



Australian Government

Reforms to address corporate misuse of the Fair Entitlements Guarantee scheme

Consultation paper

May 2017

CONTENTS

- Consultation process ii
- Foreword iii
- 1. Introduction 1
- 2. The Fair Entitlements Guarantee scheme 1
- 3. Sharp corporate practices 4
- 4. Proposals for reform 7
- 5. Reform to Part 5.8A of the Corporations Act 8
- 6. Preventing abuse of corporate group structures to avoid paying employee entitlements 14
- 7. Sanctioning directors and officers with a track record of involvement in insolvencies where FEG is relied upon 18
- 8. Other related reforms 21

CONSULTATION PROCESS

Request for feedback and comments

The questions in this consultation paper aim to frame discussion however, they are not intended to limit consideration of related and relevant matters.

Non-confidential submissions may be made available on the Treasury and the Department of Employment websites. Submissions made in confidence will not be published. A request for access to a confidential submission will be determined in accordance with the *Freedom of Information Act 1982* (Cth). In the absence of a clear indication that a submission is intended to be confidential, a submission will be treated as non-confidential.

Closing date for submissions: 16 June 2017

Submissions should be sent to: ImprovingFEG@employment.gov.au

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Disclaimer: This document is designed to assist consideration of issues and options to inform the consultation process. It does not indicate a commitment by the Australian Government to a particular course of action.

FOREWORD



The Australian Government operates the Fair Entitlements Guarantee (FEG) scheme which assists certain employees when their employer's business fails and the employer has not made adequate provision for employee entitlements (such as accrued leave, redundancy payments and unpaid wages). It is a scheme of last resort to support redundant workers.

Costs under the FEG scheme have dramatically increased with FEG payments totalling more than \$1 billion between 2012-13 and 2015-16. This represents a 75 per cent increase over the preceding four year period.

There is increasing evidence that some employers are deliberately structuring their corporate affairs to avoid paying employee entitlements when a business becomes insolvent. In several recent cases, practices have been openly employed to shift the cost of the employee entitlements to the FEG scheme.

This inappropriate reliance by some employers on the FEG scheme to cover the payment of employee entitlements is unacceptable. For the Australian Government to make FEG payments in circumstances where businesses can pay their employee entitlements but choose not to, is contrary to the purpose of the scheme.

To address these issues and ensure the FEG scheme remains viable, the Australian Government is consulting on options for targeted law reform to address corporate misuse of the FEG scheme and to improve the recovery of FEG payments.

Any proposed amendments to the law will be largely tailored around FEG, and will support and be complementary to other Australian Government processes such as the work of the Phoenix Taskforce and the improvements to insolvency laws under the National Innovation & Science Agenda.

The Australian Government seeks your views on the options for reform outlined in this paper and your participation in the consultation process.

A handwritten signature in black ink, appearing to read 'Kelly O'Dwyer'.

The Hon Kelly O'Dwyer MP
Minister for Revenue and Financial Services

A handwritten signature in black ink, appearing to read 'Michaelia Cash'.

Senator the Hon Michaelia Cash MP
Minister for Employment

1. INTRODUCTION

Under the Fair Entitlements Guarantee (FEG) scheme,¹ the Australian Government provides financial assistance for certain unpaid employee entitlements to eligible employees who have lost their jobs due to the insolvency of their employers (including entitlements such as accrued leave, redundancy payments and unpaid wages). After assistance is paid to an eligible claimant, the Government “stands in the shoes” of the employee and becomes a creditor of the insolvent entity.

Costs of the FEG scheme have been increasing due to the adoption of sharp corporate practices² by select employers and parties associated with them, resulting in cost shifting to the scheme and through it, to taxpayers.

While certain sharp corporate practices can be addressed through current administrative and legal mechanisms,³ more needs to be done to ensure all inappropriate practices are addressed to enhance the recovery of FEG payments. Claims on the scheme have increased dramatically and the Government believes that legislative reforms are required to ensure that employers take more responsibility for paying the entitlements of their employees.

The Government is seeking views on options for targeted law reform to address this issue.

2. THE FAIR ENTITLEMENTS GUARANTEE SCHEME

2.1 Background to the FEG scheme

The first government assistance program to protect employee entitlements was the Employee Entitlements Support Scheme (EESS), which was established in January 2000 to provide a national safety net for the basic protection of entitlements of employees whose employment was terminated because of an employer’s insolvency.⁴

The EESS was implemented in response to a number of significant corporate insolvencies which left employees with unpaid entitlements, and raised public concern about the lack of existing protections for such entitlements.⁵ Key features of the EESS underpin all successor federal government employee entitlement schemes.

In September 2001, the EESS was replaced by the General Employee Entitlements and Redundancy Scheme (GEERS).⁶ GEERS was established to be fully funded by the federal government and signalled government acceptance that the taxpayer would ‘insure’ employees for their unpaid employee entitlements (including redundancy pay) in the event of their employer’s insolvency.

