ARITA
AUSTRALIAN RESTRUCTURING INSOLVENCY & TURNAROUND ASSOCIATION

9 July 2018

Mr Peter Krizmanits
Recovery and Litigation Branch
Workplace Relations Programmes Group
Department of Jobs and Small Business
10 Mort Street
CANBERRA ACT 2600

By email: ImprovingFEG@jobs.gov.au

Dear Sir

Proposed Reforms to the *Corporations Act 2001* (Cth) to Address Corporate Misuse of the Fair Entitlements Guarantee Scheme

The Australian Restructuring, Insolvency & Turnaround Association (**ARITA**) appreciates the opportunity to be involved in and provide feedback on the Exposure Draft for the *Corporations Amendment (Strengthening Protections for Employee Entitlements) Bill* 2018 (**Exposure Draft**).

We also refer to our submission, dated 16 June 2017, made as part of the previous consultation on these proposed reforms (**previous submission**). A copy of the previous submission appears in the appendix to this submission.

The matters covered in this submission are limited to specific comments about the Exposure Draft and does not go into detail in respect of other suggested legislative amendments which were detailed in the previous submission.

ARITA repeats and confirms the matters raised in its previous submission.

The key points which we wish to make about the Exposure Draft are summarised below.

Key points

General

- Assessed against the intention of the new safe harbour and ipso facto reforms to create a stronger restructuring and turnaround culture in Australia, we are concerned that there is a risk that the proposed provisions could, in certain instances, capture a

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genuine attempt at business restructure which has not been successful and careful consideration needs to be given to ensure that this is avoided.

Part 5.8A Amendments

- There is a need for the amendments to be clear in their operation to capture the activities of pre-insolvency advisors.

Contribution Orders

- The changes to provide for contribution orders from members of corporate groups are supported in principle but there is a need for clarification around the approach to quantification of such orders.

Director Disqualification

- To ensure that these provisions act as a deterrent to the "sharp corporate practices" the target of the amendments consideration should be given to making the ASIC disqualification automatic in operation (subject to some tightening of the trigger requirements).

Should you have any queries arising from this submission please contact Natasha McHattan on (02) 8004 4347 or nmchattan@arita.com.au or Narelle Ferrier on (02) 8004 4350 or nferrier@arita.com.au.

Yours sincerely

John Winter
Chief Executive Officer

About ARITA

The Australian Restructuring Insolvency and Turnaround Association represents practitioners and other associated professionals who specialise in the fields of insolvency, restructuring and turnaround.

We have more than 2,200 members and subscribers including accountants, lawyers, bankers, academics and other professionals with an interest in insolvency and restructuring.

Some 84 percent of registered liquidators and 89 percent of registered trustees are ARITA members.

ARITA's mission is to support insolvency and recovery professionals in their quest to restore the economic value of underperforming businesses and to assist financially challenged individuals.

We deliver this through the provision of innovative training and education, upholding world class ethical and professional standards, partnering with government and promoting the ideals of the profession to the public at large.

The Association promotes best practice and provides a forum for debate on key issues facing the profession. We also engage in though leadership and advocacy underpinned by our members' knowledge and experience.

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1 General

1.1 Balancing Policy Objectives

The policy underlying the proposed changes to the Act, as detailed in the Exposure Draft and the draft Explanatory Memorandum, are sound objectives which are supported by ARITA. As detailed in the previous submission, ARITA supports:

(a) reform to Part 5.8A of the Act to make its provisions more effective as a deterrent to avoiding or preventing the recovery of employee entitlements, while not unduly restricting legitimate business restructures which serve the interests of the creditor body of a company in financial distress
(b) reforms to improve the accountability of companies within corporate groups for shortfalls in employee entitlements for those who have provided a benefit to the wider corporate group
(c) increased focus on, and powers of disqualification in respect of, company directors who habitually fail to make sufficient allocations or allowances for employee entitlements
(d) increased focus and accountability by those who help facilitate such behaviours.

However, the policy objectives, which underlies the Exposure Draft must also be balanced against the broad and transformational shifts in policy objectives under the National Innovation & Science Agenda (**NISA**) which have been made to corporate insolvency laws to strike a better balance between encouraging entrepreneurs and protecting creditors by creating a restructuring safe harbour and a moratorium on ipso facto clauses.

At a high level, the structure and detail in many of the provisions contained in the Exposure Draft may be perceived as going against the broad objectives underlying the NISA reforms, particularly for example, the director disqualification provisions which could be interpreted as "punishing business failure". To this end, we note that the main strength of the safe harbour reforms was to drive a cultural shift toward business rescue. If these reforms are perceived as undermining this, the NISA reforms may fail to meet their objectives.

We also believe that there is a risk that the proposed provisions could, in certain instances, capture a genuine attempt at business restructure which has not been successful and careful consideration needs to be given to ensure that this is avoided.

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2 Comments on Exposure Draft

General Recommendation:
ARITA confirms its broad agreement with the proposed changes detailed in the Exposure Draft. The underlying policy objectives "to deter inappropriate market behaviours which result in the avoidance of the payment of employment entitlements…"[1] is supported by ARITA and the comments detailed below are put forward as mechanisms which ARITA considers will improve the Bill's ability to meet the policy objectives.

2.1 Part 5.8A Amendments

- **Sections 596AB and 596AC and the application of these provisions to "pre-insolvency advisors";**

  The intention of the Exposure Draft to extend the operation of section 596AB, and introduce a new section 596AC, is supported by ARITA.

  However, there is concern that the proposed amendments in the Exposure Draft do not operate to clearly extend liability to cover pre-insolvency advisors or non-director executives within distressed organisations who may promote avoidance schemes. For clarity, we highlight that the term 'pre-insolvency advisors' should encompass any advisor who helps facilitate the inappropriate market behaviours targeted by the Bill.

  The references in sections 596AB and 596AC in the Exposure Draft refer to "*if the person* ***enters into*** *a relevant agreement or transaction…*" (emphasis added).

  This wording is unduly restrictive and there is a real risk that it could lead to the sections being read down with the effect of not capturing pre-insolvency advisors or non-director managers. Pre-insolvency advisors, in particular, invariably structure their activities so that they do not "enter into" nor become party to any formal agreement or transaction. Non-director managers may promote schemes internally (possibly on external advice) but may not be captured for their responsibility unless they are specifically identified within the legislation.

  While section 79 of the Act is available in respect of accessorial liability there are limitations to this course and has limited documented success in this area.

  Noting the policy objectives underlying the Exposure Draft[2] the inclusion of specific wording within the provisions would be a preferable course to strengthen the provisions in terms of their operation and reach. Clarification of the position could be achieved by relatively straightforward textual amendments, for example, changing

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[1] Draft Explanatory Memorandum, *General outline and financial impact* p3
[2] See draft Explanatory Memorandum in Chapter 1, in respect of the general context and objectives, and at para 2.21, in respect of persons to whom the Part may apply.

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the reference "*enters into*" to instead read "***is involved in***", or by the addition of wording reflecting that which is contained in section 181(2). [3]

- **Consideration as to whether the carve out in section 596AB in relation to deeds of company arrangement should also be extended to include schemes of arrangement**

  The exclusion from section 596AB liability for deeds of company arrangement is supported by ARITA, however, consideration should be given to whether a relevant agreement or transaction pursuant to a scheme of arrangement should be similarly excluded. The policy basis underlying the exclusion of DOCAs is similarly applicable to the exclusion also being applied to schemes.

  An additional issue which is noted for consideration in respect of the exclusion is whether it may leave open a risk that the FEG regime could still be abused in circumstances where a company may move from voluntary administration, through a DOCA (which may be used to move or restructure employee entitlements) and then into liquidation. In those circumstances there remains a risk of abuse which necessarily needs to be balanced against the facilitation of genuine restructuring.[4]

- **Support for the expanded parties with standing to bring claims under Part 5.8A pursuant to section 596F**

  Subject to the comments below in relation to section 596AG, ARITA supports the inclusion of new section 596AF to expand the bodies with standing to bring proceedings under the expanded provisions in Part 5.8A to include the Commissioner of Taxation, the Fair Work Ombudsman and the Department of Jobs & Small Business[5] as well as employees of the affected company.

