Reforms to Address Corporate Misuse of the Fair Entitlements Guarantee Scheme

ACTU Submission in Response to Departmental Consultation Paper

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OUR POSITION ON THE PROTECTION OF EMPLOYEE ENTITLEMENTS IN INSOLVENCY

1. The Australian Council of Trade Unions ('ACTU') welcomes this consultation process. The ACTU is the peak body representing almost 2 million working Australians. The ACTU and its affiliated unions have a long and proud history of representing workers' industrial and legal rights and advocating for improvements to legislation to protect these rights.

2. We have participated in all open policy development consultations concerning the Fair Entitlements Guarantee ('FEG') and its predecessors and our affiliates have worked closely with the Department of Employment in the day to day implementation of each of them. Our affiliates are also regular participants in committees of creditors appointed to work with insolvency practitioners during the administration and/or winding up of employing entities and have witnessed first hand the consequences of the types of sharp corporate practices which the consultation paper is concerned with.

3. Our position on the protection of employee entitlements is that whilst we accept that the FEG is critical element of the social safety net, there is more than can be done to protect employee entitlements and improve their recovery in insolvency situations (a position that accordingly reduces the costs of the scheme). The most recent ACTU Congress, in 2015, relevantly adopted the following policy:

> Congress believes that no employee should be left short-changed when their employer becomes insolvent. The ACTU and Unions will continue to advocate for reforms to the Fair Entitlements Guarantee, the Corporations Act and the Fair Work Act to ensure that:
>
> a) all employee entitlements, including all deductions and contributions, are fully recoverable from the Fair Entitlements Guarantee;
> b) the Commonwealth is armed with the laws and resources it needs to maximise its recovery in insolvencies, including from individuals and related entities in appropriate circumstances;
> c) irresponsible dealing with and avoidance of employee entitlements and trading when insolvent is better detected and deterred;
> d) employees and their unions are better informed about the financial activity and performance of employers and are able to take meaningful action to protect and recover entitlements;
> e) there are strong incentives through supply chains to encourage timely payment of entitlements;
> f) the priority status of employee creditors is further elevated;
> g) there are more accessible options to secure employee entitlements against the assets of an employer or place them in trust; and
> h) individuals involved in phoenix operations are put out of business for good.

4. Our Congress in 2015 also supported changes to the industrial relations framework including the creation of portable leave based on employment in an industry rather than employment with a single employer, which, if fully funded through an investment or insurance based model, would considerably reduce the footprint of the FEG scheme.

5. We are pleased that the Government has moved to a more constructive position on reforms to FEG and the associated regulatory framework than was advanced in the 2014 Parliament. It is also a welcome development that a variant of the Active Creditor Pilot, which we urged the government to re-initiate at that time, was in fact recommenced and provided with recurrent funding. Nonetheless, the "moral hazard" argument advanced in 2014 and earlier still looms large in the consultation paper. It is an argument that ought to be rejected, for two reasons.

6. Firstly, the language of "moral hazard" tends to disguise the base dishonesty that lies behind a false representation that employee entitlements can and will be paid. The language is more apt to direct the blame for such action at the source of the temptation to engage in wrongful conduct, rather that conscious decision to engage in it. Secondly, the existence of the FEG scheme is no more an incentive for wrongful behaviour than any other insurance type benefit or other social benefit. When business, home or other property owners engage in insurance fraud, we call it for what it is rather than denigrate the insurance model as a social evil. The same should apply here.

COMMENT ON SPECIFIC PROPOSALS FOR REFORM

PART 5.8A OF THE CORPORATIONS ACT

7. Reforms to Part 5.8A of the *Corporations Act* ('the CA') are a necessary part of any response directed to deterring non-payment of employee entitlements and enhancing the Commonwealth's prospects of recovery. Part 5.8A should continue to provide criminal penalties as well as a civil penalty scheme which provides for the recovery of compensation.

8. In terms of the offence provisions, we agree that changing the fault element to recklessness is likely to assist prosecutions and we support that proposal.

