KordaMentha

Employee Entitlements

December 2003

The KordaMentha Research Unit
Paper 304

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Table of Contents

Introduction

When an Australian company enters a formal insolvency process, the treatment of its employees' entitlements is governed by the provisions of the Corporations Act (the Act) and also by the Commonwealth Government's General Employee Entitlements and Redundancy Scheme (GEERS).

Key stakeholders in the process include Insolvency Practitioners, Commonwealth and State Governments, the Australian Chamber of Commerce and Industry on behalf of employers, the ACTU and unions on behalf of employees, and ultimately all secured and unsecured creditors of the insolvent company. A range of issues have been raised by these stakeholders, in determining how well the Act and GEERS deliver outcomes, including the following questions:

Should employee entitlements have an absolute priority ahead of all other creditors, including secured creditors, upon liquidation?[1]

What employee entitlements should be protected and by whom? Should every entitlement which is built into an award or contract be protected?[2]

Should related companies[3] **be required to contribute to the loss of employee entitlements by an employer company under external administration?**[4]

KordaMentha's discussion paper seeks outcomes for stakeholders that are both fair and reasonable, taking into account the vulnerability of employees, as well as others in the business community who suffer hardship and financial loss when a company fails. Our recommendations have also been formulated having regard to the interests of banks and secured lenders which play a significant role in facilitating existing and new business activity, and the implications for economic and social policy of Government.

[1] The Parliamentary Joint Committee on Corporations and Financial Services Improving Australia's Corporate Insolvency Laws Issues Paper, May 2003
[2] Ibid
[3] Defined under S50 of The Act otherwise known as "Related Bodies Corporate"
[4] The Parliamentary Joint Committee on Corporations and Financial Services Improving Australia's Corporate Insolvency Laws Issues Paper, May 2003

Should employee entitlements have an absolute priority ahead of all other creditors, including secured creditors, upon liquidation?

Background

Presently, employee entitlements for unpaid wages and unpaid superannuation contributions, long service leave and retrenchment payments rank ahead of other creditors, except debts secured by a fixed charge.

On 14 September, 2001 the Government proposed to increase protection for employee entitlements (other than redundancy payments) by giving priority to unpaid employee entitlements over all liabilities including debts secured by a fixed charge (not to apply retrospectively).

Many stakeholders do not generally support the "maximum priority proposal", and in fact state a number of serious concerns, whilst the ACTU has qualified its support for the proposal. KordaMentha acknowledges the following broad range of concerns:

- The Australian Chamber of Commerce and Industry has submitted that the Government stood to benefit from the adoption of a super-priority for employees as it would serve to defray Government's exposure under GEERS.[5]

- The Australian Banking Association considers that a maximum priority for employees would impact significantly on the lending and loan security arrangements of many businesses and would not benefit employees[6]. It also suggested that new funding may dry up and the changes may bring forward appointments because of a more conservative approach.

[5] Submission 13 p.9 to The Parliamentary Joint Committee on Corporations and Financial Services Improving Australia's Corporate insolvency Laws Issues Paper May 2003
[6] Submission 28 p.1 to The Parliamentary Joint Committee on Corporations and Financial Services Improving Australia's Corporate insolvency Laws Issues Paper May 2003

- Other stakeholders suggest that super-priority for employee entitlements would lead to artificial commercial arrangements designed to avoid the operation of the rule[7], for example a proliferation of companies employing no staff and holding no assets other than a receivable from an operating or trading company[8]. The impact would be particularly severe on companies with long serving work forces[9].

- Others argue that treating employees as priority creditors is difficult to justify and disadvantages ordinary unsecured creditors such as subcontractors, trade creditors and tort claimants. These stakeholders say it is inconsistent with the longstanding principles of insolvency law, in particular the *pari passu* principle that all creditors within a class should be treated equally. The employees are unsecured creditors and should be accorded equal treatment with other unsecured creditors and have an equal entitlement to share in a proportionate distribution of the assets of an insolvent debtor.[10]

- The ACTU endorses the "maximum priority proposal", but adds that the Commonwealth Government should give priority to 100% of employee entitlements above secured creditors (not just the GEERS component), and only recover its own expenditure once employees' claims have been satisfied in full.[11]

Discussion

We believe that employee entitlements should continue to rank behind creditors whose debts are secured by a fixed charge. The risks and costs associated with increasing the priority of employee entitlements above debts secured by a fixed charge are significant, and do not guarantee that employees will be any better off.

We are concerned that the consequences of "demoting" secured creditors would:

- Encourage businesses to hold assets subject to a fixed charge in one company, and employees in a separate company. Overall, employees would be worse off.