¹ The FEG scheme is a legislative safety net that covers certain employee entitlements. Further information on the FEG scheme is available from <https://www.employment.gov.au/fair-entitlements-guarantee-feg>. Additional background on the scheme is at ‘2. The Fair Entitlements Guarantee scheme’.

² Sharp corporate practices are a range of methods and approaches adopted by certain company representatives, company owners or other parties involved in corporate restructures and insolvencies, which seek to prevent, avoid or reduce the payment of obligations to creditors. Further information is at ‘3.2 What are sharp corporate practices?’.

³ See material at ‘3.4 The need for law reform’.

⁴ The Hon Peter Reith MP, ‘National scheme to protect employee entitlements’ (Media Release, 8 February 2000).

⁵ Ibid.

⁶ The Hon Tony Abbott MP, ‘Even Better Arrangements to Protect Employee Entitlements’ (Media Release, 20 September 2001).

GEERS and the EESS operated under administrative arrangements. Subsequently, government decided to enact a legislative employee entitlements scheme.

The arrangements for the federal government to legislatively protect certain employee entitlements were enshrined in the *Fair Entitlements Guarantee Act 2012* (Cth) (FEG Act),⁷ with the operative provisions of that Act commencing on 5 December 2012.⁸

The key principle underpinning the FEG scheme and its predecessor administrative schemes (GEERS and EESS) is that employers should be responsible for meeting employee entitlements. Accordingly the FEG scheme is designed to operate as a scheme of last resort, where no alternative avenue exists for eligible employees to be paid their accrued employment entitlements or redundancy pay due to the insolvency of their employer.

The FEG scheme provides financial assistance (by way of an advance) to cover five basic employment entitlements for redundant employees being:

- unpaid wages (up to 13 weeks);
- annual leave;
- long service leave;
- payment in lieu of notice (up to five weeks); and
- redundancy pay (up to four weeks per full year of service).

The FEG Act imposes a range of eligibility conditions that a redundant worker must satisfy in order to receive assistance. Consistent with these eligibility conditions, FEG assistance is only available for employees who are Australian citizens or permanent residents. FEG assistance is not available for contractors and cannot be sought by persons who are temporary visa holders. The scheme also has some payment thresholds.⁹

Once a payment is made to a redundant worker under the FEG scheme, the Australian Government “steps into the shoes” of the employee with standing to recover the amount of FEG advanced through the insolvency process.

As a safety net for the payment of employee entitlements, the costs of the FEG scheme are ultimately borne by taxpayers. This includes meeting costs associated with misuse of the scheme.

The existence of the FEG scheme presents a moral hazard as it enables certain employers to arrange their affairs to prevent, avoid or minimise paying their employee entitlements with the knowledge that the government (and ultimately the taxpayer) will pay some or all of the entitlements. There is also some evidence indicating that unions, during bargaining for enterprise agreements, negotiate higher redundancy entitlements knowing that the FEG scheme can cover this in the event of an employer’s insolvency.

2.2 FEG scheme statistics

Annual costs for the FEG scheme and its predecessor schemes have been trending strongly upwards in recent years. In the 2007-08 financial year, the cost of total assistance paid under

⁷ The FEG Act received Royal Assent on 28 November 2012 (see <https://www.legislation.gov.au/Details/C2012A00159>).

⁸ Section 2 of the FEG Act outlines the commencement date of the various provisions of that Act.

⁹ A maximum weekly wage is applied when calculating the FEG assistance payable to eligible redundant workers. The current indexed maximum weekly wage cap is \$2451.00. Further information is available from <https://docs.employment.gov.au/node/35951>. Also see sections 5, 26 and 27 of the FEG Act.

the FEG scheme and its predecessor schemes was \$60.8 million, however by the 2015-16 financial year, the annual cost had risen to \$284.1 million.¹⁰

Contributing to the increasing cost of the FEG scheme is the growing number of cases and claimants in which FEG assistance is being paid, with demand having roughly doubled since 2007-08. In this time, the average number of claimants per insolvency has remained stable.¹¹

Historically FEG assistance has been paid to employees of insolvent entities across all industries in Australia. The construction, manufacturing, and retail industries are the largest contributors to the number of individuals claiming FEG assistance, collectively totalling just under half of the total claims made per year.¹² FEG payments to employees made redundant in the construction and manufacturing industries are the two largest contributors to the costs of the FEG scheme each year, together comprising over a third of the costs per year.¹³

Recoveries of FEG assistance through the insolvency process have been historically very low averaging around ten per cent of the FEG amounts advanced each year.¹⁴ However, recoveries improved significantly in 2015-16 to around 19 per cent after the commencement of the two-year pilot Fair Entitlements Guarantee Recovery Program (FEG Recovery Program).

