Hall&Wilcox Lawyers

16 June 2017

Our Ref: KAP NXT WWK

Director
Fair Entitlements Guarantee Recovery Team
Workplace Relations Programmes Group
The Department of Employment
12 Mort Street
CANBERRA ACT 2601

By email: ImprovingFEG@employment.gov.au

Dear Sir / Madam

Submission regarding Consultation Paper concerning reforms to address the corporate misuse of the Fair Entitlements Guarantee scheme ('FEG'), ('Consultation Paper')

Hall & Wilcox is a leading Australian independent law firm with six offices throughout Australia. We act nationally for a variety of Australian-based and multinational clients including, relevantly, clients in the commercial and insolvency sectors. We have regular involvement with the practical application of the *Corporations Act* 2001 (**Act**) employee entitlement provisions the subject of the Consultation Paper (**EE Provisions**), including in relation to corporate structuring and restructuring, insolvency matters, and in our role acting on behalf of employers in employment matters generally.

Below we provide our submission to assist in the Government's review of the EE Provisions.

1 PRELIMINARY COMMENTS

Generally, we are supportive of reform of the EE Provisions. In our experience, the FEG Recovery Program has given rise to uncertainty in the insolvency market as to the proper entitlement of employees (and, accordingly, the Department of Employment (**CDoE**)) in the event of an employer's liquidation, administration or receivership.

Whilst we appreciate the current limitations upon the FEG Recovery Program, we note from the Consultation Paper that its recovery activity currently only comprises:

(a) funding liquidators' and/or trustees' recovery actions to improve the return of FEG monies; and

(b) funding actions on behalf of the Commonwealth of Australia to recover FEG advances in circumstances whereby the CDoE suspects that insolvency practitioners may have breached sections 433 or 561 of the Act.[1]

In circumstances whereby the majority of the sharp corporate practices identified by the CDoE[2] involve conduct in respect of business structuring and restructuring, illegal phoenix

[1] FEG Recovery Program streams of recovery activity, as set out at footnote 16 on page 4 of the Consultation Paper

[2] As set out at pages 4 to 6 of the Consultation Paper

activity, and broad practices by directors, officers and/or advisers, we support reforms which would enable the CDoE (and other entities) to pursue pro-active enforcement options beyond those associated only with the return of monies from liquidators, receivers and trustees.

For the purposes of this submission, we address primarily the 'other related reforms' at section 8 of the Consultation Paper, however make high level comments as to the remaining proposals.

2 'OTHER RELATED REFORMS'

2.1 Option 7: Trust assets

We agree that reform is required to clarify the powers and obligations held by an insolvency practitioner appointed to a trustee company in respect to trust assets.

(a) Application of the Act's priority regime

Option 7 of the Consultation Paper concerns a proposed reform of the law regarding trust assets where an insolvent company is a corporate trustee. This seeks to adopt legislative amendment to address the current uncertainty as to whether the Act's priority regime applies where the company in receivership or liquidation acted solely in its capacity as trustee of a trust.

The recent cases of *Amerind*[3] (Victorian Supreme Court) and *Mooney's Contractors*[4] (Federal Court) supported the approach adopted by the NSW Supreme Court in *Independent Contractor Services*[5], to the effect that, where a company holds assets as trustee of a trust, the Act's priority regime (including sections 556 and 561) does not apply to the distribution of those assets. Rather, unsecured assets are distributed *pari passu* between the unsecured creditors. This has the effect, inter alia, of removing the higher priority provided to certain employee entitlements under section 561 of the Act.

However, prior to *Amerind*, the Full Court of the Victorian Supreme Court had supported the traditional approach that trust assets be dealt with in accordance with the Act's priority regime.[6]

The Federal Court has also been subject to inconsistent decisions. In *Bell Hire Services*[7], the Court held that the section 556 priority regime did not apply; in *Reborn Enterprises*[8], the section 556 regime was held to apply.

Naturally, this judicial inconsistency causes significant uncertainty for insolvency practitioners seeking to ensure that trust assets are distributed properly and in accordance with creditors' rights.