  ARITA also supports the requirements in section 596AF(2) and (3) requiring that a liquidator give consent to such an action being commenced in accordance with section 596AF(1), or that the Court grant leave to proceed taking into account written notice provided to the liquidator.

- **Whether it is necessary to include the restrictions in section 596AG**

  In regard to the inclusion of section 596AG relating to the prevention of proceedings for a contravention of section 596AC(1), ARITA recommends that this provision be removed from the Exposure Draft. Given that there are already provisions in the Exposure Draft which address the potential for multiplicity of proceedings (through the mechanism in section 596AF(2)) there is no need for the inclusion of an additional specific bar pursuant to section 596AG.

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[3] This textual amendment would need to apply to section 596AB(1), section 596AB(1A) and section 596AC(1).
[4] If the risk identified is sufficiently significant to address, then a possible response may be to consider whether the DOCA exclusion provision should only apply to fully effected DOCAs.
[5] As the department responsible for the administration of the *Fair Entitlements Guarantee Act 2012*.

Further, the inclusion of such a bar to the commencement of proceedings is likely to be unduly restrictive when taking into consideration the practical approach used by liquidators in recovery actions. In most instances, a liquidator will commence recovery proceedings for breaches of a number of different provisions within the Act and issues relating to potential double recovery in those instances are adequately addressed by the flexibility provided to the Court in making orders in circumstances where liability is established. If section 596AG were to be inserted into the Act there is a risk that its effect may be to prevent proceedings under sections 596AC being commenced where a liquidator is pursuing his/her statutory recovery actions.

- **Some observations about the examples used in the draft Explanatory Memorandum**

  Finally, in the examples included in the draft Explanatory Memorandum, ARITA has noted that all these examples relate to situations where an insolvent company has transitioned through voluntary administration and then into liquidation, rather than including an example of a standalone liquidation scenario. So as not to create the potential for any unintended restrictions on the interpretation of the amended Part 5.8A, ARITA recommends that the examples be adjusted to illustrate a wider range of circumstances through which the insolvent company could come to be the subject of the winding up.

2.2 Contribution Orders

The proposed inclusion of section 588ZA to provide for contribution orders for a corporate group is a potentially powerful amendment to the Act, the inclusion of which is broadly supported by ARITA.

Although, the list of factors in section 588ZA(4) that may be considered in making a determination of a “contribution order group” should also reference formal GST and income tax grouping arrangements.

Further, the method of calculation for contribution orders proposed in section 588ZA(1)(b) and (2)(a) is problematic.

In relation to the timing for an application pursuant to section 588ZA(1)(b), we note that an adjudication process equivalent or similar to that under the FEG should suffice instead of the formal adjudication of proofs of debt [6].

Feedback from ARITA members has highlighted the potential difficulty the proposed wording of section 588ZA(2)(a) presents to liquidators in terms of the assessment of the value of unpaid employee entitlements and therefore, the potential benefit of making an application pursuant to the provision.

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[6] Noting that the legislative requirements for calling for proofs of debt do not distinguish between priority employee and ordinary unsecured creditors

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The use of wording in the provision based on the concept of "*benefit*" is the basis for the uncertainty and potential difficulties expressed by ARITA members in relation to this provision. In particular, this formulation, based on the concept of "*benefit"* and "arm's length" dealing, is difficult to apply in circumstances where there is a financial loss across a corporate group.

An alternative formulation for the concept in this sub section may be to focus on the unpaid market value of services provided to a corporate group by the employees of the insolvent company for which there is an unpaid entitlements amount. A quantification referable to an objective measure of market value provides a more certain point of reference for the assessment of the value of employees' contribution to a corporate group.

Furthermore, the existing approach would seemingly limit liability by excluding accrued and contingent liabilities (namely for leave and retrenchment costs such as notice and redundancy). The quantification should therefore be referable to simply the unpaid amount of employee entitlements owed by the insolvent entity rather than an unnecessarily complex calculation of services rendered and whether these were provided at market value and/or arm's length terms.

ARITA supports the extension of the bodies with standing to apply for contribution orders under section 588ZA(5) but considers that it would be beneficial to include in that section a mechanism for Liquidator notification and/or consent similar to that which is in place in section 596AF(2) and (3).

We note that any payment under a contribution order is made to the liquidator of the insolvent company for a benefit received by the contributing entity for work done by the employees. Given the compensatory nature of the payment, as opposed to an advance, we suggest that the subrogation rights pursuant to section 560 of the Act should be specifically excluded from the provisions.

It would appear that a payment pursuant to a contribution order would be akin to proceeds received by a liquidator from preference recoveries. In this regard, we note that there have been a series of cases which have recognised the circumstances in which a secured creditor has received proceeds from a liquidator preference action on the basis of subrogation rights.[7] We also refer you to the annexed article titled 'A call for law reform – Secured creditors entitlement to preference recoveries', which highlights this issue. This issue may also arise in relation to the proceeds received from contribution orders.

2.3 Director disqualification provisions

The policy objective of strengthening the director disqualification provisions in the Act are, subject to the general matters noted in section 1 above, strongly supported by ARITA.

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[7] See *Cook v Italiano Family Fruit Company Pty L:td (In Liquidation)* (2010) 276 ALR 349; *Re Damilock Pty Ltd (In Liq)* [2012] FCA 1445; *Divitkos, in the matter of ExDVD Pty Ltd (in liq)* [2014] FCA 696.

However, based on the current wording of the provisions, ARITA maintains a concern that the disqualification provisions may not be fully utilised by ASIC.

An alternative, and in ARITA's view, potentially more effective approach to embedding behavioural change in this area, is for the director disqualification provisions to:

(a) require more than 2 "strikes" to trigger the disqualification; and
(b) subject to some specific adjustments, the ASIC disqualification power must be made automatic in operation.

A regime whereby there is an automatic disqualification of more limited temporal scope, triggered by specific circumstances and administered by ASIC, which is then supported by a more general discretionary power implemented by the Court, is likely to have a more effective deterrent effect and, in the long term, bring about behavioural change in directors' conduct in terms of ensuring proper provision for employee entitlements.

This proposed alternative regime would require some amendments to each of sections 206EAB (Court power) and 206GAA (ASIC power).

<u>Section 206GAA</u>

To give effect to changes to the ASIC disqualification regime the following amendments are suggested:

(a) the disqualification power of ASIC *must* be exercised to "disqualify a person from managing corporations" but only for a period of "up to *5 years*" (i.e. a lesser period than the 10 years presently provided in the Exposure Draft;
(b) the cumulative trigger in section 206GAA(2) must have applied to the person in relation to *3 or more corporations, not including corporations within the same corporate group* (i.e. the trigger should be set higher and where the trigger arises from a corporate group scenario that should only operate as one instance); and
(c) in terms of there being a contravention of the Act[8] this element should be able to be satisfied under section 206GAA if *ASIC has reasonable grounds to believe that there has been* contravention of the Act. For the purposes of reaching this reasonable belief ASIC should be able to have regard to information obtained from its own investigations, or may be able to rely on information received from the company's liquidator, including but not limited to section 533 reports; and
(d) there would then be a shifting onus for ASIC's reasonable belief which a director could disprove with evidence to the contrary in respect of one or more of the 3 instances of application in section 206GAA(1)(a).

ARITA submits that changes to the disqualification provision as outlined would reduce the regulatory burden on ASIC, increase the likelihood of the disqualification being used as it would have an automatic application in very specific instances and, as such, provide a more

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[8] Or the *Corporations (Aboriginal and Torres Strait Islander) Act 2006*.

effective deterrent to the “sharp corporate practices” which are the target of the provisions in the Exposure Draft.