¹⁰ The table outlines the cost of total payments made to redundant workers under government employee entitlement schemes (GEERS and FEG) since 2007-08. The table also details that the number of cases where government assistance has been provided has increased, producing a commensurate increase in the number of persons provided with assistance. The average number of persons paid per case however has remained reasonably stable, with just over eight persons paid per insolvent employer.

Financial year	Cases paid	Persons paid	Costs (\$ millions)
2007-08	983	7808	60.8
2008-09	1346	11027	99.8
2009-10	1869	15565	154.1
2010-11	1623	15413	151.3
2011-12	1737	13929	195.5
2012-13	1755	16019	261.7
2013-14	1113	11255	197.2
2014-15	2060	19074	312.5
2015-16	1746	14341	284.1

Data source: Department of Employment.

¹¹ For example in the 2007-08 financial year, 7,808 workers across 983 insolvent entities were paid FEG assistance. This compares with 14,341 redundant workers across 1,746 insolvent entities paid FEG assistance in 2015-16.

¹² The construction, manufacturing, and retail industries comprise on average around 18 per cent, 17 per cent and 12 per cent of total claims made per year.

¹³ Payments to redundant employees in the construction and manufacturing industries comprise on average 22 per cent and 14 per cent of total costs per year.

¹⁴ The table outlines recoveries of payments of government assistance for employee entitlements (under GEERS and FEG) through the insolvency process since 2007-08.

Financial year	FEG/GEERS paid (\$ millions)	FEG/GEERS recovered (\$ millions, cash)	Recovery as proportion of cost
2007-08	60.8	16.8	27.6%
2008-09	99.8	9.1	9.1%
2009-10	154.1	18.7	12.2%
2010-11	151.3	15.6	10.3%
2011-12	195.5	21.4	10.9%
2012-13	261.7	37.2	14.2%
2013-14	197.2	19.1	9.7%
2014-15	312.5	23.3	7.5%
2015-16	284.1	54.4	19.3%

Data source: Department of Employment.

3. SHARP CORPORATE PRACTICES

3.1 Cost drivers of the FEG scheme and evidence of inappropriate employer behaviours

Against the backdrop of increasing costs of the FEG scheme, in the 2015-16 Budget the Australian Government agreed to a two-year pilot of funding activities to strengthen the integrity and sustainability of the scheme.¹⁵

The pilot FEG Recovery Program¹⁶ was successful, returning \$22.8 million in its first year of operation. The success of the pilot resulted in the Australian Government agreeing to make the program ongoing and providing it with expanded funding from 1 January 2017.¹⁷

As part of the pilot FEG Recovery Program, work was undertaken to enhance understanding of the cost drivers of the FEG scheme. This work revealed evidence of an increasing trend of employers deliberately structuring their corporate arrangements to avoid or reduce paying employee entitlements in the event of insolvency, including certain employers (and their agents or other associated parties) adopting a range of sharp corporate practices to achieve these ends.

The use of such sharp corporate practices can significantly impede, reduce or prevent, the recovery of FEG payments through the insolvency process.

3.2 What are sharp corporate practices?

Sharp corporate practices are approaches and techniques adopted by certain company representatives, company owners, or other parties who provide advice to or who are otherwise involved in corporate restructures and insolvencies (such as insolvency advisors), that seek to prevent, avoid or reduce obligations of the company to pay its creditors (including employees for their employee entitlements).

Some broad examples of these techniques include:

- i. utilising a company structure and/or utilising corporate group structures in ways that the employees are employed by an entity which does not appropriately provide for their employee entitlements and where insufficient realisable assets are available to offset liabilities owed to the employees if they are made redundant, or the assets of the entity which employs the workers are transferred to related entities prior to the employees being made redundant;

¹⁵ Commonwealth of Australia (2015), *2015-16 Budget: Budget Measures, Budget Paper No. 2*, Canberra, page 82.

¹⁶ The FEG Recovery Program enhanced recoveries of FEG advances through adopting two distinct streams of recovery activity. In the first stream of activity, the Department of Employment funded recovery actions of company liquidators and bankruptcy trustees to improve the return of FEG monies, where the liquidators and trustees would not otherwise have had the financial resources to pursue those actions. In the second stream of activity, the Department of Employment funded actions on behalf of the Commonwealth of Australia to recover FEG advances, mainly being actions for suspected breaches by company receivers and liquidators of sections 433 and 561 of the *Corporations Act 2001* (Cth), which require those parties to provide for the payment of outstanding employee entitlements out of the proceeds of circulating assets of the business. Further information about the FEG Recovery Program is available at <https://www.employment.gov.au/feg-recovery-program>.

¹⁷ Commonwealth of Australia (2016), *2016-17 Mid-Year Economic and Fiscal Outlook*, Canberra, page 106.

- ii. utilising illegal phoenix company activities and arrangements, including transmissions of businesses and transfers of a company's assets for nominal or no value to another company with a similar name, with the same directors or officers, before placing the company in liquidation for the purpose of avoiding debts to company creditors including liabilities owed to employees;
- iii. 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); and
- iv. 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.