- Act as a disincentive to secured lenders, as arrangements which result in separation of assets and employees may invoke potential breaches of Part 5.8A of the Act. A secured lender participating in or insisting on the arrangement would be a person within the meaning of Section 596AB of the Act and potentially liable to recovery of the amount of any unpaid entitlements in any event.

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[7] Submission 27 to The Parliamentary Joint Committee on Corporations and Financial Services Improving Australia's Corporate insolvency Laws Issues Paper May 2003
[8] Submission 6 p.12 to The Parliamentary Joint Committee on Corporations and Financial Services Improving Australia's Corporate insolvency Laws Issues Paper May 2003
[9] Submission 28 p.1 to The Parliamentary Joint Committee on Corporations and Financial Services Improving Australia's Corporate insolvency Laws Issues Paper May 2003
[10] Submission 4, p7 to The Parliamentary Joint Committee on Corporations and Financial Services Improving Australia's Corporate insolvency Laws Issues Paper May 2003
[11] ACTU Proposed Changes to Corporations Law regarding maximum priority for accrued employee entitlements November 2002

- Make reconstructing a business much more difficult if a business' core assets i.e. employees and plant and equipment were in separate companies and these companies were not the subject of some form of pooling of assets and liabilities.

- Further reduce the return to unsecured creditors, if any, as a result of the corporate separation of assets and employees.

- Increase the cost of lending, so that lending institutions cover the additional risk of losing funds if a company becomes insolvent. This may mean a decrease in the number of new business enterprises because of resultant costly lending arrangements, and an increase in the number of insolvencies as companies find it difficult to obtain finance to trade through difficult times.

- Result in Australia being the only developed common law jurisdiction in the world to grant a priority over fixed charge holders with potential impact on investment and provision of finance by foreign entities.

What employee entitlements should be protected and by whom? Should every entitlement which is built into an award or contract be protected?

Background

The Act

The Act does not cap the quantum of employee entitlements, neither does it offer recourse to an alternate source of funds or cap individual payments where there are insufficient assets of a company to meet the payment of full employee entitlements as calculated under the relevant industrial agreement or contract.

This situation sometimes results in inequitable outcomes; e.g. a highly paid individual may be paid a large and disproportionate employee entitlement when other, lower paid employees rank *pari passu* for a comparatively small entitlement. There may be an exacerbated differential between one employee and all others, or perhaps between a group of employees and other groups. In the Ansett Administration, all employees proportionately shared in the asset pool; however certain employee entitlements were calculated at an average rate of $134,000 p.a. compared to other employee entitlements at $32,000 p.a.

Furthermore, there would be a public outcry if high paid executives were claiming millions based on their contacts being terminated.

An example: the CEO of Ansett was paid many millions in redundancy. He was an employee of Air New Zealand. If not (ie he was employed by Ansett Australia Limited) the claim would have been Ansett's to pay.

GEERS

Payments made under GEERS are subject to an annual income cap of $81,500 for 2002-2003. The income cap is used to calculate eligible GEERS payments for:

- Unpaid wages
- Accrued annual leave
- Accrued long service leave
- Pay in lieu of notice, and
- Up to 8 weeks redundancy entitlement.

GEERS does not however fund employees unpaid superannuation contributions. Under the Act, superannuation contributions are afforded equal priority to unpaid wages. KordaMentha believe that GEERS should be expanded to include unpaid SGC superannuation contributions calculated at the capped level referred to above. KordaMentha welcomes the recent changes to legislation that compels SGC contributions to be paid quarterly rather than annually.

The Commonwealth Government pays GEERS funds to the external administrator of an insolvent business as an advance on the condition that, in the event of liquidation, the Commonwealth effectively stands in the shoes of the employees and enjoys the equivalent priority in any distribution which those employees would otherwise have had in the liquidation. Notwithstanding, the GEERS scheme in 2003/2004 cost the Commonwealth $73.2m.[12] We recognise that the Commonwealth would like to reduce the cost of the scheme.

The ACTU welcomed the introduction of GEERS and acknowledged that it significantly increased the Commonwealth's financial exposure in the case of corporate insolvency.[13] However, the ACTU also continues to lobby strongly for a combination of actions and changes to Enterprise Bargaining, the Act and GEERS that collectively would guarantee 100% of employee's entitlements in the event of insolvency.

KordaMentha recommends that GEERS be given legislative enactment. Union campaigns for protection of entitlements have highlighted that there is no guarantee of continuity of the scheme and so are attempting to secure employee entitlements at enterprise level.

[12] Department of workplace Relations and Small Business Portfolio Budget Statements 2003/2004
[13] ACTU Proposed Changes to Corporations law regarding maximum priority for accrued employee entitlements

Comparison to Global Practices

On a country by country comparison of insolvency legislation and Government safety net schemes, Australian employees generally receive more of their entitlements when their employer fails. [14] Appendix A details practices across various countries.

