CHAPTER 3

SUBMISSIONS AND EVIDENCE RECEIVED

3.1 As noted earlier, the Committee received 14 submissions on the Bill. Given the short time in which it was required to report, the Committee was pleased with the range of the submissions and of the evidence of witnesses at its public hearing on the Bill. This Chapter sets out the main points made by the submissions and witnesses.

3.2 The submissions and evidence reflected wide and diverse views.

Section 588G - Extension of existing duty on directors not to engage in insolvent trading

3.3 Most submissions addressed the proposed amendment of s.588G. The Shop, Distributive and Allied Employees' Association (SDAEA) submitted that the amendment is a positive move in extending the liability of directors for insolvent trading. However, the real problem is that this does not lead automatically of itself to a protection of entitlements. The amendment provides only an onerous procedure for the liquidator or a creditor to obtain compensation from a director who has breached the provision. This compensation, given that employees are unsecured creditors, may not be enough to meet all entitlements.

3.4 The SDAEA also submitted that the Bill does not address the priority of employee entitlements in a liquidation. The Corporations Law provides that secured creditors always have priority over unsecured. This results in employees being in a second rate position. Accordingly, it is imperative that the Bill provides for employee entitlements to rank as a first priority in a liquidation, even before secured creditors, to the full extent of all entitlements. Until this is done no amount of tinkering will guarantee entitlements.

3.5 The SDAEA finally submitted that employees should be able to recover entitlements directly from directors who breach s.588G. This right should be absolute and not depend on the consent of a liquidator or court.

3.6 The Australian Catholic Commission for Industrial Relations (ACCIR) supported the uncommercial transaction provision, because the current legislation protects the rights of creditors only where a company incurs a debt. However, there may also be merit in treating employee entitlements as ranking with secured creditors.

3.7 The Textile Clothing and Footwear Union of Australia (Victorian Branch) (TCFUA) submitted that the Bill did not address the existing very weak insolvent trading provisions. At present a company may trade well beyond the point when it is able to pay entitlements, but an action for insolvent trading seldom ensues.

3.8 The NSW Attorney-General and Minister for Industrial Relations, the Hon J W Shaw QC MLC, submitted that the s.588G amendment was not a specific measure to address employee entitlements, because it only extended the scope of an existing provision which provides general protection to creditors. It was difficult to see how this will assist the payment of entitlements; it is arguable that the Corporations Law already imposes a duty on directors not to engage in an uncommercial transaction.

3.9 Mr David Noakes submitted that the proposed s.588G amendment did not address situations where there is no insolvent trading and no uncommercial transaction. It is true that the threat of criminal penalty for those who break the new duty knowingly, intentionally or recklessly may ensure that directors make timely payments prior to insolvency. The problem with this ex post facto approach, however, is that the company is already insolvent and this does little to recover entitlements. Also, the use of civil penalties does not prevent insolvency or ensure that entitlements are met; civil penalties are generally unsatisfactory.

3.10 Mr Ian Parsonage submitted that the amendment to s.588G resulted in a questionable extension of liability. The existing definition of uncommercial transaction in the Corporation Law is already extremely broad, and to extend it further would go beyond the purposes of the Bill.

3.11 Mr ARM Taylor, of Horwath Chartered Accountants, submitted that applying sanctions to impecunious directors will do little or nothing to increase the funds available in a company failure; the directors may have no money and the company's affairs may have been legally and properly refinanced with the active approval of leading banking and finance lawyers, bankers and other advisers. The fundamental problem is that employee entitlements are paid from assets that are subject to a floating charge, such assets being mainly a company's debtors and stock. In recent years, however, banks are other lenders have encouraged companies in difficulties to "factor" their debtors. This is a growing financial product which banks are actively promoting. The result is that a major floating charge asset, debtors, is no longer available in an insolvency to meet employee entitlements.

3.12 Mr Taylor submitted that stock is the next most significant floating charge asset in a corporate insolvency. However, trade creditors, usually suppliers, are by now quite sophisticated in developing "retention of title" (ROT) clauses in their contracts to supply stock. The effect of these ROT clauses is that, in a corporate insolvency, title to stock reverts to the supplier. Little is left for priority claimants such as employees. Floating charge assets at the end of a receivership are further reduced by the costs and charges of the insolvency administration, including the inevitable losses incurred in trading-on an insolvent company. It is not surprising that there is little or nothing left for employee entitlements.