[3] *Re Amerind Pty Ltd (receivers and managers appointed)(in liq)* [2016] VSC 127

[4] *Kite v Mooney, in the matter of Mooney's Contractors Pty Ltd (in liq) (No 2)* [2017] FCA 653

[5] *Independent Contractor Services (Aust) Pty Ltd (in liquidation) (No 2)* [2016] NSWSC 106

[6] *Re Enhill Pty Ltd* [1983] VR 561; *Re Pharmore* [2016] VSC

[7] *Bell Hire Services Pty Ltd (in liq)* [2016] FCA 1583

[8] *Reborn Enterprises Pty Ltd (in liq)* [2016] FCA 1197

We agree that legislative reform is required to remove this uncertainty and enable insolvency practitioners to act consistently. This would increase certainty for creditors as to their rights and reduce the requirement on insolvency practitioners to expend further fees on assessing the proper approach and seeking Court approval.

Having regard to the benefits of such consistency and certainty, we submit that the reform should confirm that the Act's priority regime (including sections 556 and 561) applies to assets held by the company in its capacity as trustee of a trust. In many instances, this was the approach adopted by insolvency practitioners prior to the judgment in *Independent Contractor Services*. Returning to this position is likely to provide the best opportunity for certainty and consistency. In doing so, it would also minimise confusion:

(i) for stakeholders such as employees, who may not be aware of whether their employing entity holds assets in its own right or only as a trustee; and

(ii) in circumstances where a company holds assets both as trustee of a trust and in its own capacity.

(b) Requirement for Court approval of remuneration

There is also judicial inconsistency as to whether, where the company in liquidation acted as trustee for a trust, the liquidator is entitled to have its costs and remuneration paid from the trust assets.

The recent case of *Mamounia*[9] provides a summary of the relevant case law. This reveals several different approaches adopted by the Courts, including:-

(i) The liquidator is not entitled to be paid their remuneration from the trust assets. (See, for example, *Byrne Australia*[10].)

(ii) The liquidator is entitled to be paid remuneration from trust assets, however Court approval is first required. Approval is a matter of Court discretion. (See, for example, *Sutherland*[11].)

(iii) The liquidator is entitled to be paid their remuneration (both general fees and equitable (or 'specific') lien fees[12]) from trust assets where the Company's assets are insufficient to meet the costs and fees. This has been particularly applied where the Company does not act solely in its capacity as trustee. (See, for example, *Berkeley Applegate*[13]*; Sonray Capital*[14]*; AAA Financial Intelligence*[15].)

(iv) The liquidator is entitled to be paid both its general fees and equitable lien fees where the company traded solely as trustee for a trust. (See, for

[9] *Re Mamounia Pty Ltd (in liquidation)* [2017] VSC 230

[10] *Re Byrne Australia Pty Ltd (No 1)* [1981] NSWLR 394

[11] *Re Application of Sutherland* (2004) 50 ACSR 297

[12] In accordance with *Universal Distributing Co Ltd (in liq)* (1933) 48 CLR 171

[13] *Re Berkeley Applegate Ltd (No. 2)* (1989) 1 Ch 32

[14] *Re Sonray Capital Markets Pty Ltd (in liquidation)* [2010] FCA 1371

[15] *Re AAA Financial Intelligence Ltd (in liq)* [2014] NSWSC 1004

example, *Re Enhill; North Food Catering*[16]; *Suco Gold*[17]; *AAA Financial Intelligence*.)

On balance, it appears that the approach broadly adopted by the Courts is that the liquidator is entitled to recover its remuneration and expenses from trust assets. However, questions remain as to whether or not a Court application is first required. As stated by Robson J in *Mamounia*:-

> *"A question remains whether or not a liquidator may, as a right, exercise the powers that courts in Australia have recognised* [to entitle the liquidator to apply trust assets to fees and expenses]*…, or whether the power to access the trust assets need be sought from the court. The issue does not require determination in this case…* (emphasis added)*"*[18]

This ambiguity and lack of consistency gives rise to uncertainty in the insolvency profession as to the proper entitlements of, and obligations upon, liquidators and administrators.

Where the insolvency practitioner determines that the powers should be sought from the Court, this generally involves a Court application by which the administrator or liquidator seeks to be appointed as receiver of the trust (to confirm their ability to deal with the trust assets), together with orders confirming that the fees of the winding up of the company (both in respect of the equitable lien and more generally) are payable from trust assets. Often such applications are done 'on the papers', but in several instances (such as those set out above), the Court has elected to hear the matter.

Whether the orders are provided 'on the papers' or after the Court has heard the application, unnecessary costs are incurred by the insolvency practitioner in determining their rights.

It is not uncommon business practice for a company to act (solely or in part) as trustee of a trust. Requiring a Court application in every such circumstance to approve remuneration and/or appoint a receiver to the trust significantly increases costs, both in respect to the fees of the insolvency practitioner and of their legal representatives. As such costs are necessarily borne by the available assets, these increased, and arguably unnecessary, costs are ultimately borne by the creditors.