3.3 The impact on the FEG scheme

While use of such corporate practices is not always strictly illegal, they place an unfair burden on taxpayers where those practices result in reliance on the FEG scheme. Sharp corporate practices also impact other parties such as businesses (for example, suppliers of goods and services who were not paid, and competitors who may be at a financial disadvantage after paying their debts including the costs of funding their employee entitlements).

To assist in determining the impact of such practices on the FEG scheme, a large sample of FEG cases over a three year period¹⁸ was reviewed to identify and determine the prevalence of a dozen sharp corporate practices, their fiscal impacts on the FEG scheme, and the effectiveness of currently available mechanisms to address them. The dozen practices were more specific instances of the four broad example practices outlined above.

Analysis of the sample found that approximately one in seven FEG cases had one or more sharp corporate practices present which had financial consequences for the scheme. Key findings were:

- i. business restructuring resulting in the avoidance of the payment of employee entitlements is increasing costs to the FEG scheme;
- ii. the incidence of illegal phoenix company activity, and subsequent costs to the FEG scheme, is increasing;
- iii. a small but still significant percentage of company receivers and liquidators have not been complying with their legal obligations under sections 433 and 561 of the *Corporations Act 2001* (Corporations Act) to pay amounts recovered from the proceeds of circulating security assets to employees (including FEG as a subrogated creditor), rather than their secured creditor;

¹⁸ Around 650 cases where companies went into liquidation in the period 1 January 2013 to 31 December 2015, (and which had not otherwise already been reviewed by the Department of Employment) were examined. The broad results from the sample have been re-affirmed in subsequent samples of cases for the same and different time periods in terms of impacts of sharp corporate practices on the FEG scheme and predecessor employee entitlements schemes.

- iv. provisions in Part 5.8A of the Corporations Act, which are intended to prevent business agreements and transactions directed at preventing the payment of, and avoiding or reducing the payment of employee entitlements, are not effective; and
- v. measures which could be used to ban company directors under the Corporations Act could be better tailored for the purposes of reducing the moral hazard associated with the FEG scheme, being that employers rely on the scheme knowing that government will pay the majority of any outstanding employee entitlements if the employer cannot.

The analysis found that this corporate misuse of the FEG scheme was not isolated, with the relevant sharp corporate practices not being quarantined to select industries.

The costs of these behaviours were also found to be significant. As an example, the cost imposed on the scheme in just a few select cases where there had been arrangements designed to avoid the payment of employee entitlements through business restructuring were in excess of \$100 million in just the last few years.

3.4 The need for law reform

To assist in mitigating the impacts of sharp corporate practices on the FEG scheme, a range of administrative actions and legal approaches have been adopted by government departments and agencies. These approaches included funding recovery actions under the FEG Recovery Program, government departments/agencies cooperating on cases of common interest, and relevant matters being pursued through the Australian Government's Phoenix Taskforce and Serious Financial Crimes Taskforce to combat illegal phoenix activity.¹⁹

While this will assist in mitigating the impact of certain sharp corporate practices, the actions are largely targeted at illegal activities after they have occurred and will not address all of the sharp corporate practices adopted by select corporate employers and their representatives.

In particular, the current law does not adequately mitigate the risks and costs imposed on the community and appropriately deter or sanction the behaviour of:

- i. those involved in arrangements which result in the intentional avoidance or reduction of the payment of employee entitlements, resulting in FEG being relied upon;
- ii. those who use a corporate group structure to avoid or reduce their exposure to meet employee entitlement obligations where as a consequence the FEG scheme is relied upon; and
- iii. company officers and directors who have a history of involvement in insolvencies, where FEG is repeatedly relied upon to pay part or all of the outstanding employee entitlements.

To address these concerns, it is proposed that targeted law reforms are made that will address corporate misuse of the FEG scheme and improve the recovery of FEG payments.

¹⁹ Further information on the Phoenix Taskforce is available from: <https://www.ato.gov.au/General/The-fight-against-tax-crime/Our-focus/Illegal-phoenix-activity/Phoenix-Taskforce/>.

4. PROPOSALS FOR REFORM

Without law reform, the Australian Government will not be able to appropriately address certain behaviours which are exerting financial pressure on the FEG scheme and unfairly burdening taxpayers. Further, it will become increasingly difficult to maintain the integrity and future sustainability of the scheme if the relevant practices were to become entrenched and more prevalent.

This noted, the majority of businesses do exercise appropriate behaviours in providing for their employees' entitlements. The parties and entities which the potential law reform measures would impact, while not large in number, have a disproportionately large impact on the scheme. Market perceptions of the professional reputations of businesses and their company directors and officers are also impacted by their behaviours.