Further, it is our view that this would not have a depressive impact on genuine entrepreneurialism. It is accepted that even with responsible entrepreneurialism, business failure is a potential outcome. If a director respects the need to ensure the payment and provisioning of employment entitlements, as is required for the use of the recent safe harbour protections, then they would not fall foul of the requirements of section 206GAA(2). While other creditors may suffer loss, those creditors are able to make a consenting risk decision which employees are not able to make in relation to the non-payment of their entitlements. Accordingly, we believe our recommendation strikes a responsible balance in protecting the community, workers and fostering a positive culture of appropriate risk taking for entrepreneurs.

Section 206EAB

For the Court power for disqualification to provide consistency, it is suggested that this power should also be amended such that it is triggered by an application of the cumulative trigger in respect *3 or more corporations, not including corporations within the same corporate group* (as above).

The final aspect of these provisions for which ARITA suggests amendment is that the reference to “minimal return” (quantified as “*10 cents in the dollar or less*”) could be adjusted to bring the amounts in line with the reporting obligations placed on liquidators under section 533 of the Act, which requires a report to be provided to ASIC in cases where the recoveries are likely to be 50c in the dollar or less.

While we note that 50c in the dollar is an arbitrary amount, its consistency with section 533 holds merit, and it also represents a simple requirement that directors are able to honour the ‘majority’ of their obligations.

Appendix A - ARITA’s previous submission dated 16 June 2017

ARITA
AUSTRALIAN RESTRUCTURING INSOLVENCY & TURNAROUND ASSOCIATION

16 June 2017

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

Reforms to Address Corporate Misuse of the Fair Entitlements Guarantee Scheme

The Australian Restructuring, Insolvency & Turnaround Association (ARITA) is grateful for the opportunity to provide feedback and comments in relation to the matters raised in the consultation paper considering Reforms to Address Corporate Misuse of the Fair Entitlements Guarantee (FEG) Scheme.

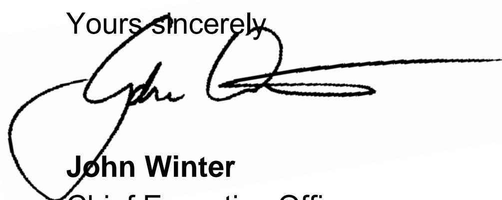
We also take this opportunity to provide comments in relation to other employee related and relevant matters, particularly the need to provide clarity in the law regarding the determination and treatment of priority employee entitlements where you have concurrent appointments (ie a receiver and liquidator appointed at the same time).

Key points

- Consideration should be given to restricting the extent of financial assistance provided by the FEG Scheme, so that the generosity of the scheme dovetails with the National Employment Standards, particularly in respect of redundancy entitlements. This would be more in keeping with the notion of a 'safety net' scheme;
- Wilful sharp corporate practices are unacceptable, however the complexity in applying the law may lead to inadvertent misallocation of proceeds of circulating assets;
- ARITA supports reform to Part 5.8A of the *Corporations Act* to make the provisions more effective as a deterrent to avoiding or preventing the recovery of employee entitlements, whilst not unduly restricting business restructures which may serve the interests of a company's creditors as a whole;

- ARITA supports reforms to improve the accountability of corporate groups for shortfalls in employee entitlements;
- ARITA supports increased action against miscreant company directors and the introduction of a Director Identification Number ('DIN') which will assist such action;
- ARITA supports holistic reform to ensure the ordinary application of Chapter 5 of the *Corporations Act* to the external administration of corporate trustees. We do not support limited amendments that only focus on the issue of the priority of employee entitlements;
- We reject that there is any uncertainty in the right of receivers to recoup as a priority specific costs, and general costs apportioned on a pro-rata basis, from circulating security asset realisations;
- ARITA supports amendments to s 561 which provide clarity on the recovery of remuneration and costs of liquidators; and
- ARITA supports amendments to ss 433, 560 and 561 which reduce the complexity of the interaction and application of these two provisions and allow for the timely resolution of employee entitlement claims by receivers.

Yours sincerely



John Winter
Chief Executive Officer

About ARITA

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We have more than 2,000 members including accountants, lawyers, bankers, credit managers, academics and other professionals with an interest in insolvency and restructuring.

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1 The Fair Entitlements Guarantee scheme

Recommendation 1: Consideration should be given to restricting the extent of financial assistance provided by the FEG Scheme, so that the generosity of the scheme dovetails with the National Employment Standards, particularly in respect of redundancy entitlements. This would be more in keeping with the notion of a 'safety net' scheme.

Since the first government assistance program, the Employee Entitlements Support Scheme (EESS) established in 2000, a moral hazard has existed whereby responsibility for unpaid employee entitlements could be passed on to the tax payers.

We recognise that the FEG scheme, and its predecessor schemes, were established to provide a 'safety net' to employees who suffer financial loss as a result of their employer's insolvency. ARITA supports the existence of such a scheme. However, it is important that the scheme remain viable and we note the increasing cost of the scheme and the minimal amount recovered by way of subrogation.

The stated premise of the Consultation paper – that the 'adoption of sharp corporate practices' has increased the costs of the FEG scheme – appears to overlook the impact of changes in levels of entitlements. For instance, in 2011 the operational arrangements of the predecessor scheme (GEERS) were changed to provide for up to four weeks severance pay for each year of service (based on a capped salary rate). The data provided in the Consultation Paper indicates that this change caused a significant increase in the cost of the scheme.

As a 'safety net' scheme of last resort, we believe that consideration should be given to the extent of financial assistance provided by the FEG scheme and whether the coverage provided should be limited to those entitlements covered by – and to the same extent as - the National Employment Standards (NES). Such limitation would ensure employees are covered for nationally recognised minimum entitlements and remove the incentive for negotiating higher redundancy entitlements through workplace negotiation (as referred to in the Consultation paper at page 2).

This issue is specifically pertinent to redundancy entitlements. Put simply, we consider that the FEG scheme is too generous in guaranteeing up to four weeks' pay for each full year of service for which the employee's 'governing instrument' (eg, employment contract) provides. The NES provide for a minimum amount of redundancy pay which could be as much as (but not more than) 16 weeks, depending on length of service.

The fact the FEG scheme guarantees redundancy entitlements up to an amount which is significantly greater than the minimum entitlement afforded by employment law is anomalous for a 'safety net' scheme. We note the introduction of the Fair Entitlements Guarantee Amendment Bill 2014 – which lapsed in 2016 - that purported to reinstate the previous 16-week cap on redundancy payments made under the scheme. The stated intention of the Bill at the time was to 'secure the financial sustainability of the scheme' and 'address the moral

hazard that overly generous redundancy entitlements create'.[1] ARITA believes that serious consideration should be given to revisiting this approach, including in respect of entitlements other than redundancy.

If the generosity of the FEG scheme was better balanced, entitlements over and above the NES limits would remain priority entitlements in the liquidation or bankruptcy should sufficient funds become available. This should be considered in conjunction with the reforms to improve recoveries for payments of employee entitlements discussed below.

2 Sharp corporate practices

Recommendation 2: Wilful sharp corporate practices are unacceptable, however the complexity in applying the law may lead to inadvertent misallocation of proceeds of circulating assets

The consultation paper contemplates some broad examples of sharp corporate practices which can significantly impede, reduce or prevent, the recovery of FEG payments through the insolvency process. Again, at the outset, we would repeat our observations in Section 1 above that the data does not support the contention that 'sharp corporate practices' are responsible for the significant increase in cost of the FEG scheme.

ARITA does not support any practice which wilfully seeks to prevent, avoid or reduce obligations of a company to pay its creditors (including employees for their entitlements). This includes the example provided of 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).'

