Minority Report to Joint Committee on Corporations and Securities Report on Corporations Law Amendment (Employee Entitlements) Bill 2000 : April 2000

Senator Andrew Murray – Australian Democrats

1. Prevention Better Than Cure

My concern with the public debate on employee entitlements is that much of it is focussed on compensating employees for lost entitlements, rather than concentrating on prevention and safeguards.

It is one thing to simply promise to pay out employee entitlements up to $20,000 if a company becomes insolvent – it is another to try to reduce the incidence of insufficiency of funds to pay out employee entitlements.

In my statements on the issue of lost employee entitlements over the last few years, I have always emphasised that prevention is better than cure. By that I mean that preventing the loss of employee entitlements is a far better strategy than attempting to recover them after insolvency or trying to compensate for their loss. Plainly the nature of commercial risk will mean that there will always be insolvencies, and that is part of the market mechanism, but the extent to which large numbers of employees have unnecessarily suffered to date at the hands of directors and the market has been unacceptable.

The focus of any prevention strategy has to be on realising greater security for employee entitlements, rather than on punishing directors nonetheless with a limited scope for the timely and full recovery of monies lost. In that regard it is important that the prevention and safeguards mechanisms therefore include prescriptive law which firstly prohibits certain kinds of behaviour and secondly guarantees employee entitlements have better safeguards and protections than they have at present.

2. Making Related Companies liable for Debts of Insolvent Companies

The problem which we need to attend to is that of corporate restructuring, which occurs with the purpose of depriving employees and creditors generally of their rights and entitlements. I have attempted to address this problem on two occasions previously.

The Law Reform Commission in 1988 in its report which followed the General Insolvency Inquiry (known as the 'Harmer Report') recommended the implementation of a provision of this nature and amendments which I have moved are in accordance with the Commission's draft provision.

The substance of the proposal is that a liquidator or creditor of an insolvent company would be able to apply to a court for an order that a related company must pay an amount of a debt. Whether the court ordered the payment and how much was ordered to be paid would be determined by a consideration of a number of factors namely:

- the extent to which the related body corporate took part in the management of the company
- the conduct of the related body corporate towards the creditors of the company generally and to the creditor to which the debt or liability relates
- the extent to which the circumstances that gave rise to the winding up of the company are attributable to the actions of the related body corporate
- the extent to which the insolvent company has, at any time, engaged in one or more transactions which have resulted in the value of the insolvent company's assets being reduced.

I moved the following amendments firstly in the committee stage of the *Company Law Review Bill 1997,* and secondly in the committee stages of the *Financial Sector (Shareholdings) Bill 1998* and the *Financial Sector Reform (Consequential Amendments) Bill 1998:*

> (1) On the application of the liquidator or a creditor of a company that is being wound up in insolvency, or on the application of the Commission, the Court may, if it is satisfied that it is just, order that a company that is or has been a related body corporate must pay to the liquidator the whole or part of the amount of a debt or liability of the first-mentioned company that is an admissible claim in the winding up.
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> (2) In deciding whether it is just to make an order under subsection (1), the matters to which the Court must have regard include:
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> (a) the extent to which the related body corporate took part in the management of the company;
> (b) the conduct of the related body corporate towards the creditors of the company generally and to the creditor to which the debt or liability relates;
> (c) the extent to which the circumstances that gave rise to the winding up of the company are attributable to the actions of the related body corporate; and
> (d) the extent to which the insolvent company has, at any time, engaged in one or more transactions which have resulted in the value of the insolvent company's assets being reduced; and
> (e) any other relevant matters.
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> (3) An order under this section may be subject to conditions.
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> (4) An order must not be made under this section if the only ground for making the order is that creditors of the company have relied on the fact that another company is or has been a related body corporate of the company.

and

Recovery of profits, and compensation for loss, resulting from contravention

> 1. Where a person contravenes a civil penalty provision in relation to a corporation, the corporation, a creditor or the Commission may recover from the person, as a debt due to the corporation:
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> (a) if that or another person has made a profit because of the act or omission constituting the contravention—an amount equal to the amount of that profit; and

> (b) if the corporation has suffered loss or damage as a result of that act or omission—an amount equal to the amount of that loss or damage; whether or not:
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> (c) the first-mentioned person has been convicted of an offence in relation to the contravention; or
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> (d) a civil penalty order has been made against the first-mentioned person in relation to the contravention.
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> 2. Proceedings under this section may be begun only within 6 years after the contravention.

