15 June 2017

Mr Peter Krizmanits
Recovery and Litigation Branch
Workplace Relations Programmes Group
Department of Employment

Mr James Mason
Financial System Division
Markets Group
The Treasury

By email only: ImprovingFEG@employment.gov.au

Dear Sirs

Submissions – Reforms to address corporate misuse of the Fair Entitlements Guarantee Scheme (the Consultation Paper)

PPB Advisory appreciates the opportunity to provide feedback and comments regarding an important area of reform for the national economy and legal framework governing Australian insolvency law.

Our submissions in response to the Consultation Paper are set out as follows:

Part A. About PPB Advisory

Part B. Framework for reform

Part C. Response to questions in the Consultation Paper

We welcome the opportunity to discuss our paper. I can be contacted on +61 3 9269 4136.

Yours faithfully

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Part A. About PPB Advisory

PPB Advisory is a professional advisory firm employing more than 300 people with offices in across Australia (in Sydney, Melbourne, Brisbane and Perth) and Singapore. We specialise in corporate recovery and restructuring, management consulting and corporate advisory.

Our dedicated corporate restructuring team comprises of 19 partners and over 80 staff nationally of which 29 are registered liquidators.

Our firm has been involved in many significant mandates with the Department of Employment including but not limited to performing verification work following the liquidation of the Byron Group and acting as Special Purpose Liquidators of Queensland Nickel Pty Limited.

PPB Advisory has a proud history of contributing to the development of legislation and policy in Australia and has made numerous public and private submissions to both federal, state and local governmental agencies and departments including the ASIC and the Department of Treasury, Commonwealth.

Part B. Framework for reform

PPB Advisory welcomes the opportunity to provide feedback and comments on the Consultation Paper.

Our paper focuses on the following three parts of the framework. They are discussed in further detail below:

i. Capitalisation
ii. Winding up
iii. Deterrents.

Item I. Capitalisation

Background

A corporation should be appropriately capitalised to meet its obligations to its creditors, particularly employees. We recognise however that it is a legitimate commercial practice for some corporate groups to be structured so that its employees are held by one corporation whereas its assets are held by other entities within the corporate group.

Under existing legislation (and in the absence of any cross guarantees) there are limited circumstances by which the creditors of the employing entity in an insolvency (namely the employees) have recourse to the assets held by other entities within the corporate group. This is often despite the asset owning entities within the corporate group obtaining the benefits of having access to the staff in the insolvent (and often assetless) employing entity. This inequity can result in unjust outcomes particularly when coupled with sharp corporate practices (such as phoenix behaviour).

Options

Our view is that the FEG scheme should serve as a last resort safety net to meet unpaid employee entitlements. Accordingly, it is appropriate that entities which have utilised the services of employees of the insolvent entity should be made liable for any unpaid entitlements.

Potential options to capitalise insolvent entities to meet their obligations to employees for their entitlements are listed below:

a. Contribution/Pooling Orders
b. Holding company liability mechanisms
c. Other grouping mechanisms
d. Industry levy
e. Government funding (FEG scheme).

We consider each of these, including their respective risks and benefits, in further detail below.

a. Contribution/Pooling Orders

We support the recommendation of Option 5 as detailed in the Consultation Paper.

This enables the Court to make contribution orders against related solvent entities to pay amounts toward the employee entitlements of an insolvent member of a corporate group where it is just and equitable. This would be based on similar models currently being used in Ireland and New Zealand. We envisage that this would attach claims for unpaid employee entitlements against solvent entities within a corporate group which hold assets and have utilised the services of the insolvent to care and preserve their assets.

The potential risks with Option 5 is that:

1. It relies on the Court's discretion which may make the exercise expensive and the outcomes uncertain.

2. Sharp directors may seek to participate in transactions or other contractual arrangements designed to disguise the true nature of the relationship between capital and labour.

One way to address this risk is to have a low threshold for establishing liability against the asset owning entities so it is difficult to dispute and facilitates the Court process.

We note any amendments to legislation that make other corporations liable for the obligations of an insolvent entity may make it difficult for some corporate groups to raise capital (debt and equity). This in turn could inhibit their trading and growth as the contingent liability owed to the employees of the related entity would need to be disclosed to their funders.

A possible way to address this risk is to cap any liability to the maximum amount of the following unpaid employee entitlements:

i. wages
ii. superannuation contributions
iii. leave entitlements.