9. Some doubt is expressed regarding the scope of section 596AB (and, consequentially, 596AC) in the discussion and the footnotes. In our view, section 596AB as drafted is capable of applying to any person who "enters into" a relevant agreement or transaction and should therefore apply to all parties to that agreement or transaction. These will typically be the company that is seeking to avoid the relevant entitlements as well as the person or entities that are transacting with it to achieve that purpose, which may be another company within the same corporate group. We agree with the suggestion in the discussion that such a footprint is too narrow.

10. A suggestion not canvassed in the paper is to consider including section 596AB (and, consequently, 596AB) as provisions that section 79 of the CA apply to. This would provide clear accessorial liability based on drafting that is conventional and increasingly utilised in regulatory compliance proceedings. In terms of effective compensation recovery, we favour a more fundamental change however we don't accept that such change needs to be mutually exclusive: The retention of a compensation provision that relies on liability under section 596AB (including accessorial liability) is likely an efficient way of obtaining that compensation in those matters where criminal proceedings are taken.

11. In terms of the models proposed for reform of civil penalty and compensation arrangements, we strongly favour a "reasonable person" test, as described as option 2A in the discussion paper, over the objective "reasonable in the circumstances" test described in option 2B. In our view, the latter is less likely to result in successful claims for compensation, for two reasons. Firstly, it effectiveness is reduced where each of the arrangements or transactions

that together constitute the scheme can be described (either by design or by re-writing history) to have *some* facially neutral operational purpose to them. Secondly, the CA and its common law underpinnings are burdened with jurisprudence that assumes prima facie legitimacy in anything that is capable of generating or preserving wealth to shareholders (who, in many private companies, are probably limited to the sole or husband and wife directors who enter into the transactions in question). This weight of history is likely to colour the judicial interpretation of what is "reasonable in the circumstances".

12. The benefit of the "reasonable person" test is that its central focus is what a reasonable person in the circumstances *knew or ought to have known* were the likely consequences of their actions in entering into the arrangements or transactions in question. If a reasonable person knew or ought to have known that the consequences would include preventing the recovery of employee entitlements or significantly reducing the amount of entitlements that could be recovered, they ought to be liable to compensate for what is effectively their negligence (at best). Subject to some clarification about the intended interaction between this option and section 444DA of the CA, we do not share the guarded view expressed in the discussion paper that such a provision might impact "legitimate business operations, including the capacity to genuinely restructure an otherwise viable business".

13. Additionally, a compensation provision based on the "reasonable person" test can and should be framed in such a way that permits it to operate not only on persons who enter into the transaction or arrangements, but those who facilitate those arrangements. Conceptually this could be achieved by largely adopting the terms of section 79 but replacing references to a "contravention" with references to a "transaction or arrangement". This would form a definitional subsection to the head civil penalty and compensation provision that created liability based on what a reasonable person entering into or being involved in an arrangement or transaction knew or ought to have known.

14. Whichever approach is taken to the civil penalty and compensation provision, it is important to remove the need for multiple actions. The present subrogation arrangements in section 29 of the FEG legislation and section 560 of the CA provide that the Commonwealth's interest is limited to the advance it has paid. However, an employee's loss may be larger than the amounts provided in the FEG advance (for example, non-payment or underpayment may extend for longer than the permitted 13 weeks, there may be unpaid employer superannuation contributions and the wage exceed the maximum FEG weekly wage). If the Commonwealth is going to go the trouble of running a liability case that is capable of satisfying both debts, it

ought to be permitted to recover both of them and required to distribute the employees' unmet loss to them when it is recovered where employees consent to this. This ought not be at the expense of employee rights to bring independent proceedings, but rather as a supplement to them. A further useful supplement to the list of parties in section 5.3 of the discussion paper would be to allow unions to conduct such actions as representatives of the employees concerned.

15. Separately from the question of the legal basis for liability is the critical issue of accessibility. Insolvency practitioners are highly unlikely to enter into detailed investigations which cannot be funded by the assets available from the company from which they are paid. Similarly, employees who have lost their job and their entitlements are in no position take on the costs and risks of litigation. Some unions, who presently have no right to bring compensation claims, would have the technical capacity in house to conduct some level of investigation but the resources required to litigate a matter may not be available to them. It is important that Commonwealth make funding available to progress such actions not only to its own agencies but also to unions who may be able to assist or conduct such proceedings.