The first half of the amendment (to the *Company Law Review Bill 1997*) was passed by the non-Government parties, but on rejection by the House of Representatives, was not insisted on by Labor in the Senate. Both parts of the amendment were rejected by the Senate when the expanded amendments were put by me in the Financial Sector Bills in 1998.

The substantive amendment is that of item 2, and it refers to the liability for debts or liabilities of a related body corporate. We are concerned here with entities structuring themselves in such a way as to avoid liabilities or responsibilities by interposing companies with little capital backing between creditors, employees and the companies within the group which have substantial assets.

This is not a new problem. In 1988 the Law Reform Commission conducted a general insolvency inquiry. As a part of that inquiry, the Commission considered the possibility of making related companies liable for the debts of an insolvent company in certain circumstances, and the Commission recommended that companies should be so liable. A draft section D13 was produced. That draft section was a relatively simple one which essentially handed a discretion to a court to order a related company to contribute an amount to the debts of the insolvent company on its winding up.

In its considerations the Law Reform Commission said on pages 146 and 147 of that report:

> *Liability for debts or liabilities of a related company*
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> *334. Relaxation of separate entity principle. Although this topic of liability for debts or liabilities of related companies does not strictly fall under the heading of director liability and disqualification, it is similar in that it deals with the imposition of liability on persons who have been closely connected with the running of the company but who would ordinarily be protected from being required to contribute to the amount available for distribution in the winding up. Under the existing law, the separate personality of each company prevents access to the funds of one company for the payment of the debts or liabilities of a related company except where the debtor company is a shareholder or creditor of the related company. This may operate unfairly where the business activity of a company has been directed or controlled by a related company. It is as though the related company was acting as a `director' of the other company and causing it to incur debts and liabilities.*

335. Proposal in DP 32 . In DP 32 (para 222) the Commission proposed to give the court a wide discretion to order that a company that is or has been a related company pay to the liquidator all or part of an amount which is an admissible claim in the winding up `if it is satisfied that it is just'. Three specific criteria to which it was proposed the court may have regard were:

- *the extent to which the related company took part in the management of the company*
- *the conduct of the related company towards the creditors of the company and*
- *the extent to which the circumstances that gave rise to the winding up of the company are attributable to the actions of the related company.*

It should not, of course, be sufficient that creditors have merely relied on the assets of the related company in their decision to deal with the company.

336. Assessment and recommendation. The Commission's proposal was supported by several submissions. One submission, from the Law Council of Australia, strongly opposed the proposal on four grounds.

- *Separate entity principle. The Council said that it is a fundamental principle of company law that separate companies have separate legal entities. However, as a matter of policy, the Commission sees no reasonable objection to recommending the imposition of liability where a parent company permits its subsidiary to incur debts when insolvent.*
- *Project financing. The Council argued that financing for large resource and other projects needs to be done on a limited recourse basis, but that, under the Commission's proposal, it would not be possible for a parent company to satisfy itself that it would not be liable for the debts of the project. However, the fact that creditors have entered into contracts on a limited recourse basis would be one of the `other relevant matters' to which the court is required to have regard.*
- *Uncertainty. The Council said that the uncertainty in commercial dealings that would be created by the wide discretion given to the court would be undesirable. Lenders would be unable to ascertain the true liabilities of parent companies and could be expected to assume that at least some unguaranteed liabilities of subsidiaries should be taken into account. However, persons lending to the parent of a group of companies have regard not only to its balance sheet but to the consolidated balance sheet of the group and generally take cross-collateralised security. The Commission does not accept therefore that the suggested uncertainty would follow from its proposal. Moreover liability for a subsidiary's debts otherwise than under a guarantee would only arise in the context of the Commission's recommendations where that subsidiary was or became insolvent.*
- *Accounts. The Council suggested that auditors and company directors would have enormous difficulty in producing accounts which represent a true and fair view of a parent company. However, the Commission does not accept that accounting difficulties are sufficiently serious to deter it from recommending the imposition of liability on a parent company, which has permitted its subsidiary to trade while insolvent.*