Further, in many smaller liquidations, there are simply not always the assets available to meet the costs of such a Court application. In circumstances whereby section 545 of the Act provides that a liquidator need not take any steps where it does not have the assets available to do so, requiring Court applications in the liquidation of every trustee company is impractical and cost prohibitive.

We recommend that in implementing legislative reform contemplated above, the Government also implement reform to confirm that the Act's regime for approval of remuneration of payment of costs (including disbursements) applies equally to assets held by the company in its capacity as trustee of a trust. Reform of the priority regime as suggested in the Consultation Paper without clarification on

[16] *Re North Food Catering Pty Ltd* [2014] NSWSC 77

[17] *Re Suco Gold Pty Ltd* (1993) 33 SASR 99

[18] *Re Mamounia Pty Ltd (in liquidation)* [2017] VSC 230 at [159]

these additional matters would result in creditors continuing to bear unnecessary costs.

2.2 Option 8: Priority of employee entitlements under section 561

We agree that the uncertainty regarding the application of section 561 ought be addressed. We address two points regarding these sections.

(a) Priority over the claims of the security holder: Timing of entitlements under section 561

There is currently confusion in the insolvency market as to the operation of section 561.

It appears that an approach has been adopted by CDoE in some matters to the effect that section 561 provides it with a right, applicable immediately upon the appointment of a liquidator, to require the liquidator to hold aside all circulating assets which might possibly become subject to a subsequent CDoE claim under section 561 (**561 Interpretation**).

In our view, such an approach is inconsistent with the wording, intent and practical application of the Act, as follows.

(i) As at the appointment of the liquidator, CDoE cannot be said to hold any rights in the circulating assets. First, as at that date it has not made any payments under the FEG scheme, so it is not a creditor of the Company. (We note in this regard that some of the reforms addressed below are intended by the CDoE to decrease the likelihood of it being required to make any payment under the FEG scheme at all, meaning that CDoE would not become a creditor in that liquidation.) The 561 Interpretation requires assets to be held aside for a potential future creditor who might never eventuate.

Second, section 561 is only enlivened once the liquidator is in a position to determine that there will be insufficient unsecured assets to satisfy employee entitlements under section 556 of the Act. The Court in *Italiano*[19] held that:-

> *"[70] In my view, there is only one assessment of the sufficiency of a company's assets and that is to be made when enough is known about the company's affairs. The assessment must take into account all actual and potential realisations. …*
>
> *[71] First, arbitrary or even perverse results can arise if the sufficiency of the company's assets is for the purposes of s 561 assessed on an interim basis.*
>
> *… To ignore possible future realisations and to take assets away from a secured creditor only to realise later that the secured creditor was not required to pay out particular creditors is, to say the least, unjust."*

[19] *Cook v Italiano* [2010] FCA 1355; (2010) 190 FCR 474, 491

Until such a determination is made, the priority of employee entitlements under section 561 is not activated. It is difficult to see on what basis a liquidator ought owe a duty to creditors in advance of those creditors actually having the relevant rights.

(ii) Once rights under section 561 are enlivened, the wording of the section makes clear that those rights consist of payment of employee entitlements *"in priority over the claims of a secured party in relation to a circulating security interest created by the company…"*[20].

That is, the right of employees / CDoE under section 561 is to receive the payment from circulating assets that would otherwise be made to the secured creditor(s). Section 561 does not seek to restrain the liquidator from dealing with the circulating assets (for example, realising those assets). Nor does it impose a trust obligation upon the liquidator, nor a requirement to seek prior consent of employees / CDoE to deal with the assets.

Section 561 requires only that the amount which would have been payable to the secured creditor be diverted instead to the relevant employee entitlements.

(iii) In the practical application of the Act, it would cause significant challenges, including delay and confusion, if the 561 Interpretation were to be applied. It would effectively prevent liquidators from being able to realise, deal with, apply or otherwise use the Company's circulating assets without the prior consent of the beneficiary of the employee entitlements. Difficulties caused by such an approach include:-

(A) Whether or not payment is ultimately made under the FEG scheme, there is necessarily a time delay between the date of administration / liquidation (at which time, the employees are the beneficiaries of the entitlements) and the date upon which CDoE makes any payment under the FEG scheme (at which point CDoE becomes subrogated to the employee's rights). Requiring the insolvency practitioner to seek consent from differing beneficiaries at different times in the insolvency process will cause confusion and inconsistency of approach.

