of insolvency. Insolvent employers overwhelmingly seek to meet those obligations, and to work with administrators/insolvency practitioners to that end.

17. However as noted above, the Consultation Paper is largely focused on changes to the Corporations Act to address what it terms "sharp corporate practices" which it defines as:

> *approaches and techniques adopted by certain company representatives, company owners, or other parties who provide advice to or who are otherwise involved in corporate restructures and insolvencies (such as insolvency advisors), that seek to prevent, avoid or reduce obligations of the company to pay its creditors (including employees for their employee entitlements)*.[9]

18. Part 3.2 of the Consultation Paper goes on to further articulate an understanding of this term through provision of examples explored below.

2.1 Insolvency practitioners

19. Part 3.2 of the Consultation Paper raises concerns about:

    a. *the adoption of deliberate practices by certain company directors, company officers, and some advisers in seeking to unfairly manage an insolvency to the detriment of creditors (for example, by a director appointing a 'friendly' liquidator to wind-up a company, with the liquidator then not investigating suspect transactions in the liquidation process); and*

    b. *conduct of company receivers and company liquidators appointed by security agreement holders who do not comply with their obligations under the law to pay employee entitlements out of the proceeds of circulating assets of the business (such as trade debtors), but instead pay those amounts to their appointers.*

20. The Consultation Paper suggests that it is "a small but still significant percentage of company receivers and liquidators [that] have not been complying with their legal obligations under sections 433 and 561 of the Corporations Act to pay amounts recovered from the proceeds of

[9] Consultation Paper, p. 4.

circulating security assets to employees (including FEG as a subrogated creditor), rather than their secured creditor".[10]

21. It should be noted that the *Insolvency Law Reform Act 2016* made amendments to the Corporations Act, *Australian Securities and Investments Commission Act 2001* (Cth) and *Bankruptcy Act 1966* with the intention of aligning and strengthening the registration, disciplining and regulator oversight of corporate insolvency practitioners.[11] Also of note, the amendments provide ASIC with new information-gathering powers that are intended to assist ASIC in its efforts to undertake an efficient proactive surveillance program of corporate insolvency practitioners. These powers include the ability to direct a practitioner to provide certain information and produce specified books to assist ASIC in its role as the corporate insolvency regulator.[12]

22. A number of these changes only took effect in March 2017 and further changes are scheduled to take effect in September. An exposure draft of a further bill was the subject of public consultation in May 2017 which, among other things, aims to "avoid potential disruption to the Fair Entitlements Guarantee (FEG) Recovery Program". The Australian Chamber submission to the Productivity Commission's Inquiry into Business Set-up, Transfer and Closure supported amendments as proposed in the then *Insolvency Law Reform Bill 2014*, to create transparency and accountability in the regulatory framework applying to insolvency practitioners and reinforcing the position of creditors and supports the ongoing advancement of these objectives.

2.2 Illegal phoenix activities and arrangements entered into for the purposes of avoiding liabilities owed to employees

23. The Consultation Paper expresses concern regarding the practice of:

> *utilising illegal phoenix company activities and arrangements, including transmissions of businesses and transfers of a company's assets for nominal or no value to another company with a similar name, with the same directors or officers, before placing the company in liquidation for the purpose of avoiding debts to company creditors including liabilities owed to employees.*[13]

24. The Australian Chamber supports targeted enforcement action against those who deliberately or knowingly liquidate a company to avoid payment of liabilities to creditors, including employees, and who recreate the business through another corporate entity controlled by the same person or persons who have engaged in illegal and/or fraudulent activity.

25. It should be noted that there is not always a direct correlation between unpaid employees seeking help from the FEG scheme and phoenix activity. The fact that employees have been paid (and therefore do not rely on a government scheme) does not mean that illegal phoenix

[10] Consultation Paper, p. 5.
[11] Second reading speech for the *Insolvency Law Reform Bill 2015* (Cth), Commonwealth, *Parliamentary Debate*s, Senate, 22 February 2016, 600, Senator the Hon. Mitch Fifield.
[12] Second reading speech for the *Insolvency Law Reform Bill 2015* (Cth), Commonwealth, *Parliamentary Debate*s, Senate, 22 February 2016, 607, Senator the Hon. Arthur Sinodinos.
[13] Consultation Paper, p. 6.

activity has not taken place. Conversely, while companies whose employees relied on the FEG Scheme may have few or no assets these circumstances will not in themselves be symptomatic of illegal phoenix activities. Legitimate liquidations or legal restructuring in the form of business rescues may see circumstances triggered that result in access to the FEG scheme. Furthermore, illegal phoenix activity is not just a matter for consideration in the context of the FEG scheme. These practices also unfairly disadvantage other creditors, including other businesses and the broader community.