Accordingly, the Commission recommends that companies be liable for the debts or liabilities of related companies in the manner set out in D13.

I have quoted at length to make sure that it is clear what the recommendations of the Law Reform Commission were. It went on to outline, in what it refers to as section D13, the way in which this section should be structured. My amendment is closely modelled on the Law Reform Commission draft provision, given that the Commission had obviously carefully considered the matters and weighed the manner in which it should be presented.

I added one section, item 2(d). That arose because in three specific instances in relation to employee entitlements, what is known as the Woodlawn, the Cobar and the Patrick examples made necessary such a clause.

The second part of the amendment inures for the benefit of all creditors, including those who have judgment debts against the insolvent company as a result of proceedings taken under sections 51AA, 51AB or 51AC of the Trade Practices Act or the franchising code of conduct or any other of the state based retail tenancy legislation for that matter.

Not only am I referring to creditors in general, but I am referring to matters that affect small business in particular. I was alerted to this by a letter I received in 1998 from an organisation which indicated the real danger. The letter said:

I consider that your proposed amendments

(because I had circulated these,)

- *may also have a wider application to the recent fair trading package in that franchises and shopping centre owners could establish corporate shells to run various business enterprises. Should a franchisee or a retail tenant in a shopping centre ultimately be successful in court proceedings against a business enterprise concerning unconscionable conduct, an award for damages may not be effective if the entity has no assets or puts itself into voluntary administration. The establishment of such corporate structures would, of course, defeat the fair trading reforms.*

Those are important points because the law should prevent companies being able to avoid their obligations to suppliers, banks, landlords, tenants and customers as well as to employees through the restructuring and the deliberate manipulation of their corporate structures to avoid their legitimate obligations.

3. Defining Entitlements

The Australian Institute of Company Directors (AICD) have quite properly distinguished between accrued entitlements and those entitlements which are consequent to an event. In a very blunt, but in my opinion, very accurate article, Kenneth Davidson of the Age on 17 February 2000 wrote an article entitled ‘Put free riders on employee entitlements out of business’. The thrust of Davidson’s article, with which I agree, was that there are a number of entitlements which have been earned by employees and are therefore held in trust (in escrow) by the company on their behalf, which a company should not use without employees’ express permission.

Such employee funds would approximate to the AICD's definition of accrued entitlements which belong to the employees, and which the AICD believe should have priority over secured creditors.

Accrued entitlements could be broadly defined as being unpaid wages, leave and long leave entitlements, amounts due for injury compensation, and PAYE, superannuation and other statutory contributions due from the company on the employees behalf. Entitlements which are not accrued and arising from an event would be items like redundancy and retrenchment provisions and pay in lieu of notice.

It seems to me that accrued entitlements should rank in priority immediately after costs and charges of insolvency administration. However this may pose some risk to the financing arrangements that many companies presently enjoy since they are using employee entitlements as an unsecured cash flow and financing source.

Accrued entitlements are effectively held in trust by companies on behalf of employees, a trust which is often abused. There are at least three ways in which accrued entitlements could be better dealt with :

- Full and regular disclosure to employees of what entitlements are outstanding and of the financial position of the company so that they can evaluate their risk. Support by employees for the use of their entitlements by companies should be with their full informed consent, given without duress.
- Entitlements could be safeguarded through the use of arms length trust funds as a repository for accrued entitlements. Trust funds are already used in some industries for the accumulation of long service leave and for a redundancy pool.
- Employee entitlements could be appropriately secured against assets of the company. The prospect of employee entitlements being secured by a floating or fixed charge over assets of the company has merit to the extent that it would improve the likelihood of a greater payout, although it would not guarantee a full payout.