3.13 Mr Taylor submitted that the solution was not to penalise directors, but to make lenders accountable. The Corporations Law should provide that employee entitlements are payable from fixed as well as floating charges. Lenders would then ensure that their net security position reflects the prior claims of employees. It is not enough to leave employee entitlements to the whims of factoring, ROT clauses and trading-on costs.

3.14 The Law Council of Australia (Corporations Law Committee) submitted that it objects strongly to the extension of the insolvent trading provisions, advising that it is unnecessary both in the light of existing prohibitions and the proposed new Part 5.8A. Australian insolvency legislation has provided employees with increasing levels of protection, but there is a delicate balance to be struck. Employee protection must be included within a wider policy framework, which also takes account of the legitimate (and sometimes competing) interests of financiers, equity investors and trade creditors. That policy must promote and facilitate the free flows of capital and credit.

3.15 The Law Council submitted that the change has potential possibly unintended consequences beyond employee entitlements. In addition, the artificial extension of the insolvent funding provisions may adversely affect the proper functioning of boards of directors and is inconsistent with the recently introduced business judgment rule. All of the present circumstances in s.588G which are taken to constitute the incurring of a debt involve some form of outflow of money or value from the company. This extended definition was intended to deal with potential abuses resulting from share buy backs and reductions of capital. The proposed inclusion of uncommercial transactions, however, is quite different in character; instead of dealing with very specific circumstances the proposal is extremely broad and need not involve any outflow of money or value.

3.16 The Law Council also submitted that the present provisions dealing with voidable transactions provide more appropriate remedies for insolvent or uncommercial transactions. In fact, unfair laws are already included within the voidable transaction provisions, protecting the rights of all creditors including employees. Such transactions are voidable if the company is wound up within 10 years of the transaction. Also, the general directors' duties provisions, including the new "business judgment rule", provide adequate and appropriate criminal and quasi-criminal sanctions. It is difficult to justify an additional layer of complexity.

3.17 The Australian Institute of Company Directors (AICD) submitted that it objected strongly to the amendment to s.588G because it introduces further potential for directors to be judged with the benefit of hindsight for decisions taken in good faith and with diligence, at anearlier time. The result is that directors would be exposed to unreasonable risk of further personal liability in addition to the onerous obligations already placed upon them. The amendment is unfair, unnecessary and damaging to the economy, in that it has the potential to prevent directors from effectively carrying out their duties.

3.18 The AICD suggested a different way of dealing with the situation. The AICD submitted that there is a tendency to lump together all employee entitlements, but whereas unpaid wages, annual leave and long service pay are accrued benefits, pay in lieu of notice and redundancy pay are not. In fact, these two categories should be treated differently. The Corporation Law should place accrued benefits above the debts secured by a floating charge, or even above other secured creditors, so that employees would be near the head of the queue in a voluntary liquidation or receivership. There should be a maximum limit for claims, with a Court discretion to raise the limit. The AICD submitted that those proposals may have some adverse implications for capital raising, but companies and their lenders would adjust to the proposal, which would introduce greater discipline into bank lending and credit practices. However, non-accrued benefits should not be the responsibility of the Corporations Law.

3.19 The Department of the Treasury submitted that the rationale for s.588G extending the duty on directors to prevent insolvent trading to include uncommercial transactions is that such transactions impact directly on amounts payable to creditors, including employees. There is at present a perceived gap in the present insolvent trading provisions, which do not include all transactions which could impact upon creditors; in particular, the transfer of assets away from the company for an uncommercial consideration. Such transactions, which effectively amount to asset stripping, can impact adversely on creditors just as much as incurring debts or paying dividends out of company funds. The intention of the amendment is that directors will need to be vigilant in ensuring that a company does not enter into an uncommercial transaction while insolvent. Similarly, directors will be under a duty to ensure that a company does not enter into any uncommercial transaction if it would result in the

insolvency of the company. This would be in addition to the existing duty not to incur debts, pay dividends or take similar action, in those circumstances.