The paper sets out a number of possible changes to the current law, which aim to:

- i. deter practices which prevent, reduce or avoid the proper payment of employee entitlements;
- ii. reduce improper reliance on the FEG scheme; and
- iii. increase the consequences for corporate wrongdoing.

The paper asks for submissions on whether these changes should be adopted wholly or partly, or if other changes would be appropriate to rectify the issues identified at '3.4 The need for law reform.'

Any amendments proposed to the law (including potential changes to the Corporations Act) will be largely tailored to mitigate the impact on the FEG scheme, and will be complementary to and support other Australian Government processes, so as not to hinder the ability of company directors to manage their corporate affairs while striving for commercial success, and more broadly supporting innovation and business rescue.²⁰

²⁰ See for example, the Australian Government's National Innovation & Science Agenda insolvency law reforms (<https://www.innovation.gov.au/page/insolvency-laws-reform>).

5. REFORM TO PART 5.8A OF THE CORPORATIONS ACT

The provisions of Part 5.8A of the Corporations Act (the Part) were introduced into the law in 2000²¹ after a number of high profile insolvencies.²²

The Part protects employee entitlements that receive preferential payment on a winding up from agreements and transactions that are entered into with the intention of defeating the recovery of those entitlements²³ by

- i. making it a criminal offence for persons to intentionally enter into a relevant agreement or arrangement that prevents the payment of, or avoids or significantly reduces some or all of a company's employee entitlement liabilities;²⁴ and
- ii. allowing a civil action to be brought by the liquidator (or employees in select circumstances) to recover the loss or damage incurred by the avoidance of the employee entitlements.²⁵

Since being introduced into the Corporations Act, there have been no successful criminal or civil court actions under the provisions in the Part.²⁶

Reasons for this may include that:

- section 596AB requires proof of a person's actual, subjective intention to avoid some or all of the employee entitlements at the time that a transaction occurred or relevant agreement was entered into, which is difficult to prove;²⁷
- the core provisions of the Part (section 596AB and section 596AC) are awkwardly drafted;²⁸ and
- the provisions of the Part (and the explanation in the accompanying explanatory memorandum)²⁹ do not define with sufficient clarity the circumstances and scenarios in which the Part is anticipated to operate, as well as the persons to whom it may apply.³⁰

²¹ *Corporations Law Amendment (Employee Entitlements) Act 2000* (Cth), which amended the *Corporations Act 1989* (Cth) (the predecessor of the *Corporations Act 2001* (Cth)). The amending Act received Royal Assent on 30 June 2000 and began operation on that day (per section 2 of that Act).

²² Commonwealth, *Parliamentary Debates*, House of Representatives, 17 February 2000, 13723 (Joe Hockey, Minister for Financial Services and Regulation).

²³ Paragraph 14 of the explanatory memorandum to the *Corporations Law Amendment (Employee Entitlements) Bill 2000* (Cth) (see <https://www.legislation.gov.au/Details/C2004B00639/>).

²⁴ Section 596AB of the Part.

²⁵ Section 596AC of the Part.

²⁶ In addition, see Helen Anderson, *The protection of employee entitlements in insolvency: An Australian perspective*, Melbourne University Press (1st ed, 2014) 40 and 58 (footnote 77).

²⁷ See Helen Anderson, *The protection of employee entitlements in insolvency: An Australian perspective*, Melbourne University Press (1st ed, 2014) 40; and Scott Atkins et al, 'Underwriting the downturn: Australia's employee entitlements guarantee and moral hazard' (2016) *Third Quarter Insol World*, 12-13.

²⁸ As an example, subsection 596AB(1) is drafted in the negative ('A person must not enter') and does not utilise more commonly used approaches for differentiating between physical and fault elements for a criminal offence.

²⁹ See for example, section 596AA of the Part and paragraphs 14 to 37 of the explanatory memorandum to the *Corporations Law Amendment (Employee Entitlements) Bill 2000* (Cth).

³⁰ For example, it is not clear whether the Part was intended to operate in situations where there is an avoidance of employee entitlements due to phoenix company activity or was applicable to corporate group situations. It is

As such, it seems relevant parties such as liquidators and employees believe the Part is too difficult to utilise, which is borne out by the lack of actions pursued under it.

Also, the majority of academic commentary on the Part argues that reform to improve its operation is desirable and necessary.³¹

This paper sets out potential reforms to strengthen the Part so that it becomes a more effective deterrent to those who intend to misuse the system.

Making the Part operate more effectively will help deter corporate misuse of the FEG scheme and improve the recovery of FEG payments.

5.1 Option 1: Extend the fault element in section 596AB to include recklessness and increase the maximum penalty

An option to enhance the operation of the Part is to extend the fault element required to contravene subsection 596AB(1) from a person's actual, subjective intention to also include a person recklessly entering into an agreement or arrangement that prevented the recovery of, or avoided some or all of a company's employee entitlement liabilities.