26. There is a complex legal framework in place which regulates against unlawful conduct meeting the description in the Consultation Paper.[14] This framework is comprised of a range of criminal, corporations, taxation laws targeted towards fraud, directors duties, insolvent trading and unpaid liabilities. The Corporations Act framework imposes a direct and positive duty on directors to prevent their company from trading while insolvent. The consequences of insolvent trading include civil penalties, compensation proceedings, criminal charges and/or disqualification from managing a corporation. Obligations also exist with regard to the keeping of records to explain transactions and the company's financial position and performance. A failure of a director to take all reasonable steps to ensure a company fulfils these requirements contravenes this existing legislation. Directors' also have fiduciary duties which include the duties to act in good faith in the best interests of the company, to act for proper corporate purposes and to avoid conflicts of interest. It has been held that the duty of directors to act in good faith and in the best interests of the company includes consideration of the interests of creditors upon insolvency.

27. Liquidators and external administrators have obligations to investigate causes of failure and identify and report breaches of law to ASIC. These obligations are aimed at ensuring inappropriate director/corporate behaviour is identified and addressed by the party capable of taking disciplinary action. Liquidators also have powers to investigate and void certain transactions such as unfair preference payments. ASIC, in turn, has a range of existing powers to take action against reported breaches however the extent to which the effect of the legislation is being met and achieved will depend on the effectiveness of regulator enforcement.

28. Of particular relevance to unpaid employee entitlements, the *Corporations Law Amendment (Employee Entitlements) Act 2000* made significant changes to the Corporations Act. This included the introduction of a new offence to penalise persons who deliberately enter into agreements or transactions for the purpose of avoiding payment of employee entitlements or significantly reducing the amount that employees can recover. The Explanatory Memorandum identified the object of this new section 596AB as "to deter the misuse of company structures and of other schemes to avoid the payment of amounts to employees that they are entitled to prove for on liquidation of their employer".[15] The inclusion of new section 596AC had the effect of allowing a court to order persons in breach of the new offence provision to pay compensation to employees who have suffered loss or damage because of the agreements or transactions.

14

15 Explanatory Memorandum to the *Corporations Law Amendment (Employee Entitlements) Bill 2000*, para 18.

29. Adding uncommercial transactions to the list of actions in section 588G(1A) also had the effect of deeming that a company incurs a debt for the purposes of the insolvent trading provisions when it enters into an uncommercial transaction, extending the duty on directors not to engage in insolvent trading. As noted in the Explanatory Memorandum this change had implications for the protection of employee entitlements, the prosecution of directors involved in 'phoenix' activity and recovery actions by liquidators for the benefit of creditors generally.[16] The changes had general application to all uncommercial transactions including but not limited to those in relation to employee entitlements or transactions between related parties. Directors who breach this duty knowingly, intentionally or recklessly can be prosecuted and ordered to pay compensation for a breach which would be distributed amongst creditors on liquidation, including employees.

30. Also of note, s 550 of the *Fair Work Act 2009* (Cth) also introduced (from 2013) accessorial liability for persons involved in contraventions of that Act. This includes circumstances where a person has:

    a. aided, abetted, counselled or procured the contravention;

    b. induced the contravention, whether by threats, promises or otherwise;

    c. been in any way, by act or omission, directly or indirectly, knowingly concerned in or party to the contravention; or

    d. conspired with others to effect the contravention.

31. This is an increasing area of focus for the Fair Work Ombudsman. Anyone who is found to be involved in a contravention of the Act can be personally liable for compensating employees and paying penalties imposed by the court. While the provision can be used to hold company directors personally account for the actions of their companies it is much broader in scope and can capture persons and entities in the supply chain, human resources managers, lawyers, accountants etc. Also of note is the *Fair Work Amendment (Protecting Vulnerable Workers) Bill 2017* (Cth) which is currently before the Parliament and seeks to give effect to the Government's 2016 election policy to introduce new provisions that would impose liability on franchisors and holding companies that "should have reasonably been aware of the breaches and could have reasonably taken action to prevent them from occurring". This goes beyond actual knowledge and captures holding companies that may be unaware of the misdeeds of their subsidiaries but should reasonably have been.