3.20 The Treasury noted that a breach of the new provisions would result in the same sanctions as a breach of the current s.588G; that is, personal liability of directors for losses suffered by creditors as a result of the transaction, as well as civil and criminal penalties. Similarly, defences available to directors under the present s.588G will be available, including that the director reasonably expected that the company was solvent at the time of the transaction.

Section 596AB – Entering into agreements or transactions to avoid employee entitlements

3.21 Almost all submissions addressed proposed new s.596AB. The Australian Council of Trade Unions (ACTU) supported a strengthened Corporations Law framework but noted that under s.596AB an offence is committed only where a person *intends* to enter into a transaction to prevent or *significantly* reduce the recovery of entitlements. The ACTU submitted that, given the evidentiary difficulties with establishing intention, this standard of proof is an impossible burden that significantly reduces the effect of the section. The intention requirement will defeat the objects of the new Part. Instead, the section should provide that the mere existence of an agreement or transaction that has the effect of avoiding or reducing liability for employee entitlements gives rise to the offence. However, such an offence should include defences such as lack of intention or the exercise of appropriate diligence to try to ensure that there was no breach. This strict liability approach is based on provisions of the Queensland *Workplace Relations Act 1999*. The results would be a positive incentive to directors to ensure the protection of entitlements; a standard of proof that is fair, given the relative positions of directors and employees; and protection for directors who act diligently and in good faith.

3.22 The NSW Attorney General and Minister for Industrial Relations, the Hon J W Shaw QC MLC, submitted that in practice there might be few successful prosecutions under S.596AB . The criminal standard of proof, combined with the necessity to prove intent, is a high hurdle. However, the bar need not be so high. Civil penalties are already an important sanction within the Corporations Law. Civil penalties allow a court to fine or make orders against a person who has, on the balance of probabilities, contravened specified sections of the Law. These provisions already apply in such areas as directors' duties, protection for shareholders and certain dealings in relation to managed investment schemes. The provisions include fines of up to $200,000 and orders disqualifying offenders from being involved in managing a corporation. Mr Shaw submitted that this would also discourage the "phoenix company" phenomenon where one company fails, but sells its remaining assets to a new company that has the same directors as the earlier failed company. The proposed new offence should be a civil penalty, which would make the new laws more effective than their present form and deter undesirable corporate behaviour.

3.23 Mr Shaw also submitted that "intention" in s.596AB would be difficult to establish. However, this could be remedied by replacing "intention" with "effect", so that it is an offence if the effect of the agreement or transaction is to prevent payment of entitlements. This would place an onus on directors and others to ensure the security of entitlements. There could be an exception where the person was not in a position to influence the conduct that led to the failure to pay, or used all diligence to provide for entitlements. The

qualification "significantly" is uncertain in effect and should be removed to avoid legal argument.

3.24 Mr Shaw submitted that a crucial question is whether the phrase "relevant agreement or transaction" is broad enough to include all circumstances that should be covered. The provisions should be wide. For instance, the *Income Tax Assessment Act 1936* uses the word "schemes" to cover the various forms of tax avoidance. "Schemes" are defined more widely than agreement or transaction and s.596AB should be extended to include schemes. Also, "agreement or transaction" is deficient in that it does not include *unilateral* steps. In other words, there may not always be two parties involved and unilateral steps may not always come within the present drafting.

3.25 The SDAEA submitted that the purpose of the Part is commendable, but it fails in that it applies only when there is a deliberate intention to defeat the recovery of employee entitlements. The SDAEA viewed the Part as a "toothless tiger" in that it may be very difficult, if not impossible, to prove the necessary intent. The reality is that the offence will be so hard to prove that nobody will be effectively prosecuted. The solution is to expand the Part to catch any agreement that has the effect of preventing or significantly reducing recovery of entitlements.

3.26 Ms Nicola Roxon MP, Federal Labor Member for Gellibrand, submitted that the provision aims only at prosecuting directors who take action with deliberate intent to avoid paying employee entitlements. It does not punish irresponsible or incompetent directors, yet the potential harm to employees is the same. Consideration should be given to reviewing the onus of proof where there is prima facia evidence of a failure to pay employee entitlements.