CORPORATE GROUPS

16. We support the proposal to develop a contribution order framework for the recovery of employee entitlements from solvent members of a corporate group. Such orders should be available to liquidators, employees, unions and the Commonwealth. The list of possible criteria provided in the discussion paper for courts to consider in deciding whether to make such an order identifies the right issues in our view, but what it is seeking to do is establish some kind of proxy for fault based liability rather than approaching the issue merely on the basis of capacity to pay. In any event, it would useful to consider approaching the first criteria – control between entities – on the basis of a statutory presumption of control as between companies in the group that hold assets and those that do not.

17. The discussion paper proposes modifications to the asset pooling provisions as a potential alternative to an employee entitlements specific contribution order framework. We do not see merit in such an alternative as it relies on more than one company in the group being wound up and may, in a practical sense, result in a trade-off between the interests of creditors in the group that could negatively impact employee dividends compared to what could be available under a contribution order model.

18. Another option is to blend the "no fault" underpinnings of the Asset Pooling provisions with the policy behind an employee entitlement contribution order model to craft provisions that simply allocate loss to those who are most capable of bearing it. There is a powerful argument for allowing employee entitlements to lie outside the limited liability characteristics of an insolvent entity where a related entity, particularly a parent entity, is able to absorb the shortfall and had an established *practice* of acting as the failing company's line of credit without a formal or documented legal obligation to do so. Just as the Courts were able to see a way through these tactics for Wittenoom miners employed by the asset stripped Australian Blue Asbestos Pty Ltd and sheet liability home to CSR, the law should recognise such tactics for what they are and distribute liability accordingly.

SANCTIONING DIRECTORS

19. We agree that director disqualification is an appropriate remedy, however, we differ in the policy reasoning as to why.

20. The discussion paper seems to premise argument in favour of such a penalty on the basis of repeated "improper reliance on the FEG scheme". In our view, the wrongdoing that ought to be regarded as the trigger for the Court's decision to disqualify a director is the non-payment of entitlements.

21. Viewed in this way, a more appropriate amendment to section 206D of the CA would be one which permitted disqualifications to be made where a director has been knowingly concerned in depriving employees of their entitlements.

22. Such a power ought to be able to be exercised in independent proceedings, as well as by an applicant in any relevant proceedings brought under the Fair Work Act. ASIC should be permitted to intervene in such Fair Work proceedings to seek such orders if they are not sought by the applicants to the proceedings. Or, in the alternative, directors could be required to show cause as to why they ought not be disqualified in any circumstances where they are found to have been knowingly concerned in the relevant wage theft or underpayment related contraventions.

OTHER PROPOSALS

LEVEL OF PRIORITY

23. The loss of accrued entitlements can have a devastating impact on workers and their families. An individual generally has few sources of income and financial security. The ACTU strongly supports a re-calibration of the priorities in insolvency to rank employee creditors above secured creditors, who typically do have larger reserves to absorb such risks.

24. In our affiliates' experience, the priority given to secured creditors in insolvency and the appointment of Receivers and Managers can extinguish the prospects of any reasonable dividend on employee entitlements. A Receiver's sole interest and duty is to protect the debt owed to the secured creditor they represent and in our experience this is pursued ruthlessly. Unlike an Administrator, they are not required to turn their mind to any prospect of saving the business in which the assets reside. An Administrator who is appointed to a struggling company is effectively beholden to any Receiver. Further, a receiver is not under the same obligations to report to creditors generally, thus employees and their representatives are largely left in the dark regarding the receivers activities let alone being in any position to influence them. If a Receivership continues for an extended period of time, significant fees will accrue and these will also be given priority over employee entitlements. There are instances of such fees reaching $3-$5 million in medium sized companies.