32. Directors also have personal liability for unpaid PAYG deducted from employee wages and unpaid superannuation contributions. Also of note, the Explanatory Memorandum for the *Treasury Laws Amendment* (*2017 Enterprise Incentives No. 2) Bill 2017* explains that the proposed safe harbour provisions are intended as a protection for competent directors who are acting honestly and diligently and will only be open only to directors who have been ensuring

[16] Explanatory Memorandum to the *Corporations Law Amendment (Employee Entitlements) Bill 2000*, para 10.

that the company complies with its obligation to pay its employees (including their superannuation) and meet its tax reporting obligations.

33. While the Consultation Paper notes that the existing regulatory framework will assist in mitigating the impact of certain sharp corporate practice it suggests it won't adequately address all concerns of appropriately deter/sanction the behaviour of "those involved in arrangements which result in the intentional avoidance or reduction of the payment of employee entitlements, resulting in FEG being relied upon"[17] and puts forward reform options for consideration.

34. Balance in this area is critically important. Illegal phoenix activity and arrangements entered into with the intention of avoiding liabilities to creditors, including employees, create an uneven playing field for legitimate operators who are paying wages, taxes and debts as they fall due and can have the effect of causing significant financial hardship and the collapse of other businesses which are owed debts that remain unpaid. However it is critical that any changes do not inhibit responsible risk taking, innovation, entrepreneurship, legitimate business structuring and restructuring and rescue efforts. Indeed legal 'phoenix' activity in the form of business rescue are often pursued in the interests of employees retaining employment, and care needs to be taken to ensure our laws do not have the effect of discouraging business rescue.

[17] Consultation Paper, p. 6.

3 Part 5.8A of the Corporations Act

35. The Consultation Paper states that "provisions in Part 5.8A of the Corporations Act, which are intended to prevent business agreements and transactions directed at preventing the payment of, an avoiding of reducing the payment of employee entitlements, are not effective".[18]

36. Part 5.8A of the Corporations Act was given effect to by the *Corporations Law Amendment (Employee Entitlements) Act 2000* (Cth) following several high profile corporate insolvencies and of imposed personal liability for unpaid employee entitlements in certain circumstances. This extends beyond provisions in the Corporations Act that makes directors personally liable for certain debts if they are found to have allowed the company to trade on when it was insolvent.

37. The Australian Chamber supports the objects of existing Part 5.8A which are:

> *to protect the entitlements of a company's employees from agreements and transactions that are entered into with the* ***intention of defeating the recovery of those entitlements*** (emphasis added).[19]

38. However the Consultation Paper explores amendments that would capture conduct extending beyond conduct which is intentional. The Australian Chamber urges caution in this regard, particularly given that breaches of the part have the potential to result in personal liability and a custodial sentence. Such consequences should remain confined to conduct which is undertaken with the purpose of defeating recovery.

3.1 Option 1: Extend the fault element in section 596AB to include recklessness and increase the maximum penalty

39. Section 596AB(1) of the Corporations Act currently provides:

> *A person must not enter into a relevant agreement or a transaction with the intention of, or with the intentions that include the intention of:*
>
> *(a) preventing the recovery of the entitlements of employees of a company; or*
>
> *(b) significantly reducing the amount of the entitlements of employees of a company that can be recovered.*

40. Establishing a breach of this provision requires proof of a subjective intention on the part of the person to prevent or significantly reduce the recovery of employee entitlements. A breach of the provision can result in penalties and imprisonment of up to 10 years. Employees also have

[18] Consultation Paper, p. 5.
[19] *Corporations Act 2001* (Cth) s. 596AA.

a right of recovery for the loss or damage incurred as a result of the contravention of section 586AB.[20]

41. The Consultation Paper points to the absence of successful prosecutions in this area as raising questions around its effectiveness as a deterrent to those who intend to avoid obligations to employees. As such, Option 1 proposes broadening the range of conduct captured by the part through extending the fault element in section 596AB(1) "*from a person's actual, subjective intention to also include a person recklessly entering into an agreement or arrangement that prevented the recovery or avoided some or all of a company's employee entitlement liabilities*".[21] Option 1 also states that "[*c]onsideration should also be given to increasing the maximum penalties for breaches of section 596AB*" suggesting "*the current penalty of 1,000 penalty units or ten years imprisonment (subject to the five times multiplier for a corporation) could be replaced by a maximum penalty of 4,500 penalty units, or three times the loss suffered or benefit gains, or ten years imprisonment (subject to the five times multiplier for a corporation)*".[22]

42. Noting the "sharp corporate practices" identified as concerns in the Consultation Paper typically involve some level of active avoidance or intent to do wrong, the Australian Chamber is not convinced that the amendment proposed squarely addresses the concerns.