3.27 The TCFUA submitted that s.596AB will be too difficult to prove, because the offence requires an intention. Instead, the offence should be based on the results of a transaction. Any agreement that results in failure to pay entitlements should constitute an offence. Also, the offence should not be limited to "preventing" or "significantly reducing" entitlements; it should include anything that reduces entitlements *to any extent.* Finally, because the offence must be proved beyond reasonable doubt, establishing intention will be nearly impossible. The offence should really be based on outcome, not intention.

3.28 The ACCIR submitted that the evidentiary requirements of the criminal standard of proof might defeat the intention of the provision. It may be appropriate to extend liability to cases where directors do not exercise reasonable diligence to ensure payment of employee entitlements.

3.29 Mr David Noakes submitted that s.596AB is well drafted in that its provisions cannot be avoided by arranging the prohibited transactions through non-related parties. However, there is a problem in that the court must determine ex post facto the intention of a person. The relevant agreement or transaction could have been made months before a voluntary administration, possibly at full commercial value, with assets sold at a price reached by an independent valuer. Also, the provisions would be easy to circumvent, because the focus on intention would give rise to numerous problems of interpretation. Corporations would be advised not to record their deliberate or real intention at any stage of a corporate restructure.

3.30 Mr Ian Parsonage submitted that s.596AB has a number of drawbacks. The provision is too broad, with ordinary commercial transactions arguably in breach of the

section. This will promote litigation and inhibit companies, particularly small business, from raising finance. At the very least, the intention test in the section should be a predominant intention. Also, the section is not qualified by restricting it to an uncommercial transaction (which, as submitted above, is itself too broad) or even (which, it is submitted, would be a more preferable qualification) to an insolvent transaction. There are no such qualifications even though the section imposes criminal liability. Finally, the section fails to take into account the fact that many choices by directors otherwise authorised by the Corporations Law may be adversely affected. For instance, if a lender took a fixed charge over an asset (fixed charges are not subject to employee claims and lenders are aware of this) then the lender (as well as the directors) may be in breach of the section.

3.31 7The Law Council of Australia (Corporations Law Committee) submitted that it does not object in principle to the intent based provisions in proposed Part 5.8A, but has concerns with unintended application and some technical aspects. The rationale for placing fixed charge creditors ahead of employees in a winding up is that it is important to facilitate the flow of loan capital by providing unimpeachable first ranking security. Otherwise lending would be greatly impaired and freedom of access to and movement of capital would be hindered. Also company directors should be free to take calculated risks with capital to the advantage of all stakeholders, including the company's present and future employees. Present employee priority on the other hand arguably operates to the detriment of small and medium businesses who are unsecured trading creditors and who cannot afford to have unpaid debts. The legislation must balance these company interests. The difficulty here is that s.596AB, which extends criminal liability to agreements or transactions which significantly reduce the entitlements that can be recovered, may include a range of otherwise acceptable transactions. For instance, the provision may catch a financier who takes a fixed charge (which has priority over employee entitlements) as opposed to a floating charge (which does not have priority). It would also include entering into a deed of company arrangement, which is the clearest possible case of intentional reduction of employee entitlements and which would seem to be within the new provision even if approved by a court, creditors and the affected employees. The Law Council advised that many other instances would arise in practice.

3.32 The Law Council of Australia also noted that s.596AB is expressed to apply even if the agreement or transaction is approved by a court. The Law Council submitted that in fact court approval is the best means to determine a balance between the competing interests of potential creditors; court approval ought to put to rest any outstanding concerns as to the validity of a transaction. The Law Council noted (as did a number of other submissions) that the provision is inconsistent with the amendments to the insolvent trading provisions, where court approved transactions are expressly exempted.

3.33 The AICD submitted that it had no objection to s.596AB.

3.34 The Department of the Treasury submission addressed the suggestion that the offence provision would be improved if it was included within the existing civil penalty regime in the Corporations Law, with the object of expanding the remedies for breach. However, the civil penalty provisions are based on the premise that contravention of those provisions causes damage *to the corporation.* The proposed Part 5.8A, on the other hand, focuses on damage *to employees* caused by prohibited transactions, and any person may be in contravention. The civil penalty provisions would need to be modified in these and other areas to apply to the proposed provision.