The Consultation paper also refers to the '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' as an example of sharp corporate practices.

While we would acknowledge, and censure, any such wilful practices, we submit that the law regarding the calculation and payment of entitlements and the allocation of proceeds of circulating assets is not straightforward to apply in some instances, for example, where receivership and liquidation exist concurrently. Factually complex issues can arise in practically applying the law.

Indeed, interpretation of the law in this area has been the subject of healthy debate between ARITA and the FEG teams in trying to divine correct application. Further, we would question how widespread such a practice is and, even where it has occurred, if receivers and

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[1] Fair Entitlements Guarantee Bill 2014, Second Reading Speech, 1 October 2014 (Sen Michaelia Cash).

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liquidators have been working toward a genuine best outcome or goal for the FEG scheme as a whole and with the intention of preserving employment (eg, via a sale of ongoing business). Further, instances of settlements reached with receivers in specific cases are not necessarily evidence of the practice referred to and may instead reflect the commerciality and practicalities of revisiting matters which have been finalised some time ago.

The issues regarding the ambiguity and complexity in the interaction of ss 433 and 561 of the *Corporations Act* are addressed in detail in section 6 below.

As a general comment, we agree with the observations made by the Law Council of Australia in its submission that laws and remedies already exist to address some of the types of sharp corporate practices mentioned at [3.4] of the Consultation Paper (eg, illegal phoenix activity). We also agree that more specific details or scenarios of the other sharp corporate practices referred to would be helpful in considering specific reforms to address practices or techniques which the Consultation paper itself states are 'not always strictly illegal'.

The need for specific details is particularly pertinent to the examples of 'business restructuring' referred to in the Consultation paper. Business restructuring scenarios can involve complex affairs and issues, and tensions can arise between the interests of specific stakeholders and the interests of a company and its creditors as a whole. As mentioned below, we consider it is important that the reforms being considered do not unduly restrict business restructurings which can preserve business and jobs.

3 Reform to Part 5.8A of the Corporations Act

Recommendation 3: ARITA supports reform to Part 5.8A of the *Corporations Act* to make the provisions more effective as a deterrent to avoiding or preventing the recovery of employee entitlements.

We note that Part 5.8A of the *Corporations Act* was introduced to provide protection from agreements and transactions entered into with the intention of avoiding employee entitlements or preventing their recovery. However, there appears to be a consensus view that these provisions have proven to be ineffective.

ARITA supports the amendment of section 596AB to enable a more effective application of the provision, including the introduction of objective tests (in lieu of subjective tests) and more active pursuit of director misconduct by the Australian Securities and Investments Commission (ASIC).

It is noted that by their nature, the majority of administrations involving FEG scheme claims have little or no assets. A lack of available funds will mean that an appointee's ability to pursue civil action under Part 5.8A will be constrained regardless of any reforms, unless they are assisted by creditors or an external funder.

We acknowledge and support the Department of Employment's commitment to providing assistance for recovery actions by appointees.

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3.1 Test based on objective assessment of the agreement or transaction

With respect to Option 2, we note that Courts currently enjoy powers under the *Fair Work Act* which can render directors subject to a penalty and/or compensation order where they are knowingly concerned in a company's contravention of a civil remedy provision of the *Fair Work Act* (a failure to pay redundancy entitlements under a collective employment agreement is an example of such a civil remedy provision: see *Automotive, Food, Metals, Engineering, Printing and Kindred Industries Union v Benyon* [2013] FCA 390). Therefore, the necessary powers and remedies against directors – in the nature of a civil penalty provision - may already exist without the need for change.

We also note that the suggested reforms in option 2B would provide a similar test to that already applied in uncommercial transaction recoveries pursuant to s 588FB of the Act. However, we have concerns that such a test may be vulnerable to an argument that having FEG meet outstanding employee entitlements was to the 'benefit' of the company or its creditors as a whole. Any such 'corporate benefit' test should be carefully considered in terms of how it aligns with the objective of the FEG scheme as a scheme of last resort.

As pointed out in the Consultation paper, not all transactions or restructurings may strictly be unlawful simply because the FEG is left to respond to outstanding unpaid employee entitlements. For example, the restructure may have resulted in the majority of employees having retained their positions in the restructured business, resulting in less employee entitlement claims than if the company had proceeded into liquidation.

There is an inherent tension in proposing reforms which will minimise the impact of a transaction on one priority creditor (or class thereof) whilst not unduly restricting restructures which may serve the interests of a company's creditors as a whole.

3.2 Expand the parties who may initiate civil action

While we have no particular views on the various reform options considered in the consultation paper, we note that 'Option 3' includes the suggestion that section 596AC be amended to enable the Department of Employment to bring an action for a suspected breach where FEG has been paid.

As noted in the consultation paper, currently the liquidator of a company and former employees of the company in certain circumstances, have standing to bring civil actions under section 596AC.

Section 560 which gives FEG subrogated rights where advances are made for priority payments for employee entitlements provides that:

> "(c) the person by whom the money was advanced has the same rights under this Chapter as a creditor of the company."

On this basis, we query whether the Department already has the right to pursue civil action under the existing provisions.

3.3 Alternative approaches

The consultation paper seeks alternative approaches that produce a genuine protection against the avoidance, prevention or reduction of payment of employee entitlements.

Without wanting to overstate the potential impact, some protection could be achieved by bringing the accrual of certain employee entitlements within the concept of a ‘debt incurred’ for the purposes of insolvent trading under s 588G of the Act. Presently, wages and other entitlements which accrue in the last few months of a company’s trading may be held to have been ‘incurred’ years earlier when the underlying employment contracts were entered into: *McEvoy v Incat Tasmania Pty Ltd* [2003] FCA 810. It appears anomalous that directors who would otherwise be liable for insolvent trading for ‘debts incurred’ during the period just prior to liquidation are not equally answerable for these types of accrued entitlements.

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

Recommendation 4: ARITA supports reforms to improve the accountability of corporate groups for shortfalls in employee entitlements.

4.1 Corporate groups to provide a contribution equivalent to any unpaid employee entitlement in some limited circumstances

ARITA supports reforms which would see corporate groups more accountable for any shortfall in employee entitlements where companies within the group obtain an economic benefit from employees employed by an individual entity within the group. That said, great care needs to be exercised when considering the imposition of one company’s liabilities upon another.

We note that such accountability should extend to any shortfall in employee entitlements, not just instances where the FEG scheme has been relied on and not just to the extent of any FEG advance. It would be unreasonable that priority creditors that rank equally with amounts advanced by FEG – eg, superannuation, superannuation guarantee charge and claims in excess of FEG thresholds - would be excluded from such a compensation remedy.

For clarity and consistency, we would also suggest that any such contribution or compensation should be payable to the company in liquidation, to be distributed by the liquidator according to the usual winding up provisions of the Corporations Act. We are not

supportive of the legislative introduction of new, standalone priority claims beyond those which already exist in established provisions such as ss 433, 556 and 561.

Naturally, the effectiveness of any such reform will be limited in circumstances where the whole corporate group is placed into external administration.

We agree with the Law Council's submission that consideration be given to the approach in Victorian state legislation whereby joint and several liability is imposed upon related entities in a corporate group for taxes and charges relating to employees. We concur with the potential benefits of such an approach, as explained in the Law Council's submission.

We note the suggestion that, as an alternative to an employee entitlements-specific contribution order, the current pooling of assets provisions (in Division 8 of the *Corporations Act*) could be modified to achieve a similar result. We would suggest that any proposed regime for the pooling of solvent group entities with insolvent group entities would need to be carefully considered and calibrated, given the obvious potential detriment to creditors of the solvent entities.

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

Recommendation 5: ARITA supports increased action against miscreant company directors and the introduction of a Director Identification Number ('DIN') which will assist such action.

ARITA has long advocated increased action by ASIC regarding director misconduct.