43. However noting that corporate insolvencies impact a range of stakeholders, including other business, employees, taxpayers and the general community, the Australian Chamber supports the general principle that reckless employers should not be able to abrogate their responsibilities at the expense of the more responsible, and at the expense of employees. It is also worth noting that the concept of recklessness is not foreign to the Corporations Act. For example, section 184 of the Corporations Act provides that a director or other officer of a corporation commits an offence if they are reckless or are intentionally dishonest and fail to exercise their powers and discharge their duties in good faith in the best interests of the corporation or for a proper purpose.

44. While extending the fault element in section 596AB(1) should not be considered the 'default solution' the Australian Chamber encourages further investigation of challenges and barriers faced by the regulator in the enforcement of the current provisions as an initial step prior to any further consideration of this issue. The Australian Chamber also urges caution in assuming that compliance problems always demand, or will be solved by higher penalties and the blunt force of further regulation. The threat of penalties, gaol terms and personal liability already exist, these measures have not and will never fully eradicate problems. .

45. Of note an ASIC Enforcement Review Taskforce is currently assessing the regulatory tools available to ASIC to perform its functions adequately and this process is ongoing. While evaluating the adequacy of ASIC's enforcement toolkit to deter misconduct and foster consumer confidence in the financial system, the terms of reference for the taskforce is comprehensive and extents to an examination of the adequacy of existing penalties for serious

[20] *Corporations Act 2001* (Cth), s. 596AC.
[21] Consultation Paper, p. 9.
[22] Consultation Paper, p. 10.

contraventions and the adequacy of ASIC's powers.[23] The Taskforce will report to the Government this year and subsequently will invite submissions from the public on proposed policy responses.

46. In the Australian Chamber's view, it would be premature to express a view regarding the proposed changes until this process is completed.

3.2 Option 2: Introduce a separate civil penalty provision with an objective test

47. Option 2 proposes the creation of a civil penalty provision which is separate from the criminal offence provision in section 596AB of the Corporations Act.[24] The justification for this recommendation again appears to be to move toward an objective test rather than linking a right to compensation to the establishment of a breach of section 596AB which currently requires establishment of 'intent' based on a subjective test.

48. Two options for a new civil penalty provision are canvassed in the Consultation Paper:

    a. a test based on what a reasonable person would have known or be expected to have known about the relevant agreement or transaction that occurred (Option 2A); and

    b. a test based on an objective assessment of the relevant agreement or transaction itself (Option 2B).

49. In business operating environments judgements and difficult decisions about a course of conduct often need to be made in high pressure circumstances based on the information available at that time, which is often incomplete. The Australian Chamber encourages ethical and responsible decision making but there is no 'perfect science' to ensuring that all of the decisions made by companies are the 'right' ones despite them being made in good faith. As noted by the Minister for Small Business in the *Treasury Laws Amendment (2017 Enterprise Incentives No. 2) Bill 2017* second reading speech, *"*[m]*ore often than not, entrepreneurs will fail several times before they experience success and will generally learn valuable lessons during the process*". It is much easier to evaluate decisions on the basis of hindsight and while a court will have the benefit of such hindsight, those assessing the risk associated with their businesses decisions in a real time environment will not.

50. The Australian Chamber has previously supported sensible amendments to the Corporations Act which have strengthened the obligations on directors of corporations to not enter into arrangements that seek to avoid their responsibilities to meet employee entitlements in full as and when they fall due. While the Australian Chamber opposes conduct involving an intention to prevent recovery of employee entitlements, which is currently outlawed by 596AB(1) of the Corporations Act, it does not support the creation of new civil penalty provisions based on an

[23] See Terms of Reference for the ASIC Enforcement Review at: http://www.treasury.gov.au/ConsultationsandReviews/Reviews/2016/ASIC-Enforcement-Review/Terms-of-Reference
[24] Consultation Paper, p. 10.

objective assessment or test of "*what a reasonable person would have known or be expected to have known*". In the Australian Chamber's view, such amendments are not directed toward the "sharp corporate practices" such as intentional avoidance of the payment of employee entitlements that the Consultation paper raises as a concern. These changes would also extend liability beyond recklessness.

51. The Australian Chamber considers that broadening the behaviour captured by Part 5.8A risks setting the bar too high and capturing persons making decisions made in good faith but which have unintended negative consequences that could only have been mitigated or avoided with the benefit of hindsight. Assessing "*what a reasonable person would have known or be expected to have known*" will involve an exercise of judgement and may also give rise to considerable uncertainty while the common law develops principles upon which the provision should be interpreted.