Broadly, recklessness is a level of culpability where a person is aware of a substantial risk that a circumstance or result exists or will occur, and having regard to the circumstances known to them, it is unjustifiable for them to take that risk.³²

Adopting recklessness as the fault element for the criminal offence in section 596AB should make it easier for the Australian Securities & Investments Commission (ASIC) to prosecute persons for contraventions of the section.

Making such a change to section 596AB should also enable liquidators and employees to more easily undertake civil recovery action. This is because section 596AC allows recovery for the loss or damage incurred by the avoidance of the employee entitlements from persons who contravene section 596AB but only proved on the balance of probabilities.³³ This said, courts would likely take into account 'the gravity of the matter alleged'³⁴ (being an allegation

also not clear what parties, including third parties such as insolvency advisers, the Part was intended to apply to.

³¹ See for example, Helen Anderson, *The protection of employee entitlements in insolvency: An Australian perspective* (Melbourne University Press, 2014), 167-171; and Christopher Symes, 'Will there ever be a prosecution under Part 5.8A?' (2002) 3(1) *Insolvency Law Bulletin* 17.

³² In the schedule to the *Criminal Code Act 1995* (Cth), 'recklessness' is defined in Division 5 'Fault elements' at subdivision 5.4:

- (1) A person is reckless with respect to a circumstance if:
 - (a) he or she is aware of a substantial risk that the circumstance exists or will exist; and
 - (b) having regard to the circumstances known to him or her, it is unjustifiable to take the risk.
- (2) A person is reckless with respect to a result if:
 - (a) he or she is aware of a substantial risk that the result will occur; and
 - (b) having regard to the circumstances known to him or her, it is unjustifiable to take the risk.
- (3) The question whether taking a risk is unjustifiable is one of fact.
- (4) If recklessness is a fault element for a physical element of an offence, proof of intention, knowledge or recklessness will satisfy that fault element.

³³ As section 596AC is not an offence provision, section 1332 of the Corporations Act applies such that "it is enough for a court to be satisfied of a breach of a provision on the balance of probabilities in proceedings other than for an offence" (per paragraph 25 of the explanatory memorandum to the Corporations Law Amendment (Employee Entitlements) Bill 2000).

³⁴ Per paragraph 140(2)(c) of the *Evidence Act 1995* (Cth). Also see Dixon J's discussion in *Briginshaw v Briginshaw* (1938) 60 CLR 336 at 361-362 about considerations which courts may take into account when deciding if grave allegations have been proved on the balance of probabilities.

of criminal conduct in breach of section 596AB) such that a finding that a person breached section 596AB on the balance of probabilities, would not likely be lightly made by a court.³⁵

Consideration should also be given to increasing the maximum penalties for breaches of section 596AB. For example, the current penalty of 1,000 penalty units or ten years imprisonment (subject to the five times multiplier for a corporation) could be replaced with a maximum penalty of 4,500 penalty units, or three times the loss suffered or benefit gained, or ten years imprisonment (subject to the five times multiplier for a corporation).

Other changes may also be required to ensure the provision acts as a genuine disincentive to the avoidance of employee entitlements.

5.2 Option 2: Introduce a separate civil penalty provision with an objective test

This option would create a civil penalty provision which is separate from the criminal offence provision (section 596AB).

A civil penalty is a punitive sanction imposed by a court applying civil court processes³⁶ with the sanction often being financial in nature.³⁷ Such penalties are founded on the notion of preventing or punishing public harm.³⁸

Civil penalty provisions within the Corporations Act allow courts to order individual defendants to pay penalties of up to \$200,000 where there has been a breach of a relevant civil provision.³⁹ Once a court decides a breach of a civil penalty provision has occurred, ASIC can apply to the court to seek disqualification orders of relevant persons from managing corporations for a period of time that the court considers appropriate.⁴⁰

A breach of the proposed civil penalty provision would give rise to a right to seek a compensation order and thus the existing compensation order under section 596AC would be superfluous and could be repealed.

The new civil penalty provision would be based on an objective test, for which two possible options are outlined below. These are

- a test based on what a reasonable person would have known or be expected to have known about the relevant agreement or transaction that occurred (Option 2A); and

³⁵ For example see *Neat Holdings Pty Ltd v Karajan Holdings Pty Ltd* [1992] HCA 66.

³⁶ Australian Law Reform Commission, *Principled Regulation: Federal Civil and Administrative Penalties in Australia*, Report No 95 (2002) at page 72, [2.45].

³⁷ M Gillooly and N Wallace-Bruce, 'Civil Penalties in Australian Legislation' (1994) 13(2) *University of Tasmania Law Review* 269, 269-270.

³⁸ Australian Law Reform Commission, *Principled Regulation: Federal Civil and Administrative Penalties in Australia*, Report No 95 (2002) at page 73, [2.47].