Please note that this specifically excludes retrenchment costs. The basis for this is that this largely mirrors the liabilities recorded in consolidated financial reports that are prepared for corporate groups on a going concern basis that are typically considered by funders when making a lending or equity injection decision.

b. Holding company liability mechanisms

A potential alternative option may be to amend the legislation so that all unpaid employee entitlements of an insolvent subsidiary are a deemed liability of its holding company. This option could operate in a similar fashion to the holding company liability provisions for insolvent trading contained in sections 588V and 588W of the Corporations Act.

One of the limitations however to this approach is that in some scenarios the holding company may hold no assets (for example where the assets are held in other subsidiaries). In these circumstances, such a measure would not make any additional assets available for employees.

c. Other grouping mechanisms

Other options include considering deeming all members of a tax consolidated group (or some similar grouping mechanisms) liable for the unpaid employee entitlements of an insolvent member.

The basis for this is that all entities would (indirectly) receive a tax benefit from the employee entitlements historically paid and may have had utilised the services of the staff employed by the insolvent entity to preserve and care for their own assets.

d. Industry levy

Another option for consideration may involve the introduction of a new government administered fund from which the proceeds could be used to meet the costs of unpaid employee entitlements of insolvent entities. This could be funded by the introduction of a new levy on companies subject to eligibility criteria such as size, revenue or profit.

This may be an inequitable approach because it punishes those corporations who are solvent and honour their obligations to employees. It would effectively result in solvent entities paying the employee entitlements of insolvent entities. It would also impose an extra cost of ‘doing business’.

e. Government funding (FEG scheme)

At present the Commonwealth effectively capitalises insolvent entities through the FEG scheme by (subject to some specific exceptions and limitations) agreeing to meet the claims of staff for their unpaid employee entitlements.

Our view is that (consistent with current practice) such funding should effectively be a last resort and only be accessed when there is no recourse to any further assets or alternate options.

Item II. Winding up

Background

The insolvency of a company requires the appointment of an external administrator to take charge of the company’s affairs and realise their assets so that they may be distributed equitably amongst its creditors. Significant personal liability is assumed by the external administrator in realising the assets of the insolvent, particularly if they continue to trade its business or pursue litigation to maximise the return to creditors. They are also required to exercise considerable professional judgment, conduct an independent investigation, report to ASIC, as well as comply with various other statutory obligations.

Accordingly, the fees and expenses of external administrators are a necessary cost. A priority for professional fees and expenses should be affirmed in the legislation.

Priority from circulating assets

External administrators play a vital role in maximising the realisations of circulating assets and returns to creditors (including employees). This reduces the amount payable under the FEG scheme. Accordingly, we recommend that the legislation affirms that practitioners are entitled to a priority for their fees ahead of all other creditors.

We demonstrate the basis for this recommendation with the following two examples:

1. Sale of business

A sale of business on a going concern basis by an external administrator often maximises recoveries (including those from circulating assets) and may involve the transmission of all or some of the staff employed by the insolvent entity to an incoming purchaser and may eliminate and/or significantly reduce any claim against the FEG scheme.

2. Converting and realising circulating assets

In our experience, to maximise the value from circulating assets it is often necessary to continue trading the business of the company to convert them into a saleable product, honour supply contracts to receive payment for debtor balances and/or achieve market value by selling through normal business channels.

By maximising the value of realisations from circulating assets this may also eliminate and/or reduce any claim against the FEG scheme.

In some scenarios, however (and despite the best efforts of the external administrator) a going concern sale may not be achieved and/or realisations may be below expectations. This may be for a variety of reasons. As a result, proceeds from the realisation of circulating assets may be used to meet the costs of the external administrators, including for their professional fees.

We submit however there are sufficient mechanisms available within the existing legislation for creditors, the Court and the ASIC to review and make enquiries regarding the conduct of external administrators, including but not limited to reviewing and approving their professional fees. It is entirely appropriate that practitioners obtain a priority for their costs (including for their professional fees) in priority to any class of creditors (employees or otherwise) in recognition of the risks undertaken as well as for performance of their statutory duties so long as the work they performed was necessary and proper in accordance with legislation and industry standards.

The alternative approach would be to simply immediately auction the circulating assets at liquidation value and/or abandon them which would produce suboptimal outcomes for creditors, including for employees and the FEG scheme (and constitute a breach of statutory and fiduciary duties owed by external administrators to creditors).