52. The Australian Chamber also cautions against the creation of additional penalties with regard to the same course of the conduct, particularly given existing rights of recovery under section 596AC of the Corporations Act. The Consultation Paper does note that a "*breach of the proposed civil penalty provision would give rise to a right to seek a compensation order and thus the existing compensation order under section 596AC would be superfluous and could be repealed*".[25]

3.3 Option 3: Expand on the parties who may initiate civil action

53. Actions for a suspected breach of section 596AB can be brought under 596AC by the company's liquidator or former employees with the liquidator's consent. Option 3 of the Consultation Paper proposes expanding the range of parties that can instigate recovery actions to include:

    a. the Department of Employment, when FEG has been paid;

    b. the Fair Work Ombudsman, for matters which were being investigated after which the employer was put into liquidation; and

    c. the Australian Taxation Office, where the reduced or avoided entitlements included superannuation guarantee amounts.

54. The Australian Chamber does not object to this proposal in principle however this option does appear to go beyond concerns relation to the FEG Scheme given that superannuation contributions are not recoverable under the FEG Scheme. Before exploring expansion of the range of parties that can instigate recovery actions it would also be prudent to monitor the effectiveness of the changes made by the *Insolvency Law Reform Act 2016* in enhancing the performance of liquidators in discharging their functions under the existing framework.

55. In taking control of and taking steps to wind up an insolvent company a liquidator will ordinarily:

[25] Consultation Paper, p. 10.

a. collect, protect and realise the company's assets;

b. investigate and report to creditors about the corporation's affairs, including voidable transactions and claims against the corporation's officers;

c. enquire into the failure of the corporation and possible offences by people involved in the corporation and report to ASIC;

d. distribute the proceeds of realisation of assets including processing claims by creditors—first to secured creditors, then priority creditors (including employees), followed by unsecured creditors; and

e. apply for deregistration of the company on completion of the liquidation.[26]

56. A liquidator has a primary duty to all of its creditors and it is also important, in establishing a proper perspective for this debate, to recognise that creditors owed monies do not just comprise employees. Creditors are also independent contractors, trade contractors, sole proprietors, and small and medium businesses – people who have supplied goods or services in good faith and who themselves rely on the payment of monies owed by them to meet their business and personal responsibilities. Their personal finances and capacity to meet personal and familial obligations are equally reliant on proper and prompt payment.

57. Notwithstanding this, employees' outstanding entitlements would ordinarily be paid in priority to the claims of other unsecured creditors after the liquidator has realised the assets of a company as employees are a special class of unsecured creditor. These entitlements will be grouped into classes and paid in the order set out in section 556 of the Corporations Act:

a. outstanding wages and superannuation; then

b. outstanding leave of absence (including annual leave and sick leave, where applicable, and long service leave); then

c. injury compensation; thenretrenchment pay.[27]

58. The Australian Chamber supports the continued distinction between secured and unsecured creditors and the existing order of priorities in the Corporations Act. The Australian Chamber also supports obligations on directors of corporations to not enter into arrangements with the intention of preventing the recovery of the entitlements of employees of a company or significantly reducing the amount of the entitlements of employees of a company that can be recovered.

59. The Australian Chamber also supports measures that provide a safety net level of protection for employees, whilst allowing recovery to be made on behalf of the taxpayer of available

[26] Commonwealth of Australia, Report of the Senate Economics References Committee into "The regulation, registration and remuneration of insolvency practitioners in Australia: the case for a new framework", September 2010, p. 19.
[27] *Corporations Act 2001* (Cth), s 556.

monies once assets are distributed. Government is right to look to ways to enhance recovery efforts against the backdrop of a scheme with escalating costs.

60. However in administering its functions the liquidator will have access to the range of creditors impacted by insolvency in the specific and often highly complex circumstances. In contrast, Government agencies and departments focussed on their discrete areas of interest may not have such overall visibility. In investigating and reporting to creditors about the corporation's affairs a liquidator will also have greater visibility over the full range conduct and circumstances leading to the outstanding obligations to creditors and to consider how it will access the range of levers available to it. These levers include reversal of uncommercial transactions undertaken prior to the insolvency or seeking a court order requiring persons such as directors of the relevant company to pay compensation for loss or damage suffered by employees as a result of transactions or agreements intended to prevent recovery of employee entitlements. The Australian Chamber has previously supported these measures.