³⁹ Subsection 1317G(1) of the Corporations Act lists the provisions which are civil penalty provisions. Where there is breach of such a provision, a court may order a person to pay the Commonwealth a pecuniary penalty of up to \$200,000 if:

- (a) a declaration of contravention by the person has been made [by a court] under section 1317E; and
- (aa) the contravention is of a corporation/scheme civil penalty provision; and
- (b) the contravention:
 - (i) materially prejudices the interests of the corporation or scheme, or its members; or
 - (ii) materially prejudices the corporation's ability to pay its creditors; or
 - (iii) is serious.

⁴⁰ Section 206C of the Corporations Act.

- a test based on an objective assessment of the relevant agreement or transaction itself (Option 2B).

5.2.1 Option 2A: Test based on what a reasonable person would have known or be expected to have known

Under this option, section 596AC would be amended so that a contravention would be based on what a reasonable person⁴¹ would have known, or would be expected to have known, in the particular circumstances about the relevant agreements and transactions, which caused loss or damage to employees by the prevention of the payment, or the avoidance or reduction of employee entitlements.

Such an amended section would require an assessment to be made about what a reasonable person would know or would be expected to have known in the actual circumstances of the case. This assessment would then be used to determine whether the relevant person would or ought to have known that the relevant agreements or transactions would cause the loss or damage that occurred to the employees.

As an example, assume a company director transferred almost all the company's assets to a related entity as part of a restructure, and soon afterwards the company was put into liquidation with all the employees being made redundant and with no funds available to pay employee entitlements. If the value of the transferred assets would have been sufficient to pay most of the debts of the company, a reasonable person in such circumstances would either have to know or be reasonably expected to have known that such a transfer of assets would cause the loss or damage to the employees by reduction or avoidance of payments of employee entitlements.

Reformed in this way, section 596AC would not only strengthen the Part but would also be grounded in and supported by long established common law principles.

Such an amendment would be likely to result in a broader capture of behaviour and operate as a more effective deterrent to reduce sub-optimal corporate practices, so reducing the costs of and moral hazard associated with the FEG scheme.

Amending the Part as outlined would require careful redrafting to avoid inadvertent or inappropriate impacts upon legitimate business operations, including the ability to genuinely restructure an otherwise viable business.

5.2.2 Option 2B: Test based on objective assessment of the agreement or transaction

Under this option, section 596AC would be amended so that contravention of the section would be based on an objective assessment of the agreement or transaction which is claimed to have caused loss or damage to employees due to the prevention of the payment, or the avoidance or reduction of payments, of employee entitlements.

⁴¹ A reasonable person is an ordinary and unremarkable but reasonably educated and intelligent person, against whom the relevant defendant's conduct is assessed. Classic examples of the concept are outlined in *McQuire v Western Morning News* [1903] 2 KB 100 (CA) at 109 (where Collins MR refers to a person on 'the Clapham omnibus') and *Nomikos Papatonakis v Australian Telecommunications Commission* (1985) 156 CLR 7 at 36 (where Deane J refers to a person on the 'Bondi tram').

The objective assessment would be required to be made of the actual agreement or transaction in the circumstances of the case to determine whether it was a reasonable transaction or agreement in those circumstances.

Specific statutory guidelines may be introduced to assist a court in the reasonableness assessment of the agreement or transaction, which could include consideration of factors such as:

- the benefit or detriment to the company in entering the agreement or transaction;
- the respective benefit or detriment to other parties of the company entering the agreement or transaction; and
- whether the agreement or transaction was commercially reasonable including an assessment of any other legitimate purposes to the business for entering into it.

Ultimately, the decision as to the reasonableness of the agreement or transaction would be made on the balance of probabilities.

The advantage of this amendment is it would not require determination or assessment of the intent of the alleged perpetrator. In a similar vein to Option 2A, such an amendment would strengthen the operation of section 596AC with case law on what are reasonable agreements or transactions developing over time.

5.3 Option 3: Expand the parties who may initiate civil action

The deterrent effect of the Part and the effectiveness of section 596AC could be increased by allowing a wider range of parties to initiate civil recovery actions under the section.

Currently the liquidator of a company and former employees of the company in certain circumstances, have standing to bring civil actions under section 596AC.⁴²

To encourage greater use of the provision which would lead to enhanced recovery, the section could be amended so that the following entities could bring an action for suspected breach of section 596AC as long as the liquidator did not intend to bring that action:

- the Department of Employment, when FEG has been paid;
- the Fair Work Ombudsman, for matters which were being investigated after which the employer was put into liquidation; and
- the Australian Taxation Office, where the reduced or avoided entitlements included superannuation guarantee amounts.

5.4 Option 4: Addressing other issues with the Part's drafting

It is anticipated that adoption of some of the options mentioned above will strengthen the Part significantly. However making such amendments would not address all the issues identified with the Part, such as the lack of clarity regarding the circumstances and scenarios in which the Part is intended to operate, the persons it applies to,⁴³ and the deterrent impact that an amended section 596AB may have as a criminal offence.