(B) If the circulating assets (or their proceeds) are to be held aside by the insolvency practitioners for employee entitlements, is this to be applied at the point of administration or liquidation? We note in this regard that any FEG payments are only made after a liquidator is appointed.

(C) A requirement to hold aside assets at the outset of the administration or liquidation would prevent the administrator / liquidator from being able to continue to trade the business without the consent of the employees / CDoE (as applicable), notwithstanding that it might be in the interests of all of the stakeholders of the company, and within the duties and powers of the insolvency practitioner, for such trading to continue.

[20] Section 561 of the Act

(D) It would be unusual and not in accordance with the purpose of the Act to require an administrator or liquidator, who is an officer of the Court and who is under fiduciary and statutory duties in respect of the company, to require consent from unsecured creditors as to dealings with company assets, notwithstanding that those dealings may be proper and in accordance with the insolvency practitioner's rights and duties.

(E) Further, such an approach risks creating circumstances whereby the insolvency practitioner is placed in a position of conflict between the directions of the unsecured creditor (employees or CDoE) and their duties and obligations under the Act and at general law. Conflict may also arise between directions of differing employees. The risk of such conflict will only heighten uncertainty of the insolvency process.

(F) Court directions under section 511 of the Act would necessarily follow any such conflict, thereby increasing the costs and expenses of the insolvency and reducing the assets available to creditors. As such directions are often dependent upon the specific facts, it will become necessary to build a body of case law to provide insolvency practitioners with guidelines as to the proper application of their duties across a broad range of scenarios. This will be both time consuming and costly.

We recommend that any amendment to section 561 clearly reflect the legislative intention that:

- the scope of any right under section 561 is for the beneficiary of that right (employee or CDoE) to receive the payment that ought otherwise be payable to the secured creditor(s) from the company's circulating assets;

- the timing of such an entitlement arises when the distribution is properly to be paid in the ordinary course of the winding up (to the secured creditor or employee entitlements); and

- section 561 does not prevent the liquidator from realising, dealing with, applying or otherwise using the circulating assets in the interim in accordance with the liquidator's usual duties and obligations as set out under the Act,

(**Legislative Intention**).

We consider this to properly reflect the intent of section 561. We also note that the Legislative Intention is consistent with, and indeed mirrored by, sections 2 and 3 of the Consultation Paper.

If no legislative reform is made to section 561, we recommend that a policy statement be made by CDoE to recognise the Legislative Intention, so that insolvency practitioners can proceed to undertake their duties with consistency and confidence.

(b) Liquidators' fees

The High Court in *Universal Distributing* recognised that insolvency practitioners are entitled to recover their fees in caring for, preserving or realising secured property, including work connected with creating a fund (**Equitable Lien**).

Recently, the Courts in *Atco*[21] and *Willmott*[22] have confirmed that the Equitable Lien remains payable where no fund has been created:-

> *"In a case where no fund has been created, what needs to be shown in order to establish the liquidator's lien is that:*
>
> *(a) the costs and expenses incurred by the liquidator were incurred exclusively in caring for, preserving and/or realising property;*
>
> *(b) the activity of care, preservation and/or realisation enured for the benefit of the creditors of the company (including the secured creditor); and*
>
> *(c) there is property which can properly be subjected to the liquidator's charge for remuneration, costs and expenses."*[23]

This necessarily entitles the insolvency practitioner to apply their fee entitlement under the Equitable Lien to other secured assets of the company.

While these principles are settled in many instances, as a result of matters raised by the CDoE in claims against insolvency practitioners, uncertainty has arisen as to their continued application in practice. For example, there appears to be some uncertainty in the insolvency industry as to whether the application of such principles, together with the application of sections 433 and 561, require secured assets to be 'grouped' into circulating vs non-circulating assets. No such distinction exists on the case law. Rather, the Courts refer only to secured assets as against unsecured assets.

Such uncertainty necessarily gives rise to increased fees in advice and Court applications.

Further, the effect of the provisions whereby liquidators receive their general fees only out of unsecured assets and in accordance with the section 556 priority regime creates instances whereby liquidators are required by legislation to undertake work for which they may not be able to receive remuneration. This is provides a disincentive for liquidators to accept appointments whereby their fees (or at least a portion thereof) may not be recoverable.