In summary, Canada, Singapore, New Zealand and the United States, legislations cap total payments to any one employee to no more than approx $A10,000. Only the United Kingdom has a safety net similar to GEERS known as the Redundancy Payment Scheme ("RPS") which is administered by the Department of Trade and Industry. Payments made under the RPS are subject to an annual income cap of approximately $A33,000 and cover:

- Up to 8 weeks of unpaid wages
- Up to 6 weeks of accrued annual leave
- Accrued pay in lieu of notice, and
- Redundancy entitlements capped based on age and number of years service to a maximum of 30 weeks

Also, payments made under RPS cover unpaid employer pension fund contributions for up to 12 months prior to insolvency. The amount is based on the payment which should have been made, or if that cannot be ascertained, then a percentage of actual wages paid. Payment of employer pension fund contributions is not calculated by reference to the annual income cap applied to other benefits.

The United Kingdom legislation also provides that employees receive no dividend in respect of the balance of their entitlements until RPS has been recouped in full.

In summary, GEERS is a safety net scheme, where the Commonwealth assumes significant exposure in order to protect basic employee's entitlements; and its provisions are generous when compared with many other countries. With the exception of the United Kingdom, other jurisdictions reviewed do not have GEERS or a similar equivalent, and appear to deal with hardship caused by insolvency on a going forward basis rather than by payment of past entitlements.

Entitlements calculated under the relevant Industrial Agreement

The Act does and should recognise that the full entitlements of employees of failed companies, are those detailed in the relevant industrial instrument. These industrial agreement provisions however, may well have been agreed to at a much earlier time when the company was profitable and did not foresee the insolvency of the company, nor indeed any significant restructuring. At Ansett, for example, retrenchment packages for award employees were uncapped, and on the collapse of the company, 12,600 employees were owed an average retrenchment amount of 41 weeks pay.

[14] The protection of employee entitlements in the event of employer insolvency Ministerial Discussion Paper August 1999 Attachment B protection of employee entitlements on employer insolvency – The overseas experience

The KordaMentha Proposal

In the event of insolvency, a balanced and reasonable approach may involve greater integration of S556(1) of the Corporations Act with the GEERS scheme, and the relevant industrial agreements. That part of S556(1) which relates to employee entitlements could be redrafted to reflect this integration in the following way:

1. First Priority: to be employee entitlements equivalent to the GEERS entitlement. GEERS should be expanded to include unpaid SGC superannuation contributions calculated at the GEERS income cap.

2. Second Priority: the balance of all remaining employee entitlements as a single claim, but calculated using the GEERS income cap.

3. Unsecured – Balance of all other amounts owed (i.e. all employee entitlements which exceed the GEERS income cap will rank as unsecured).

GEERS should mirror the "excluded employee" provisions of the Act. Excluded employees under GEERS are defined as a "shareholder" executive director and/or relative.

This solution aims to achieve a fair and equitable outcome and presents numerous benefits for all stakeholders, which include:

For Secured Creditors:

- Secured Creditors' position is unchanged, which mitigates all of the risks outlined above, in relation to demoting their priority.

For the Commonwealth:

- The GEERS Scheme is afforded maximum priority, which will result in decreasing the cost of the scheme.

For Employees:

- Use of income caps mean that highly paid management employees, will not receive a disproportionate share of assets.

- Award and contract-based employees whose income is less than GEERS cap of $81K will be more likely to receive their entitlements in full, because of the income cap. Although we considered carefully capping priority redundancy payments at 16 weeks, we concluded that an income cap is sufficient to provide a balanced solution for employees.

For Unsecured Creditors:

- This solution provides opportunities for better returns to unsecured creditors, by re-prioritising very large payments to employees. Under current legislation, there have been examples in insolvencies, where millions have been paid to individual employees, with no return to unsecured creditors, many of whom are small businesses or reliant sub-contractors which, as a direct result, failed themselves.

For Insolvency Practitioners:

- The solution is a simple one, which balances the outcomes anticipated by The Act, GEERS and Industrial Instruments, to the benefit of all stakeholders.

A Practical Example: The KordaMentha Proposal Applied to Ansett

By way of practical example, it is useful to compare the outcomes of the Ansett Administration under legislation (what actually happened) to the outcomes that would have otherwise occurred if the proposal had been operative.

The Ansett Administration is expected to realise approximately $600m net.