3.35 The Treasury submission also described how s.596AB would operate in the context of a deed of company arrangement (DCA). The submission advised that concern has been expressed that the proposed offence provision may prohibit any DCA which affects employee entitlements. However, this is not the case. For instance, if persons enter into a DCA by way of a moderate compromise considered necessary to preserve the company's business, then the provision would not automatically be breached. If, on the other hand, the intention of those persons in entering the DCA is to avoid employee entitlements, then they may be in breach of s.596AB.

Section 596AC - Persons who contravene section 596AB liable to compensate for loss

3.36 Almost all submissions addressed proposed new s.596AC and its associated provisions. The ACTU noted that s.596AC liability was conditional upon breach of s.596AB, the company being wound up, and the employees suffering loss or damage. However, this unnecessarily limits the protection that the Bill affords to employees; action should not be conditional on either a breach or on winding up proceedings. As a minimum, proceedings should be available where the company has been put generally into external administration. In fact, failure to pay entitlements often occurs prior to external administration; the objects of the Part would be facilitated if proceedings could be instituted both prior to external administration and at any point during external administration.

3.37 The ACTU also submitted that the intention requirement in s.596AB affected adversely the ability of employees to make directors personally liable for employee entitlements. The intention requirements of the trading when insolvent provisions of the Corporations Law illustrate the difficulties of successful litigation where intention must be proved. Sections 596AB and 596AC are strong on their face but the threshold intention requirement has made them paper tigers. Instead, company directors and management should be personally liable without the intention test, subject to the same defences as those suggested earlier by the ACTU for its proposed strict liability offence provision.

3.38 The ACTU also submitted that in practice employees have limited financial and organisational resources and are not in a position to initiate litigation, particularly where they have just lost their jobs and substantial amounts of money through unpaid entitlements. The requirement that a breach must have occurred will further reduce the likelihood of successful litigation.

3.39 The ACTU also made a number of suggestions relating to the procedural aspects of compensation actions. The ACTU submitted that the requirement in the recovery provisions for the written consent of the liquidator or approval of the court for an employee to institute proceedings, derive from Part 5.8A limiting actions to circumstances where a company is being wound up. Such consent is inappropriate if the Part is amended to provide for personal strict liability of directors and managers. In addition, under s.596AC only the liquidator or an employee may recover compensation. Instead, however, there should be subrogation of rights so that others beside employees may take action, including employee representatives such as a union, or ASIC or other government agencies.

3.40 The ACTU further submitted that it is acceptable to avoid double penalties, but s.596AI may reduce further the limited protection for employees. The blanket prohibitions in that section on employees commencing action where the liquidator has instituted or intervened in proceedings under other provisions of the Corporations Law are inappropriate

in a scheme designed to protect employee entitlements. The section should provide for the Court to exercise discretion in these cases.

3.41 The TCFUA submitted that directors should be personally liable for employee entitlements, with strict liability. Numbers of other common law jurisdictions do this, notably in Canada. Also, corporate litigation is enormously lengthy and expensive and prohibitive for most employees. The costs of such litigation will usually outweigh the amounts owed; most cases in the TCFUA experience involve small companies with few workers, which owe relatively small amounts in total to employee creditors. The TCFUA also submitted that employees may only proceed for compensation where a company is being wound up, but the recent trend is for a company to trade its way out of difficulties rather than be wound up. Finally, related companies within the corporate group should be responsible for employee entitlements of an insolvent company within the group.

3.42 Ms Nicola Roxon MP, Federal Labor Member for Gellibrand, submitted that the reach of the Bill should be extended, to allow employees and their representatives to take effective action against directors and related parties who have failed to provide for employee entitlements. Under the proposed arrangements the employee must prove intent, and litigation is expensive and can be taken only six months after the company commences to be wound up, with the consent of the liquidator. Also, the director may not have sufficient funds to pay the compensation because he or she may have placed personal assets beyond the reach of the Bill. Instead of the proposed s.596AC, employees or their representatives should be able to recover compensation from directors whenever they fail to make proper provision for employee entitlements, whether by deliberate avoidance, uncommercial decisions, incompetence or matters outside their control. In addition, employees should be able to recover compensation from corporations related to the insolvent corporation.