We note the consultation paper states that "in the FEG and GEERS cases involving 1300 directors, an examination of creditor reports and other documents revealed there were claims of potential breaches of the law present in a substantial percentage of the cases, in addition to the non-payment of employee entitlements and the non-payment of superannuation." We query if any further analysis has been undertaken to determine how many of the potential breaches of the law were reported to ASIC and in how many cases did ASIC take further action against the directors. Based on statistics reported by ASIC, we would think that most, if not all, of these potential breaches were reported to ASIC by liquidators in their s 533 reports, but few to none were actioned by ASIC.

Director misconduct extends beyond the misuse of the FEG scheme and includes a general failure by directors to meet their statutory obligations, such as providing a Report as to Affairs and delivering books and records to liquidators. In this regard we commend to you the 'Phoenix Activity: Recommendations on Detection, Disruption and Enforcement' report issued by Melbourne Law School and Monash Business School in February 2017. The report is part of ongoing research into fraudulent phoenix activity.

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As reported, failure to comply with these basic statutory obligations is done to conceal poor corporate behaviour, which may include sharp corporate practices leading to the reliance on FEG. Any amendments aimed at deterring such practices need to consider and successfully address these wider issues.

5.1 Specific FEG sanction for directors in Part 2D.6

We welcome increased deterrents against director misconduct, however we note that any reforms, including the proposed specific FEG sanctions for directors, would be ineffective without the ability to track information against directors accurately.

ARITA has long been an advocate of the implementation of a director identity number (DIN) to enable consistent identification of directors across various companies, as recommended in the Phoenix Activity Report referred to above (the DIN proposal having originated from the authors of that report). The implementation of a DIN will protect against fictitious directors and protect legitimate directors from having their identities misappropriated.

We note that the introduction of a DIN has significant support, including that of a number of shadow ministers and the current Federal Opposition.

More specifically in relation to the proposed reforms at 'Option 6' we query why the specific FEG sanction should be dependent on other contraventions of the *Corporations Act* or other laws as a prerequisite. We suggest that if a director has relied on the FEG scheme two or more times to pay employee entitlements then this should be sufficient to enable their disqualification by ASIC for a period of time. We do however, suggest that this could be moderated by a time frame being specified (ie reliance on the FEG scheme twice within a five-year period) and failure of a corporate group should only count for one reliance on the scheme.

6 Other related reforms

Recommendation 6(a): ARITA supports holistic reform to ensure the ordinary application of Chapter 5 of the *Corporations Act* to the external administration of corporate trustees. We do not support limited amendments that only focus on the issue of the priority of employee entitlements.

Recommendation 6(b): We reject that there is any uncertainty in the right of receivers to recoup as a priority specific costs, and general costs apportioned on a pro-rata basis, from circulating security asset realisations.

Recommendation 6(c): ARITA supports amendments to s 561 which provide clarity on the recovery of remuneration and costs of liquidators.

Recommendation 6(d): ARITA supports amendments to ss 433, 560 and 561 which reduce the complexity of the interaction and application of these two provisions and allow for the timely resolution of employee entitlement claims by receivers.

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6.1 Reform the law regarding the application of Chapter 5 of the Corporations Act where an insolvent company is a corporate trustee (Option 7)

We note recent decisions of the NSW Supreme Court in *In the matter of Independent Contractor Services (Aust) Pty Limited ACN 119 186 971 (in liquidation) (No 2)* [2016] NSWSC 106 (*Re ICS*) and the Federal Court in *Woodgate, in the matter of Bell Hire Services Pty Ltd (in liquidation)* [2016] FCA 1583 which impact on the priority of employee entitlements where the employee was employed via a trust.

More recently, the decision of the Supreme Court of Victoria in *Re Amerind* [2017] VSC 127 (*Re Amerind*) has applied the approach of Brereton J in *Re ICS* to deny the ordinary application of key provisions of the Chapter 5 of the Corporations Act to corporate trustee property. The recent decision in *Re Western Port Holdings Pty Ltd* [2017] VSC 280 also demonstrates that these issues afflict deeds of company arrangement as well as receiverships and liquidations.

Ordinarily, in the event of the liquidation of a company, employee entitlements are given a priority over and above ordinary trade creditors. Paradoxically, in recent decisions some courts have determined that if the business is traded and employed through a trust then all creditors rank equally when it comes to a distribution of the available funds.

As an example, if a butcher traded through an ordinary company structure, employee entitlements owing to an apprentice would be paid in priority to the debts owing to the butcher's meat supplier. If the same business was instead traded through a trust structure, the apprentice and the meat supplier would rank equally. Where there are insufficient funds available to pay all outstanding amounts, this reduces the amount of outstanding entitlements that the employee would receive.

In addition to the specific employee entitlement issues noted above, we have previously raised in other forums concerns regarding how trusts are dealt with generally in external administrations. The intersection of the law pertaining to corporate trading trusts and Chapter 5 of the Act continues to have a detrimental effect on the cost and efficiency of winding up corporate trustees. There are a variety of issues afflicting corporate trading trusts which warrant legislative attention. These issues affect all stakeholders, particularly priority creditors such as employees (and, by subrogation, the Commonwealth via the FEG scheme), due to increased costs in undertaking these administrations.

Some of the key issues are:

- the effect of 'ejection clauses' in trust instruments which automatically remove a corporate trustee in the event of a winding up or other external administration

appointment. The operation of such clauses casts doubt upon the power of sale of a liquidator appointed to a company which has been removed as trustee.[2]

Trust deeds may contain provision for automatic removal of (or right to replace) a trustee upon an insolvency event such as the commencement of a winding up. The new trustee's right to the trust assets will conflict with the right of the 'old' corporate trustee (in external administration) to assert a charge over the trust assets to secure its right of indemnity in relation to debts incurred in the proper administration of the trust (that right of indemnity and charge is of value to creditors in a winding up). There is conflicting authority among states as to whether the interest of the outgoing trustee takes priority over the right to possession of the new trustee.[3]

- The effectiveness of the liquidator's statutory power of sale under s 477 of the Act where a liquidator is appointed to a company which is a trustee. In some cases, this problem has necessitated an application to court for appointment of the same insolvency practitioner as receiver. In our view, this is an unnecessary cost befalling numerous external administrations and could be avoided by simple legislative amendment.

The 1988 Harmer Report recommended that:

- The insolvency provisions of the Act be amended to make clear that any reference to the business or affairs of the company is taken to include its capacity as trustee;

- The provisions in the Act relating to winding up insolvent companies be amended so that any reference to property or assets of a company shall include property or assets held as trustee, to the extent of any right of indemnity held by the company as trustee;

- Limits on clauses in trust instruments which automatically remove, or provide power to remove, a company as trustee upon an external administration. The Report noted that 'the operation of such a provision may lead to conflict between the liquidator and the new trustee and impair the efficient winding up of the affairs of the company, resulting in additional expense and delay.' The Harmer Report recommended that if a corporate trustee was subject to a winding up application, 'any provision in the trust instrument allowing for the removal of the company as trustee or the exercise of any power that allows for the removal of the company as trustee shall have no effect.' The Harmer Report's recommendation was that such limitation be subject to existing court powers to remove trustees.

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[2] See D'Angelo N, 'Trustee "ejection clauses": consequences for liquidators, receivers and creditors', (2016) 17(6) *Insolvency Law Bulletin* 96.
[3] See Hannan N, 'Liquidators dealing with trust assets', (2015) *Insolvency Law Bulletin* 7, citing *Re Suco Gold Pty Ltd (in liq)* (1983) 33 SASR 99 and *Lemery Holdings Pty Ltd v Reliance Financial Services Pty Ltd* (2008) 74 NSWLR 550.

ARITA endorses and renews the observation of the Harmer Report that 'the administration of a corporate trustee will be more efficient if the … [external administrator] is able to take complete control of trust assets and if there are limits on the power to remove the company as trustee.'