61. If there is to be an expansion of the range of persons who can instigate recovery actions to include the Department of Employment, Fair Work Ombudsman and Australian Taxation Office there is some risk that the potential for multiple recovery actions to run concurrently which may give rise to confusion. As such, should this option be implemented, administrative guidance should be developed to better clarify the circumstances in which such actions would be brought, and the processes to be adopted in doing so (including any cross agency/department communication). While Option 3 proposes that an action could only be brought if the liquidator did not intend to bring that action, an express requirement for liquidator approval to bring an action (as is required with employee actions) is worthy of consideration.

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4 Preventing abuse of corporate group structures to avoid paying employee entitlements

4.1 Option 5: Corporate groups to provide a contribution equivalent to any unpaid employee entitlements in some limited circumstances

62. Part 3.2 of the Consultation Paper raises concerns about:

> *utilising a company structure and/or utilising corporate group structures in ways that the employees are employed by an entity which does not appropriately provide for their employee entitlements and where insufficient realisable assets are available to offset liabilities owed to the employees if they are made redundant, or the assets of the entity which employs the workers are transferred to related entities prior to the employees being made redundant.*

63. It also suggests that the current framework is not serving as an effective deterrent for:

> *those who use a corporate group structure to avoid or reduce their exposure to meet employee entitlement obligations where as a consequence the FEG scheme is relied upon.*[28]

64. The Consultation Paper does acknowledge that:

> *…it is a legitimate business practice for company groups to be structured so that employees and associated liabilities are held by one company while the assets of the group are held by other group companies. This is a globally accepted businesses practice utilised as an effective strategy to quarantine risk.*[29]

65. Despite this acknowledgement the Consultation Paper raises concern with circumstances where a "group may be solvent and able to able to pay employee entitlements, but chooses not to pay after not paying the value for the economic benefits of the employees' work received".[30] This appears to relate to concerns that about corporate groups utilising employing entities that are subsequently liquidated resulting in FEG being called upon. The Consultation Paper suggests this "is currently a small issue in terms of the number of cases for the FEG scheme" but considers the contribution of these cases to the FEG Scheme to be disproportionate.[31]

66. In response to these concerns it puts forward the option of reforming the law "so that certain corporate groups would be required to pay a contribution equivalent to the unpaid employee entitlements of an insolvent group member where FEG has been paid to the redundant group employees".[32] This reform would see entities in a group structure have a shared obligation to

[28] Consultation Paper, p. 6.
[29] Consultation Paper, p. 14.
[30] Consultation Paper, p. 15.
[31] Consultation Paper, p. 15.
[32] Consultation Paper, p. 15.

meet unpaid employee entitlements of an insolvent group member where FEG has been paid to the redundant group employees.

67. Given that the number of cases involving conduct in these circumstances is small, a more thorough investigation of the circumstances of these cases should be undertaken to assess whether any illegality has occurred, before exploring regulation that poses wider risks in seeking to address the conduct of only a few. It is also worth noting that attributing liability to parties for the conduct of others is not a step that should be taken lightly and may have negative unintended consequences so any such step would need to be approached with great caution. It is not a step favoured by the Australian Chamber before other policy solutions are explored as alternatives.

68. The Consultation Paper identifies the following as potential criteria for a court to consider if a contribution order for employee entitlements was to be introduced into the law in Australia:

- *the control and management relationship between entities in the group, and whether the insolvent entity had common directors and officers with the related group entities*.[33] It is worth reinforcing that companies in a group structure may (for legitimate and sound commercial, competition and governance reasons) have limited awareness or oversight of the activities of other companies in their group.*;*
- *the extent to which entities of the group obtained economic benefits from the labour of the insolvent entity (including whether the insolvent entity had charged a full market rate to the other entities in the group for the use of the employees' services);*
- *whether assets had been transferred from the now insolvent entity to other entities;*
- *the efforts directors and officers of the insolvent company had made to ensure the payment of the outstanding employee entitlements; and*
- *any other matters the court thinks fit in each case.*[34]

69. The Consultation Paper also suggests that as an alternative to employee entitlement specific contribution orders, the current pooling of assets provisions in Division 8 of the Corporations Act could be modified to achieve a similar result.[35]

70. The Australian Chamber is concerned that this would risk adversely impacting and/or discouraging legitimate commercial behaviour, including the adoption of corporate structures in good faith to manage risk and facilitate business recovery. The Australian Chamber does not support use of corporate structures with the intent of avoiding payment of employee entitlements. However caution needs to be taken to ensure any 'reforms' do not run contrary to legitimate risk management practices and recent policies that seek to encourage turnaround of struggling businesses, such as through restructuring during protected safe harbour periods.

[33] Consultation Paper, p. 16.
[34] Consultation Paper, pp. 16-17.
[35] Consultation Paper, p. 17.