In the absence of any priority being afforded to practitioners for their costs (including their fees) this would disincentivise external administrators to try to achieve a going concern sale and/or maximise the value of circulating assets.
The likely consequence of this is that businesses would cease trading immediately and realisations from circulating assets would be at liquidation values. As a result, rather than reduce the amount being paid under the FEG scheme we submit that this would invariably (and almost always) lead to (increased) claims being made under the FEG scheme.

Item III. Deterrents

We submit that more punitive measures for directors of insolvent entities will act as a deterrent. We broadly support each of Options 1, 2, 3 and 4 detailed in the Consultation Paper.

PPB Advisory is a member of ARITA and understand that they will be making further submissions on this issue which we support.

Observation

We highlight that the prevalence of debtor factoring and debtor finance funding is a relevant factor that is reducing the base of circulating assets available to meet claims from employees.

We accept that such financing may provide genuine funding solutions for businesses with working capital issues and those companies facing distress. It however may contribute to the increased reliance on the FEG scheme in corporate collapses.

Part C. Response to questions in the Consultation Paper

PPB Advisory responds to each of the Questions in the Consultation Paper as follows:

Question 1 – Should Part5.8A be amended?

We have no specific comments but broadly support each of Option 1, 2, 3 and 4 as recommended in the Consultation Paper.

We understand that ARITA will be making more detailed submissions on this issue which we endorse.

Question 2 – What are the benefits and risks of the above options?

We have no specific comments but support the submissions made by ARITA on this issue.

Question 3 – What are the specific drafting issues with the Part which should be addressed?

We have no specific comments but support the submissions made by ARITA on this issue.

Question 4 – Are there alternative approaches that produce a genuine protection against avoidance, prevention or reduction of payment of employee entitlements? What are they?

We consider that a combination of existing measures and those proposed in the Consultation Paper may assist in deterring sharp corporate practices.

Question 5 (a) – What are the benefits and risks of the Option 5?

We support this recommendation as discussed in Item I of Part B of our paper. We consider this proposed reform (more than any other discussed within the Consultation Paper) will reduce the amount payable under the FEG scheme on the basis that it will:

i. act as a disincentive to sharp corporate practices
ii. encourage directors to ensure corporations are properly capitalised
iii. provide a new avenue for liquidators to have recourse to assets to meet the outstanding obligations owed to employees of insolvent entities.

We separately detail in Item I of Part B of our paper the potential risks with this approach.

Question 6 – What criteria should a court consider when deciding whether it is 'just and equitable' to order solvent corporate group entities to make a contribution? Why?

We generally concur with the criteria identified in the Consultation Paper.

Question 7 - Are there alternative approaches available which would ensure employee entitlements are paid when corporate groups have the capacity to pay? Please outline how these might work.

We have detailed some potential alternative approaches as detailed in Item I of Part B to our submissions.

Question 8 – What are the benefits and risks of the Option 6?

We support this recommendation.

We expect there may be some opposition to this recommendation on the basis that such punitive measures against directors will inhibit entrepreneurial behaviour. In our experience, however the most successful corporations maintain access to sufficient capital to ensure obligations to their creditors can be satisfied without impeding their entrepreneurial pursuits.

Any amendments to the legislation should still allow:

i. ASIC and the Court to retain discretion to elect the automatic disqualification
ii. the director the ability to appeal any decision through the AAT and the Courts.

In our views these safeguards adequately address any risks and/or downside to adopting the recommended proposal.

Question 9 – Are there alternative approaches which would sanction those with a track record of involvement in insolvencies where FEG is relied upon? What are they?

We have no specific comments but support the submissions made by ARITA on this issue.

Question 10 (a) What are the benefits and risks of Option 7?

We support the view that the inconsistency in jurisprudence on the topic of priorities of creditor claims in the winding up of a corporate trust is unhelpful.

Our preference however would be for wider consultation and drafting on legislation governing the winding up of trusts. This would allow for more comprehensive legislation to be formulated. We understand that ARITA will be making more detailed submissions supporting this approach.

Question 10 (b) What are the benefits and risks of Option 8?

We do not support the proposed recommendation.

Our submissions on this item are detailed in Item II at Part B of our paper.

The proposed recommendation is based on a premise that is inconsistent with the current drafting of the Corporations Act and its intent, including established commercial practice.

We understand that ARITA will be making more detailed submissions on this issue which we endorse.

Question 11 – Are there other issues raised by the interactions of section 433 and 561 of the Corporations Act which should also be addressed?

We have no specific comments but support the submissions made by ARITA on this issue.