The United Kingdom addressed this matter by implementing section 176ZA of the *Insolvency Act* 1986. This clearly entitles liquidators to recover their general costs of liquidation out of the company's circulating assets, in priority to any other claims to those assets. Such an approach is sensible, practical and consistent with an insolvency practitioner's rights to obtain a high priority payment for the costs and

[21] *Stewart v Atco Controls Pty Ltd (in liq)* [2014] HCA 15

[22] *Primary Securities Ltd v Willmott Forests Ltd (receivers and managers appointed)(in liq)* [2016] VSCA 309

[23] *Willmott* per Maxwell P at [16]

expenses it incurs in undertaking his/her duties. We recommend that this approach be adopted in Australia.

Should the United Kingdom's approach not be adopted, we recommend that legislative reform codify the Equitable Lien and confirm that it provides liquidators with a lien over all secured assets of the company.

3 REFORM TO PART 5.8A OF THE ACT

We support reforms to make Part 5.8A more effective in practice.

As the Consultation Paper identifies, a key difficulty in successfully pursuing claims under Part 5.8A is the requirement to establish intent. Unfortunately, this may not be addressed by Option 1 (Part 5.1) of the Consultation Paper, which proposes to incorporate recklessness as a level of culpability. To establish such a claim would still require the claimant to establish that the person was *"aware of a substantial risk … and, having regard to the circumstances known to them, it was unjustifiable for them to take that risk* (emphasis added)"[24]. Such reform would not address the practical difficulties in establishing the factors and circumstances that were subjectively known to the relevant person and their appreciation of the associated risk.

Options 2A and 2B are more likely to address these challenges. However, the broad wording of the proposed Option 2A is likely to risk impacting upon proper business practices. Further, we note that, while any legislative amendment in accordance with either Option 2A or 2B is likely to create initial uncertainty, Option 2B reflects the current regime concerning uncommercial transactions. Accordingly, judicial guidance may already exist which would assist in this regard.

As the Consultation Paper identifies, any such reforms would need careful drafting to avoid inappropriate impacts upon legitimate business operations. Businesses determine their structure based on a variety of factors, many of which concern the ongoing trading operations of the business, not simply whether a priority payment will be necessary if the business enters an insolvent liquidation and has insufficient free assets to meet employee entitlements. Any amendments to the Act should carefully consider potential impacts upon legitimate structuring considerations such as tax and practical business practices.

We do not object to the expansion of the parties who may initiative civil action, provided that the liquidator did not intend to bring the claim. That said, given that the liquidator will be the party in possession of most of the available evidence and information required to make the claim, and that such claims may be similar in nature to other claims properly available to a liquidator (as noted above), we suggest that a more efficient and productive approach would be to facilitate increased funding for liquidators to pursue such claims as part of the liquidation.

[24] Page 9 Consultation Paper

4 PREVENTING ABUSE OF CORPORATE GROUP STRUCTURES TO AVOID PAYING EMPLOYEE ENTITLEMENTS

We make no detailed comment in respect of these proposals. However, we do reiterate the matters addressed in the previous section, that businesses select corporate structures for a variety of reasons, including for legitimate operational and taxation purposes. Many such businesses ultimately do not enter insolvent liquidation, and certainly do not intend to do so when determining their structure.

We would be cautious of any amendment focused solely on the priority of employee entitlements in an insolvent liquidation, which does not give due consideration to the variety of considerations associated with structuring a business. It may be that potential liability in the form of that considered at Option 2B is sufficient to address the CDoE's concerns in this regard.

5 SANCTIONING DIRECTORS AND OFFICERS WITH A TRACK RECORD OF INVOLVEMENT IN INSOLVENCIES WHERE FEG IS RELIED UPON

We support an increased focus on pursuing and sanctioning directors engaged in illegal phoenix activities, both in respect of misuse of the FEG scheme and more broadly. However, while stronger sanctions may assist, any such legislative amendment ought be combined with an increase in the resources available to the parties seeking to enforce the regime.

Currently, a significant amount of illegal phoenix behaviour reported by insolvency practitioners is not pursued based on lack of available funding. Reforms to broaden the relevant categories of misconduct to incorporate reliance on the FEG scheme may have little practical effect where the other contraventions of the Act or laws[25] are not pursued or established.

If you have any queries regarding this submission, please contact:-

Katherine Payne
Special Counsel
katherine.payne@hallandwilcox.com.au
+61 3 9603 3646

Wayne Kelcey
Partner
wayne.kelcey@hallandwilcox.com.au
+61 3 9603 3447

Natasha Toholka
Partner
natasha.toholka@hallandwilcox.com.au
+61 3 9603 3151

Yours faithfully

Hall & Wilcox

[25] As referred to at page 19 of the Consultation Paper