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5 Sanctioning directors and officers with a track record of involvement in insolvencies where FEG is relied upon

5.1 Option 6: Specific FEG sanctions for directors in Part 2D.6

71. Option 6 proposes to amend the Corporations Act to allow disqualification of directors who engage in behaviour which repeatedly results in improper reliance on the FEG scheme.[36] In particular the Consultation Paper suggests the current framework is not serving as an effective deterrent for "*company officers and directors who have a history of involvement in insolvencies, where FEG is repeatedly relied upon to pay part or all of the outstanding employee entitlements*".[37]

72. As it stands, the Corporations Act currently provides for director disqualification in the circumstances outlined in Part 2D.6. This includes:

    a. Automatic disqualification where the person is convicted of:

        i. an indictable offence concerning a substantial part of the business of a corporation or significantly affecting a corporation's financial position; or

        ii. an offence involving dishonesty that is punishable by at least three months imprisonment; or

        iii. an office against a law of a foreign country punishable by at least 12 months imprisonment; or

        iv. an offence under the Corporations Act punishable by at least 12 months imprisonment.

    b. Automatic disqualification where the person is an undischarged bankrupt, has executed a personal insolvency agreement which has not been fully complied with or is disqualified under an order made by a court of foreign jurisdiction from being a director or concerned in the management of a foreign company;[38]

    c. On application by ASIC, court ordered disqualification for up to 20 years where:

        i. a civil penalty provision has been contravened;[39]

        ii. within the 7 years, the person has been an officer of 2 or more corporations when they have failed;[40]

[36] Consultation Paper, p. 19.
[37] Consultation Paper, p. 6.
[38] *Corporations Act 2001* (Cth), s. 206B.
[39] *Corporations Act 2001* (Cth), s. 206C.
[40] *Corporations Act 2001* (Cth), s. 206D.

d. On application by ASIC, court ordered disqualification for a period the court considers appropriate where there have been repeated contraventions of the Corporations Act;[41]

e. On application by ASIC, court ordered disqualification for a period the court considers appropriate where the person is disqualified under a law of a foreign jurisdiction;[42]or

f. Disqualification if there is a court order disqualifying the person from managing corporations in force under the *Competition and Consumer Act 2010*[43]or ASIC Act.[44]

73. Section 206D of the Corporations Act enables ASIC to apply to the Court for a disqualification order which it may make if it is satisfied that:

a. the manner in which the corporation was managed was wholly or partly responsible for the corporation failing; and

b. the disqualification is justified.[45]

74. Section 206F of the Corporations Act also gives ASIC the power to disqualify a person from managing a corporation for up to five years if the person has been an officer of two or more corporations that have gone into liquidation within the previous seven years and the Liquidator of these corporations has lodged a report pursuant to Section 533 of the Corporations Act.

75. The Consultation Paper notes that the existing disqualification provisions are not tailored to specifically mitigate behaviour which impact the FEG scheme. However closer examination of the concerns expressed in the Consultation Paper suggest this is not the case. For example, the Consultation Paper states that an examination of FEG and GEERS cases "*revealed that there are more than 1300 company directors who were directors of two or more companies which had redundant employees paid outstanding employee entitlements under FEG or GEERS" and that the majority of these directors "serially managed companies which failed*".[46]

76. In these circumstances it would be open to the regulator to investigate the conduct to consider whether it gave rise for disqualification under of the Corporations Act which deals with circumstances in which a person has been an officer of two or more corporations within a seven year period which have failed. In these circumstances the Australian Chamber does not consider a change to the legislation necessary.

77. A closer examination of the cases identified on page 5 of the Consultation Paper should also be undertaken to determine whether the issue for consideration is actually one of enforcement,

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[41] *Corporations Act 2001* (Cth), s. 206E.
[42] *Corporations Act 2001* (Cth), s. 206EAA.
[43] *Corporations Act 2001* (Cth), s. 206EA.
[44] *Corporations Act 2001* (Cth), s. 206EB.
[45] *Corporations Act 2001* (Cth), s. 206D(b).
[46] Consultation Paper, p. 17.

particularly given reference to "*avoidance of payment of employee entitlements", "illegal phoenix activity*", non-compliance with "*legal obligations under sections 433 and 561 of the Corporations Act 2001"* all of which contravene the current law. It risks being unsafe and unsound to pursue more law and more regulation where there is a an enforcement gap.