3.43 The NSW Attorney-General and Minister for Industrial Relations, the Hon J W Shaw QC MLC, submitted that employees who have lost their jobs in a company failure will not have the resources to pursue their former employer in the courts. The resources of the liquidator may also be strained. Also, it is inappropriate for employees to have to rely on the liquidator to take action. Accordingly, the Bill should be amended to allow an employee's union to initiate proceedings.

3.44 Mr David Noakes submitted that, while s.596AC was practical in that it requires only a civil rather than a criminal standard of proof, only persons in contravention of s.596AB are liable to pay compensation. The result is that employees would be reluctant to pay for costly litigation. Also, liquidators may be reluctant to intervene in what, in any case, is an impractical remedy because it only gives priority over other unsecured creditors. Personal liability could be a solution; the present insolvent trading provisions provide penalties for directors who allow a company to trade into insolvency. Another solution may be court sanctioned contributions orders against related companies

3.45 The ACCIR submitted that proceedings under the provisions of the Bill are costly and complex and out of the financial reach of almost all employees.

3.46 The AICD submitted that it had no objection to s.596AC.

3.47 The Department of the Treasury submission addressed a number of suggested alternative approaches in relation to employee entitlements. One of these was to give employees a super-priority over all other creditors. Treasury, however, submitted that there

are a number of serious concerns with this approach. These included increases in the costs, and limitations on the availability, of credit; the likelihood of borrowing and lending entities finding other ways of ensuring that the lender's funds are not put at risk; difficulties with application to existing securities; and the likely need for complex and intrusive regulatory devices.

3.48 The Treasury submission also addressed the suggestion that there should be absolute liability on directors for employee entitlements, irrespective of any wrongdoing. In this context the Treasury queried whether it was reasonable to effectively require directors to guarantee significant obligations of the owners to the employees, in the absence of any wrongdoing; suggested that this may have undesirable effects on the conduct of business and upon costs; and questioned the proportion of directors who would be able to fund entitlements if found liable.

3.49 The Treasury submission also examined the suggestion that related corporations should be required to contribute to employee's entitlements. The Treasury submitted that this would impinge on the long established doctrine that each company is a separate legal entity with its own creditors. It would be a challenge to ensure that individual creditors and shareholders of other group companies are not unfairly disadvantaged. The issues here are complex, due to the way in which ownership of companies is often split between numerous owners who may or may not own part of the employing company.

3.50 The Department of the Treasury submission expressly addressed the suggestion that s.596AC should focus on the result of the transaction, rather than the intent behind it. In other words, it has been suggested that the provision should target any transaction that *results* in the loss of employee entitlements. Treasury noted that result oriented provisions already in the insolvent trading provisions are workable in that context because they are linked to insolvency of the company and target only the directors of the company. The proposed Part 5.8A, however, is much broader in scope, in that it targets any person knowingly concerned in a prohibited transaction, not merely directors of the employer company. Also, it is not necessary to establish that the company was insolvent, or became insolvent as a result of the transaction.

3.51 The Treasury submitted that a fundamental difficulty with a results-based approach to the proposed provision is that all expenditure can potentially reduce the amount of money available to pay creditors, including employees. It would clearly be unreasonable and unworkable to make all persons involved with those transactions (such as contractors and suppliers) guilty of an offence and liable to pay compensation. In order to make a results-based provision workable, it would be necessary to limit the provision to transactions where the company was already insolvent. It would also be necessary to exclude third parties that do not have knowledge of the financial position of the company. The result would likely be a resultant provision very similar to the existing s.588G, except that it would operate only to protect employees rather than all creditors.

3.52 Finally, the Treasury submitted that the actions available for a breach of the provisions are not as limited as some commentators have suggested. For instance, actions under s.596AC are not the only means by which compensation may be received; ASIC could apply for an injunction or order for payment in relation to a breach of the provision, or commence proceedings on behalf of persons with their permission in relation to default or misconduct. Also, actions under s.596AC require proof only to the civil, not the criminal, standard. In addition, limitations on actions by employees while a company is in liquidation

are necessary to ensure liquidations are conducted in an orderly manner. All such safeguards and protections are based on similar existing provisions in relation to insolvent trading actions.