- Legislation regarding the winding up of corporate trustees 'should, so far as relevant, also be made applicable to the situation of a company under administration.'

The cost-effectiveness and efficiency of external administrations will be improved to the benefit of all stakeholders (including the Commonwealth as a subrogated creditor) if key aspects of the Harmer Report's agenda for legislative reform of insolvent corporate trading trusts - laid out almost 30 years ago – are revisited and adopted in principle.

Focusing on only one aspect of the current issues with trusts, being that of the priority of employee entitlements, is short-sighted and will not go far enough.

6.2 Priority of employee entitlements under sections 433 and 561 of the Corporations Act (Option 8)

We note the stated 'Option 8' at [8.2] of the consultation paper that '[s]ections 433 and 561 of the Corporations Act could be amended to align with their policy objectives, which are that certain employee entitlements be paid ahead of the claims of the circulating security interest holder, and that the general costs of the receiver or liquidator do not have priority over either of these claims.'

ARITA queries the premise of the statement in the related footnote (no.59) that general costs are 'costs other than those incurred associated with the realisation of the relevant assets', at least as far as receivership is concerned.

As explained below in the different contexts of receivership and liquidation, if insolvency practitioners' remuneration and expenses cannot be recovered as a priority out of circulating assets – but instead are subordinated to employees – the outcome will be that:

- No insolvency practitioner will be prepared to accept an appointment in some matters; and
- Viable or potentially viable businesses will have to be shut down with the consequence of job losses (which in turn would, ironically, place further burden on the FEG scheme).

6.2.1 Receivership and s 433

By the very nature of a receivership appointment, a receiver's tasks are focused on the realisation of the assets that are the subject of their appointment. Therefore, the 'general costs' of a receiver or receiver and manager are associated with the realisation of any circulating assets which might fall within the scope of the appointment. Some receivership costs will be specifically identifiable and attributable to a particular asset or class of assets (eg, agent's fees to conduct an auction or receiver's remuneration associated with the

recovery of debtors) while other costs have a general nexus or association with all assets to which the receiver has been appointed (eg, broad-cover insurance or rent paid for leased premises from which a business is traded on or the receiver's remuneration associated with the sale of the business as a going concern that includes both circulating and non-circulating assets).

This distinction is the basis for the long-accepted practice – sustained by long-standing authority - of apportioning costs of a receiver on the basis of attributing, so far as is possible, specific costs to the asset class to which they relate to, while apportioning general costs on a pro-rata basis between circulating and non-circulating assets. This treatment is consistent with the decision in *Waters v Widdows* [1984] VR 503. Some costs simply cannot be attributed to one specific asset or asset class, and so they must be attributed on a pro rata basis. Nonetheless, they remain legitimate and real costs of the realisation process which is innate to a receivership.

Consistent with the established position at law, we consider 'general costs' in a receivership to be legitimate costs which should continue to be paid in priority to both security holder and employees (to the extent that s 433 is relevant). Of course, this is also consistent with the contractual arrangements between a receiver and the appointor, which s 433 itself acknowledges by providing that employees receive the priority ahead of 'any claim for principal or interest in respect of the debentures' (ie, after the receiver's remuneration and costs).

The importance of the priority recovery of receivership costs – specific or general – out of circulating assets is brought into even sharper focus when one considers the situation where only circulating assets exist or fall within the scope of a receiver's appointment. Any legislative amendment which might postpone recovery of the receiver's 'general costs' out of circulating assets – ie, to rank behind employee entitlements – could leave the receiver personally out of pocket and/or unremunerated for work properly performed. This would in turn compromise the contractual right and remedy of a secured lender to appoint a receiver.

As was stated by the judge in *Waters v Widdows* over 30 years ago (Nicholson J):

> 'It would, in my opinion, produce a curious result if the receiver's costs, expenses and fees were to rank subsequent to the employees' claims ... Presumably, and in many cases, but for the incurring of these expenses the employees would have difficulty in recovering anything at all from the company.'

If a receiver's costs cannot be allocated to circulating assets, it begs the obvious question: who does pay for these costs?

For these reasons, ARITA objects to any proposed legislative amendment which purports to postpone or subordinate the long-standing priority of the general costs of a receivership.

We note ASIC's Information Sheet 54 '*Receivership: a guide for creditors*' reflects the established position by stating that:

> 'If the receiver is appointed under a security comprising both fixed and floating charges, which is common, there will be costs and fees of the receivership that cannot be directly allocated to realising the fixed or floating charge assets. These costs are allocated in proportion to the fixed and floating realisation amounts.'

Indeed, we would state that there is in fact no 'uncertainty' surrounding these issues as suggested by the consultation paper. In the recent case of *Re Amerind* at [482] - [487] it appears that the principles in *Waters v Widdows* were accepted and considered uncontroversial by the Supreme Court judge. While that case did address the ongoing issues regarding the application of s 433 to trust property, the question of the apportionment of costs of producing the s 433 fund appeared to be an uncontroversial aspect of the decision.

In *Re Amerind* the Court appeared to accept the threshold proposition that 'general costs' are real costs of a receivership and therefore attract priority. The apportionment exercise may be practically complex in certain receiverships - depending on the circumstances of any given case - but the long-standing legal principles and authorities are clear and consistent.

6.2.2 Liquidation and s 561

Presently, s 561 applies to provide certain employee entitlements a priority over the secured creditor out of circulating assets if the company's 'free' (unencumbered) assets are insufficient to meet those specified employee claims.

It is clear any claim against circulating assets under s 561 is determined after application of the company's 'free assets' in the order set down in the priority waterfall in s 556: *Cook (Liquidator), in the matter of Italiano Family Fruit Company Pty Ltd (in liq) v Italiano Family Fruit Company Pty Ltd (in liq)* [2010] FCA 1355 (*Re Italiano*).

In respect of the s 561 fund, the present law, largely based on the principle in *Re Universal Distributing Co Ltd (in liq)* (1933) 48 CLR 171, allows a liquidator to recover, as a priority, remuneration and expenses incurred in caring for, preserving or realising security property, including 'expenses attendant upon realisation of the assets' and remuneration for 'work done in connection with creating the fund'.[4] Such costs would also include those incurred by a liquidator in assessing, identifying and paying the claims to which priority is afforded by s 561, given that this would be a necessary step in confirming the entitlements to distribution of the fund which has been realised.

The UK House of Lords decision in *Buchler v Talbot* [2004] UKHL 9 expressly supported this approach: the House of Lords stated that 'if there are no uncharged assets and the liquidator reasonably incurs costs and expenses in identifying preferential creditors and paying them pursuant to the statutory obligation: those administrative costs and expenses … will be payable ahead of the debenture holder, just as much as they would be if the debenture

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[4] *IMF (Australia) Ltd v Meadow Springs Fairway Resort Ltd* (2009) 27 ACLC 46 at [64] and *Stewart v Atco Controls Pty Ltd (in liq)* (2014) 252 CLR 307 at [40]-[41].

holder himself, or a receiver appointed by him, had incurred costs and expenses in discharging this statutory duty.'[5]

While this much is clear on the current weight of authority, these ordinary priority costs of producing a fund could be expressly mentioned in an amended s 561, for the benefit of clarity. Express legislative provision for uncontroversial priority costs – ie, liquidator remuneration and expenses associated with the realisation of assets, the creation of the 's 561 fund' and assessing, identifying and paying the claims against that fund - would make the position clearer and remove the need for liquidators to revert to general law and equitable liens to establish their entitlement to recover these costs.

As regards liquidators' 'general costs' – for example, administration of the company or general liquidation work and duties such as minimum investigations – it appears that the *Re Universal Distributing* principle will not entitle liquidators to a priority claim for such remuneration and costs: *Re S & D International Pty Ltd* [2009] VSC 225. We understand there are competing views on the proper construction of s 561 as to whether the provision provides for a priority for 'general' liquidation remuneration and expenses and, as far as we are aware, there is no clear Australian authority on point.