Creditors	**Gross Amounts Owed ($m)**	**Actual Amounts Repaid ($m)**	**KordaMentha Proposal – Amount Repaid Would Be ($m):**
Secured Creditors	Nil	Nil	Nil
Highly Paid Employees	204	179	125
Award Employees on income less than GEERS cap	506	467	475
Funded by Commonwealth Safety Scheme		390(*)	354
Repaid to Commonwealth Safety Scheme		(344)	(354)
Loss to Commonwealth		(46)	Nil
Unsecured Creditors	1,800	Nil	Nil
Total		600	600

(*) If GEERS funded Ansett's employee entitlements instead of SEESA, the Commonwealth's loan would be $354m

In summary, the result shows that if the KordaMentha proposal were applied to the calculation of Ansett returns, Award Employees on low incomes would have received greater returns and the Commonwealth would have been paid in full for monies advanced under GEERS. Highly paid employees would have received less.

Should related companies be required to contribute to the loss of employee entitlements by an employer company under external administration?

Discussion

KordaMentha believes that all related wholly owned companies should be automatically grouped unless they apply to ASIC to be ungrouped. i.e. there should be a presumption of an automatic deed of cross guarantee between related companies.

We note that recent changes to company "consolidations laws" for taxation purposes, that the tax liability is joint and several for all group companies, unless a company opts out. As a direct consequence, it is likely that the incidence of corporate grouping and cross guarantees will increase.

This solution is in contrast to the current situation, where in an external administration, all related companies are considered ungrouped, unless they had previously applied to ASIC to be grouped. It makes sense to reverse this status quo to protect employees from finding themselves employed by an insolvent company without assets, and without recourse to the assets of other group companies. In recent years, as a direct consequence of this "loophole" there has been a deliberate restructuring of companies to separate employee liabilities and group assets. Also, it avoids the inadvertent consequence of assets and employees being in different companies.

Appendix A: Global Practices

A country by county comparison of the benefits provided to employees in western common law based jurisdictions, under the provisions of relevant legislations, demonstrates advantages for Australian workers.

United Kingdom

- Wages – Limited to 4 month relation back capped at a maximum of GBP800.
- Holiday Pay – No limitation
- Payment in Lieu/Redundancy – Unsecured without priority

Note that all jurisdictions other than the United Kingdom (UK) provide for an order of priority like our 556(1). However, the UK places all priorities (tax, vat etc) into one priority category which shares *pari passu* in the available funds, which is less favourable to employees.

United States

- Wages, leave, and severance – limited to 3 month relation back date and capped at a maximum of USD4000

Canada

Under the Winding Up and Reconstruction Act

- Wages – limited to a 3 month relation back with no cap

Under the Bankruptcy and Insolvency Act

- Wages – limited to a six month relation back and capped at C$2000

New Zealand

Employees have priority after the expenses of winding up in the following order (Schedule 7 of the Corporations Act)

- Wages – 4 month relation back
- Holiday Pay – no relation back limitation
- Deductions made by employer to satisfy employee obligations – no relation back limitation
- Child Support deductions – no relation back period

Payment is made in order of priority as with Sec 556(1) A cap of NZ$6,000 is applied to payments to any one individual under all of the above categories.

Singapore

Section 328 of the Companies Act provides a priority to employees after expenses of winding up in the following order:

- Wages (inc commissions and any allowances or reimbursements under an employment contract or award or agreement) – see below
- Retrenchment or ex gratia payment under contract of employment, award or agreement – see below
- All amounts due inrespect of workers compensation uder the Workmen's Compensation Act – no relation back limitation
- Superannuation contributions – 12 month relation back – no limit as to amount
- Holiday Pay – no relation back limitation – no limit as to amount

Amounts payable under 1 and 2 above are not to exceed an amount equivalent to 5 months salary or S$7,500 whichever is the lesser.

About The KordaMentha Research Unit

Background

KordaMentha partners undertook the first voluntary administration in Australia, the largest voluntary administration in Australia (Ansett with 42 companies, 15,000 employees and >$1 billion assets), the largest group of voluntary administrations in Australia (Stockford with 84 companies) and more voluntary administrations than any other insolvency firm in Australia to date in 2003.

The strength of the KordaMentha experiences and our expertise makes us well placed to monitor and evaluate issues and developments in the insolvency industry and to recommend changes.

Statement of Direction

The KordaMentha Research Unit aims to:

- Develop intellectual property
- Share our knowledge of specialist topics with insolvency stakeholders
- Develop balanced solutions for issues in the industry. We will do this by preparing position papers on topics of interest, and encouraging discussion with a view that changes to the industry will result.

Personnel

The KordaMentha Research Unit is headed by Leanne Chesser. All KordaMentha Partners and Directors contribute to the KordaMentha Research Unit.

Current Research

The KordaMentha Research Unit has conducted research in a number of areas, including:

- 301: Ansett - Part 5.3A and Chapter 11
- 302: Large and Complex Administrations – The Courts and Ansett
- 303: Regulatory Review of Australia's Insolvency Laws
- 304: Employee Entitlements
- 305: Rehabilitating Large and Complex Enterprises in Financial Difficulty