25. In our view, it is appropriate to re-examine giving employee entitlements priority above secured creditors and give Receivers/Managers duties to consult with employee creditors and represent their interests in the Receivership process. The conceptual bridge has already been crossed in policy by virtue of the priority given to employee creditors over floating charge assets in sections 433 and 561 of the CA. It now ought to be extended.

26. Any assessment of the impact on credit availability arising from such a proposal needs to take account of the fact that employees are the least well placed participants in the economy to directly absorb the costs of corporate insolvency, particularly given that the realisation of their loss occurs at the same time as the loss of their most significant, if not only, source of income. Further, if there are impacts on credit availability, then such impacts are best understood as a market based mechanism to control the risk of unpaid entitlements: In the face of such

reforms, the banks are unlikely to extend finance (or at least cheap finance) to businesses with directors with who have poor histories.

PORTABILITY OF ENTITLEMENTS

27. Another important strategy to limit the risks of employee entitlements being lost is to permit them to be housed in structures that are not susceptible to being compromised by insolvency events and the sometimes questionable dealings that precede them.

28. Such structures can take many forms, including insurance models, trust arrangements and accumulation based investment schemes. Regular contributions to such schemes provide protection against the loss of lump sum entitlements like redundancy pay and accumulated leave. Accumulation based investment schemes also have the benefit of reducing the overall cost of funding entitlements as the schemes mature.

29. Schemes having these features are currently available in some industries, including portable long service leave for the construction and contract cleaning industries. Redundancy pay, in the form of benefits from industry specific redundancy schemes included in modern awards and enterprise agreements made under the Fair Work Act, is also available on the basis of employee accounts that accumulate with contributions from successive employers.

TRUSTEES' LIEN AND PRIORITY PAYMENTS

30. We agree that the uncertainty in relation to the position of trust property where a corporate trustee is being wound up ought to be clarified so as to ensure that the priority order in section 556 of the CA applies to the realisation of trust assets. However, the subsidiary issue raised in *Independent Contractor Services* should also be attended to so that the definition of employee in section 556 of the CA accords with expanded definition in the *Superannuation Guarantee Administration Act*.

CALL ON FLOATING CHARGE ASSETS

31. We support the suggestions for improving and aligning sections 433 and section 561 of the CA to ensure that they are not read down or misapplied by receivers or liquidators. This ought to be followed with a period of targeted education and, further to that, a compliance campaign focusing on the application of those provisions.

CLARIFICATION REGARDING INSOLVENT TRADING PROVISIONS

32. We understand that there is some doubt as to whether the Commonwealth's rights as a subrogated creditor are sufficient to support it recovering FEG advances through liquidators actions under section 588M of the CA. Section 588M permits actions to recover loss or damage suffered where a debt is incurred in contravention of the duty to avoid insolvent trading. The uncertainty arises because, where an advance is provided by FEG (at least one which fully satisfies the employee's loss), the employee cannot be said to have suffered a loss. The subrogation under section 560(c) does not change this fact. Therefore, there is an argument that Commonwealth cannot recover the advance. A deeming provision could be considered in order to rectify this.

ACTIVE CREDITOR PARTNERSHIPS AND EDUCATION

33. We are pleased that the government has committed to continuing to fund recovery and compliance activities to deter and remedy the non-payment of entitlements and to contain the costs the of the FEG scheme.

34. We understand that activities under the present program are conducted on a multi-agency basis. However, we believe there would be benefits for the program and its objectives if there were formal connections with unions embedded in it. Unions can be a source of intelligence on the practices of particular directors and insolvency practitioners. At present, any concerns that unions have in this respect are raised with ASIC and "processed" by ASIC in the usual fashion. A direct contact point with the taskforce or steering group (or whatever structure is leading the present program) directly engaged in investigating and pursuing employee entitlement related contraventions is likely more valuable.

35. In addition, unions could learn from the activities undertaken in the present program in ways that they could apply not only to any additional enforcement rights that might result from the present process but also in the role they are often called on to perform on committees of creditors representing their members. A formal secondment arrangement is likely to be of benefit both to unions and to the Commonwealth.

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