In the United Kingdom, following the House of Lords decision in *Buchler v Talbot*, there was a legislative amendment - in the form of new s 176ZA of the *Insolvency Act 1986* - to ensure that liquidators could recover general liquidation costs out of circulating security assets. The rationale for this legislative intervention has been explained in terms that 'costs and expenses of winding up have always carried a high priority such that it was perceived by the UK legislature to be incongruous that any curtailing of the security holder's rights did not also extend to such a high ranking priority as the costs and expenses of winding up.'[6]

The UK developments on this issue raise the question whether s 561 of our Australian statute should be similarly amended along the lines of the UK position and approach.

6.2.3 Concurrent receivership and liquidation: ss 433 *and* 561

There is a great deal of uncertainty and complexity associated with the interaction of ss 433 and 561 when receivership and liquidation exist concurrently. As Finkelstein J observed in *Re Italiano* 5, '[a]lthough the sections are "complementary", there is a disconformity in the way that they operate.' Section 561 applies if a company is being wound up regardless of whether s 433 already applies because of a pre-existing receivership.

The key difference between the two provisions is that s 433 is not conditional upon the 'free assets' of the company being insufficient to meet the priority debts. Section 561 on the other hand, only applies when it is clear the winding up will not realise enough unencumbered

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[5] *Buchler v Talbot* [2004] UKHL 9 at [19].

[6] BRI Ferrier 'Insights' article*, Under section 561 Corporations Act is the liquidator able to claim priority for remuneration, costs and expenses ahead of employee entitlements?* (7 February 2017), available at http://briferrier.com.au/news/under-section-561-corporations-act-is-the-liquidator-able-to-claim-priority-for-remuneration-costs-a.

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assets to meet the priority claims.[7] As Finkelstein J stated in *Re Italiano*, this different operation is logical in the sense that a receiver may not know the 'free asset' position vis a vis priority claims. To this extent, complete 'alignment' of ss 433 and 561 may not be possible or desirable.

However, there are very real challenges of legislative complexity and process for insolvency practitioners in ensuring compliance with both provisions where a receivership and liquidation are running concurrently. This was demonstrated in the case of *Saker, in the matter of Great Southern Limited* [2014] FCA 771 where receivers firstly applied to Court for directions on how to ensure their compliance with s 561. Subsequently – after the receivers had paid over funds earmarked for s 561 purposes and retired – the liquidators then had to apply to Court for directions in respect of their obligations in relation to the funds which had been remitted by the receivers. The specific difficulty in that case was that provision had been made for priority claims – via funds remitted by the receivers to the liquidators – but such provision was 'insufficient once the costs of the liquidation are first paid, as the legislation dictates'. The orders obtained by the liquidators - approving their application of the remitted funds in accordance with s 556 - were made subject to satisfaction that s 561 had been complied with.

Another specific example of the complexity in the interaction of ss 433 and 561 is the application of s 558 which will deem accrued leave to be 'due' when a liquidation has commenced. If there is a receivership and no winding up has commenced, the deeming provisions of s 558 do not apply and accrued leave will not be considered 'due' for the purposes of ss 433 and 556(1)(g). However, if a receiver is appointed and then the company is wound up, those entitlements will then become 'due' for the purposes of ss 556 and 561, but not in relation to s433. This means that the receiver has a direct obligation under s433 to meet certain entitlements, including leave entitlements that are due, and the subsequently appointed liquidator has obligations to make an assessment under s 561 regarding certain entitlements, but now those entitlements also include leave entitlements that are accrued.

To complicate this even further, the receiver will not know how much needs to be contributed under s561 until the liquidator has realised and applied any free assets, which can include litigation of recoverable transactions that may take many years. If the Receiver has completed their administration, they will be wanting to resign but arguably will be unable to do so due to the potential pending claim under s561. This is inefficient and again increases the costs associated with these administrations.

Furthermore, a receiver cannot make payments to employees unless statutorily required under s433 as it would put the secured creditor's right of recoupment at risk. Payments directly to employees are not able to be subrogated under s 560[8] (except where made by the Commonwealth under the FEG Scheme[9]), and the secured creditor's equitable right of

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[7] See *Re Italiano Family Fruit* at [73] - [78] per Finkelstein J.
[8] *Dalma No 1 Pty Limited (in liquidation)* [2013] NSWSC 1335.
[9] Section 29 *Fair Entitlements Guarantee Act 2012*.

recoupment is limited to payments required under law (thus s433 payments or where a call is made by the liquidator under s561)[10].

This problem may be resolved by granting a secured creditor a right of subrogation under s 560 where the payment is made by a receiver directly to employees, in the same way that that the Commonwealth currently enjoys.

The essential point is that the tasks required of insolvency practitioners to ensure compliance with the two provisions are complicated and onerous, due to both the terms of the provisions and the differing aspects and features of receiverships and liquidations.

To help educate and guide our members and the profession on this complicated area, ARITA has developed detailed training and guidance which summarises the interaction of ss 433 and 561 of the *Corporations Act*. The tables are attached (Annexure A: Employee Entitlements in Receivership – Single and Concurrent Appointments & Annexure B: Employee Entitlements in Liquidation – Single and Concurrent Appointments) for your reference and are useful when considering why there is a need to clarify these requirements.

Indeed, the necessity for such detailed educational material is testament to the unacceptable state of the law and its complexity on these issues.

[10] *Divitkos, in the matter of ExDVD Pty Ltd (in liq)* [2014] FCA 696.

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Appendix A: Table of Employee Entitlements in Receivership - Single and Co-current appointments

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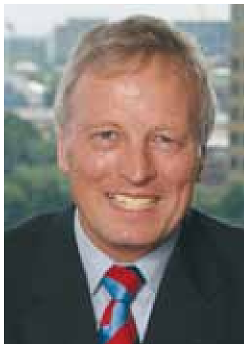
Appendix B: Table of Employee Entitlements in Liquidation - Single and Co-current appointments

CONFIDENTIAL (REDACTED)

Appendix B - Watson, N "A call for law reform" (2011) Vol 23(1) Aust IJ 20



Nigel Watson
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A call for law reform

Secured creditors entitlement to preference recoveries

Overview

His Honour Justice Finkelstein has found that a secured creditor is entitled to proceeds of preference recoveries. This finding was based on a right of subrogation to priority claims which had been paid from floating charge assets. In the course of the judgment, his Honour was critical of the *'uncertain and, perhaps, unsound rules and distinctions'* on which the current commonly held view that secured creditors cannot share preference recoveries is based. His Honour also adopted an interpretation of s 561 of the *Corporations Act 2001* (Cth) (**Corporations Act**) which is a challenge to current practice and will defer payments to priority creditors.

Introduction

It is a commonly held view that the proceeds of preference recoveries are not available to secured creditors but are only available to meet the costs of the liquidation and for distribution to unsecured creditors.

Justice Finkelstein considered this view in relation to the *Italiano Family Fruit Company Pty Limited (In Liquidation)* (***Italiano***).[1]

In this article I discuss that case, his Honour's call for law reform and the uncertain lessons for controllers.

The facts

Voluntary administrators were appointed to *Italiano Family Fruit Company Pty Limited (In Liquidation)* (**Company**) and, in due course, the Company's creditors appointed them as liquidators.

There were a number of fixed charges. The fixed charge assets were realised and the proceeds repatriated to the chargeholders. The National Australia Bank (**NAB**) also held a fixed and floating charge over the Company, which it had not sought to enforce.

Following repatriation of the proceeds of the realisation of fixed charge assets, there was still a significant shortfall owing to NAB and a number of employee creditors entitled to priority under paras 556(1)(e), (g) or (h) of the Corporations Act.