4. Uncommercial Transactions

Item 3 of this Bill amends section 588G of the *Corporations Law* and adds 'uncommercial transactions' to the list of transactions which must not be engaged in whilst a company is insolvent. This amendment does not focus specifically on the protection of employee entitlements. It strengthens the law in a manner which could potentially benefit all creditors.

The term 'uncommercial transaction' is already defined in section 588FB as a transaction that a reasonable person in the company's circumstances would not have entered into having regard to the benefits and detriment to the company of entering into a transaction and the respective benefits to other parties to the transaction. The Majority Report outlines some difficulties with this section.

I can foresee endless and costly legal debate about what an uncommercial transaction is. For instance the Department of Treasury, with regard to Section to 588G, say that uncommercial transactions could include asset stripping (see Majority Report 3.19). However asset stripping could conceivably be regarded by the courts as a profoundly commercial decision, if it was to the benefit of shareholders even not to the benefit of employees and creditors.

These ‘uncommercial’ transactions are currently ‘voidable’ and a liquidator may apply to the court for an order that the financial benefit be returned so that it could be distributed to all creditors.

The extension of section 588G to ‘uncommercial transactions’ as is proposed in item 3, while supported by the Australian Democrats, will not necessarily deliver substantial improvements to the protection of employee entitlements.

5. Preventing recovery of employee entitlements

Item 5 of the Bill introduces new part 5.8A which has the stated intention of protecting a company’s employees from agreements and transactions entered into with the intention of defeating recovery of those entitlements.

The Democrats support this sentiment but have serious concerns as to the effectiveness of the proposed provision in achieving that objective.

It is appropriate to restate part of the operative provision:

> Section 596AB
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> (1) A person must not enter into a relevant agreement or a transaction with the intention of, or with intentions that include the intention of:
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> (a) preventing the recovery of the entitlements of employees of a company; or
>
> (b) significantly reducing the amount of the entitlements of employees of a company that can be recovered.

The subjective test required (ie. the need to prove intent) will mean that it will be extremely difficult to bring a prosecution under this provision.

The burden of proving subjectively that a person intended to avoid recovery of employee entitlement may mean that successful actions for compensation under section 596AC will be rare. If this occurs the deterrent effect of these amendments on the behaviour of directors will be greatly reduced.

Consideration should be given to reducing the stringency of the test associated with section 596AB. The prospect of applying an ‘effects’ test – under which the test would be whether the transaction or agreement had the effect of preventing the recovery of entitlements is probably not appropriate because it catches transactions which are quite legitimate. However consideration needs to be given to alternative tests which lie somewhere below the proposed ‘intention’ test yet somewhere above the mooted ‘effects’ test.

6. Conclusion

Although unquantified by any of the witnesses, it seems evident that there is a genuine danger that company’s financing arrangements could be put at risk if changes to the law are not carefully constructed. The attitude of the AICD to much better protection for employee entitlements despite this risk is instructive and of assistance.

My view is that if employers are doing the right thing with the protection of accrued entitlements by securing the genuine consent of employees to their use, or by securing entitlements through a trust fund, or by securing employees as a highly ranked creditor against genuinely available assets, then consideration could be given to some relief against the more restrictive recommendations of this bill.

The issue of giving employees greater security against assets would affect existing financial arrangements and in that regard transitional provisions of three to five years might be appropriate.

The proposals in the Bill should be augmented by making related companies liable for the debts of insolvent companies as outlined in 2. above.

7. Recommendation

The Australian Democrats will draft amendments to this bill to meet some of the deficiencies outlined above.

Senator Andrew Murray