78. As noted in the Australian Government Guide to Regulation, regulation should not be the default option for policy makers and should only be imposed when it can be shown to offer an overall net benefit. Administrative guidance for the regulator and sharing of information across agencies should be explored to assist the regulator in discharging its existing functions prior to any changes being made to the Corporations Act.[47]

79. Of note, the Consultation Paper states:

> *To assist in mitigating the impacts of sharp corporate practices on the FEG scheme, a range of administrative actions and legal approaches have been adopted by government departments and agencies. These approaches included funding recovery actions under the FEG Recovery Program, government departments/agencies cooperating on cases of common interest, and relevant matters being pursued through the Australian Government's Phoenix Taskforce and Serious Financial Crimes Taskforce to combat illegal phoenix activity.*[48]

80. The Australian Chamber submits that the merits further regulation would be better assessed following an evaluation of the effectiveness of these existing administrative actions and approaches as well as the review of the resources and tools available to ASIC with a view to enhancing its effectiveness as the dedicated insolvency regulator.

81. For example, the sharing of information may assist the regulator to be aware of factors such as those identified in Option 6 in deciding to investigate the conduct of a director of two or more companies that have failed and in assessing whether to bring an action pursuant to Section 206D of the Corporations Act.

82. Other administrative solutions should also be explored as alternatives to seeking to add to law and regulation. These should include the introduction of director identification numbers which may help provide an additional level of transparency to help the regulator combat patterns of behaviour that are non-compliant with obligations under the Corporations Act. From the perspective of business, such measures may also assist companies in managing the risk of unscrupulous operators in their business to business dealings and in identifying potential conflicts. However in exploring these options care needs to be taken to balance privacy considerations and to ensure that the cost of administration and burden of regulation does not outweigh the benefits. The way in which director information is presented and accessed also needs careful consideration. The fact of a person being a director of a company that has failed should not in itself give rise to an inference of impropriety.

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[47] Australian Government Guide to Regulation: https://www.cuttingredtape.gov.au/handbook/australian-government-guide-regulation

[48] Consultation Paper, p. 6.

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6 Other reform options

83. The Australian Chamber acknowledges the problem of unpaid employee entitlements on insolvency and appreciates the Government's concern regarding its level of exposure under the FEG Scheme. However some options traversed in the paper address issues that impact well beyond concerns relating to the FEG Scheme including the treatment of trust assets and creditor priorities and these issues require consideration and consultation through a process that is broader in focus.

84. Where there are insufficient monies or assets available in an insolvent business to meet debts owed to creditors, including monies owed to employees, there will be injustice if not hardship to those creditors. Many of those creditors will themselves be businesses, often small trade creditors who stand to lose out alongside employees. The distribution of monies from available assets in circumstances where funds are not available to meet all outstanding obligations to creditors is inherently going to mean that some creditors miss out in whole or in part. There can be no completely adequate way in which public policy or legal frameworks can rectify this inherently unsatisfactory situation. However:

    a. any proposals for legislative change should be designed to minimise the negative impacts insolvency on the full range of stakeholders; and

    b. any remedy relating to the non-payment of employee entitlements on insolvency should balance the interests of employees, employers, creditors, taxpayers and the economy as a whole.

85. The Corporations Act provides certain priorities for the payment of creditors in the event of insolvency. The Australian Chamber supports the continued distinction between secured and unsecured creditors and the existing order of priorities in the Corporations Act. Should amendments to the Corporations Act be pursued to clarify priorities, it will be important that these are carefully constructed to avoid unintended consequences.

Australian
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7 About the Australian Chamber

The Australian Chamber of Commerce and Industry is the largest and most representative business advocacy network in Australia. We speak on behalf of Australian business at home and abroad.

Our membership comprises all state and territory chambers of commerce and dozens of national industry associations. Individual businesses are also able to be members of our Business Leaders Council.

We represent more than 300,000 businesses of all sizes, across all industries and all parts of the country, employing over 4 million Australian workers.

The Australian Chamber strives to make Australia the best place in the world to do business – so that Australians have the jobs, living standards and opportunities to which they aspire.

We seek to create an environment in which businesspeople, employees and independent contractors can achieve their potential as part of a dynamic private sector. We encourage entrepreneurship and innovation to achieve prosperity, economic growth and jobs.

We focus on issues that impact on business, including economics, trade, workplace relations, work health and safety, and employment, education and training.

We advocate for Australian business in public debate and to policy decision-makers, including ministers, shadow ministers, other members of parliament, ministerial policy advisors, public servants, regulators and other national agencies. We represent Australian business in international forums.

We represent the broad interests of the private sector rather than individual clients or a narrow sectional interest.

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