The liquidators with the approval of NAB realised the assets that were the subject of the Bank's floating charge.

The liquidators considered that it was their professional obligation to pay the employee claims at the earliest opportunity and proceeded to do so from the realisation of the floating charge assets. The liquidators did not inform NAB of their intention to pay the employees as they assumed that creditors such as banks are aware that preferential creditors rank ahead of distributions of recoveries under floating charge assets.

Approximately one year later, the liquidators were successful in recovering some unfair preferences from former creditors of the Company.

The issue

The liquidators raised for directions the issue of whether NAB is to rank *pari passu* with the ordinary unsecured creditors in relation to the distribution of the preference recoveries or, whether it has a higher claim to those recoveries which will prevail over the claims of ordinary unsecured creditors.

1 *In the Matter of Italiano Family Fruit Company Pty Limited (In Liquidation) ACN 107 879 096 [2010] FCA 1355*

Does a charge capture preference recoveries?

His Honour noted the generally accepted position that recoveries in preference actions which can only be brought by a liquidator are not caught by a charge over the Company's current and future assets.

The basis for this acceptance seems to be that because the chargee cannot sue to recover the preference, it is not entitled to benefit from the liquidator's ability to bring that claim.

His Honour then investigated this acceptance.

The key Australian authority is the High Court decision in *Kratzmann v Tucker* (**Kratzmann**).[2] The High Court observed that while money preferentially paid was subject to the charge at the time of payment, the money recovered by the liquidator is not the same money because the statute does not revest the money in the company – it requires the creditor to pay the liquidator an amount equal to the value of the preference.

His Honour then analysed the uncertainties and unintended results which arose from strictly applying such analysis. For example:

- it is accepted that the liquidator has power to *'sell'* the proceeds of preference claims but, if the proceeds of those claims are not the property of the company, then they could not be sold;
- if a liquidator is only entitled to recover his costs and expenses out of the company's assets or property then, if preference actions are not the property of the company, the liquidator is not entitled to recover his costs out of those recoveries.

Obviously it would appear that notwithstanding the accepted basis upon which secured creditors are not entitled to the benefit of preference recoveries, the Australian position in fact accepts that the preference recoveries are the property of the company.

His Honour then considered the 1992 amendments to the then Corporations Law and noted that s 588FF which enables the Court to make remediable orders in respect of *'voidable transactions'*, allows the Court to order a person who has benefited from such a transaction to make payment or to transfer property *'to the company'*. This section therefore no longer refers to the transaction being *'void as against the liquidator'*. This changed wording may have the unintended consequence of overturning *Kratzmann* but at the time of the amendment and before that, the Harmer Report did not make any suggestion that *Kratzmann* should be overturned.

Following an extensive analysis of the Australian and English cases and a number of relevant articles and relevant arguments, his Honour concluded (at paragraph 62):

> The present position rests on uncertain and, perhaps, unsound rules and distinctions … What is required is a careful consideration of the true role of the avoidance provisions, and, for the purpose of deciding who should benefit from them, an analysis of the competing interests of secured and unsecured creditors as well as an analysis of the liquidator's ability to seek protection for his/her costs and expenses. As the cases show these are difficult issues not easily solved. The High Court hinted … that it may reconsider *Kratzmann*. If the High Court does not do so, Parliament should resolve this matter. In any event, it is preferably for Parliament to do so, because in no small measure, questions of policy rather than legal principle are involved.

Subrogation

Justice Finkelstein then considered whether or not NAB could be subrogated to the employees' priority claims which were paid out of the floating charge assets at a time the liquidators believed the property of the Company was insufficient to meet those claims.

His Honour noted that the only circumstances under which employees are to be paid out of floating charge assets is pursuant to ss 561 and 433 of the Corporations Act. Section 561 states that:

> So far as the property of the company available for payment of creditors other than secured creditors is insufficient to meet payment of:
>
> (a) any debt referred to in paragraph 556(1)(e), (g) or (h);
>
> …
>
> Payment of that debt … must be paid in priority over the claims of a chargee in relation to a floating charge …

Section 433 applies a similar principle in circumstances where a controller is appointed and a winding up has not commenced.

His Honour expresses the view that s 561 only mandates payment of priority claims when it is clear that the liquidator will not realise free assets sufficient to meet these claims. Significantly, he comments (at paragraph 70):

> In my view, there is to be 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. That is to say, the liquidator should not, as has occurred here, make an interim assessment of the company's financial position, an assessment which only looks at the position at a single point in time.

It therefore follows that the controller must withhold funds from the secured creditor that are sufficient to pay the priority creditors but, should not actually pay those priority creditors until the controller is able to make *'only one assessment of the sufficiency'* of the company's assets.

2 *N A Kratzmann Pty Ltd (In Liq) v Tucker (No 2) (1968) 123 CLR 295l*

Justice Finkelstein observed (at paragraph 100)that his view of s 561 may result in delays in payment of a dividend to priority creditors:

> As a matter of policy, this may be an undesirable outcome given that it could delay the payment of money owing to employees, which may cause real hardship to them and their families. Equally, chargees may for good reason wish to see the employees paid as soon as possible, but not if this would mean that the payments are at the chargee's expense even if it turns out that the Company has sufficient free assets available.

In *Italiano* it was twelve months after the employees' priority claims were paid that the liquidators made their successful preference recoveries. Although the liquidators were making demands for the preference claims at the time of payment to the employees, they could not say with any confidence what those preference claims were worth until they were settled.

In order to find that the secured creditor was entitled to the preference recoveries, his Honour did make a finding that the liquidators had paid those monies to the priority creditors 'in breach of trust'

In this case, the liquidators paid out the employees on the basis of their interim assessment with the result that in his Honour's view, the liquidators *'committed a breach of trust'* and that because NAB's funds had been misapplied in breach of trust, and to the extent that it had suffered loss, NAB should be subrogated to the rights of priority creditors. His Honour also noted that it would be unconscionable for the unsecured creditors to benefit from a windfall produced by that breach of trust.

The consequence of the liquidators' breach of trust was that NAB suffered a loss. That loss however was equal to the value of the free assets that eventually became available to meet the priority claims, which were the very funds in relation to which the liquidators were seeking directions, meaning that there was no personal exposure on the part of the liquidators.

If, unlike the situation in *Italiano* the chargeholder gave informed consent to the priority creditors being paid promptly there would be no breach of trust. This breach formed the basis for his Honour accepting that the chargeholder has a right of subrogation in the *Italiano* case. His Honour expresses the view that absent the breach, the chargeholder should be entitled to subrogation. However, this view is only obiter and not free from doubt.

Conclusion

Justice Finkelstein has emphasised the *'uncertain and, perhaps, unsound rules and distinctions'* which support the accepted position that secured creditors are not entitled to the benefit of preference recoveries. He notes that this raises questions of policy and not just issues of legal principle, which must be resolved by Parliament.

In order to find that the secured creditor was entitled to the preference recoveries, his Honour did make a finding that the liquidators had paid those monies to the priority creditors *'in breach of trust'*. If there is no breach of trust, the obiter suggests that the secured creditor would be entitled to share in the preference recoveries by way of subrogation in any event.

The finding of a *'breach of trust'* is based on an interpretation of s 561, which should be of concern to controllers. It is not unusual for a controller to sympathise with the hardship faced by the former employees and, in order to promptly pay them, to make an interim assessment of the company's assets for the purpose of s 561. The effect of his Honour's view of the law is that controllers should not act upon any such sympathy by way of early payment to the employees. In fact, his Honour acknowledges that his interpretation *'may be an undesirable outcome given that it could delay the payment of money owing to employees, which may cause real hardship to them and their families'.*

The decision, in challenging the commonly held view that preference recoveries are not available to secured creditors, has highlighted a number of legal and practical concerns for practitioners and secured creditors as well as policy issues for Parliament.