⁴² Subsection 596AC(2) of the Part specifies the liquidator's right of recovery and subsection 596AC(3) of the Part outlines the employee's right of recovery.

⁴³ See footnotes 29 and 30.

To address these specific issues with the Part, it may be more appropriate to redraft it using current understandings of compliance issues and sharp corporate practices to better tailor the Part, to ensure it operates effectively. Redrafting the Part will also provide an opportunity to clarify that it does apply to specific scenarios such as illegal phoenix company activity and relevant transactions within corporate groups.

In line with this approach, it would also be useful to expand the matters (currently being 'relevant agreements' and 'transactions') to which the Part applies, to ensure it achieves its aim to capture a wide range of potential behaviours which can lead to the avoidance of employee entitlements.

The definitions of 'relevant agreements' and 'arrangements' used in the Part are broadly defined⁴⁴ to include formal and informal arrangements, written or oral agreements, as well as understandings, even where they are part of a series or are a combination of these things.⁴⁵

However to ensure a rewritten Part comprehensively protects employee entitlements, and for the avoidance of doubt about the matters the Part applies to, the situations captured by the Part could be expanded to 'cover the field'.

One approach to achieve this would be to adopt a comprehensive definition of the matters to which the Part applies, similar to the definition of 'scheme' contained in section 177A of the *Income Tax Assessment Act 1936* (Cth).⁴⁶ That section applies not only to agreements, arrangements and understandings but also to promises, plans, proposals, actions, undertakings and courses of conduct. Alternatively, the current definitions of 'relevant agreement' or 'transaction' applying to the Part could be expanded to incorporate a widened range of circumstances.

QUESTIONS (REFORM OF PART 5.8A OF THE CORPORATIONS ACT):

1. Should Part 5.8A be amended?
2. What are the benefits and risks of the above options?
3. What are the specific drafting issues with the Part which should be addressed?
4. Are there alternative approaches that produce a genuine protection against the avoidance, prevention or reduction of payment of employee entitlements? What are they?

⁴⁴ The term 'relevant agreement' is defined in section 9 of the Corporations Act with the term having been interpreted by the courts broadly to include a significant range of arrangements and understandings: see for example, *Re Cornwall Resource Corp NL* (1997) 23 ACSR 571.

⁴⁵ Subsection 596AB(3) of the Part further broadens the definition of 'relevant agreement' and 'transaction' for the Part's purposes to include things such as a series or combinations of relevant agreements or transactions.

⁴⁶ 'Scheme' is defined to mean:

- (a) any agreement, arrangement, understanding, promise or undertaking, whether express or implied and whether or not enforceable, or intended to be enforceable, by legal proceedings; and
- (b) any scheme, plan, proposal, action, course of action or course of conduct.

6. PREVENTING ABUSE OF CORPORATE GROUP STRUCTURES TO AVOID PAYING EMPLOYEE ENTITLEMENTS

Many businesses operate using a group structure of several companies, with a parent company controlling the group, and each company in the group being a separate legal entity with limited liability. Such groups are often referred to as 'company groups' or 'corporate groups'.

Many medium to large enterprises operate through corporate group structures, with these groups contributing significantly to economic activity in Australia including through providing employment. Due to the scope of operation and size of many such entities, when such groups (or parts of them) collapse, they can have significant social and economic impacts. These impacts include claims on the FEG scheme that result in the provision of assistance to former group employees.

In recent years, between five to ten per cent of FEG cases paid annually involved companies which had previously formed part of a corporate group. Payments relating to such entities (if you consider all insolvent entities of a group together) comprise a majority of higher cost FEG cases, where payments of \$10 million or more were made. Such cases can contribute substantially to the annual costs of the FEG scheme in the years (and after) that the insolvency of the corporate group entities occurred.

With corporate groups, there are few legal restrictions on the structure the group has to adopt to conduct the affairs of its business.⁴⁷

Corporate groups can be organised in many ways including:

- vertically, with different companies in the group operating at different points in a production process;
- on a location basis, with the business in each location (whether in a separate country, state or city) being operated by a separate company; or
- on a risk basis, with different parts of a business segmented according to their risk profiles, with high risk ventures being operated by separate companies.

Further, it is a legitimate business practice for company groups to be structured so that employees and associated liabilities are held by one company while the assets of the group are held by other group companies. This is a globally accepted business practice utilised as an effective strategy to quarantine risk.

While corporate groups can structure themselves in a multitude of ways, certain corporate groups may operate as a single entity where the resources of the group are deployed to meet all the obligations of all the entities in that group. Groups may operate in such a way because they have adopted a deed of cross-guarantee.

When corporate groups have adopted a deed of cross-guarantee for example, the payment of employee entitlements should not be adversely affected by the fact that the group has adopted a structure where an employing entity has no assets available to pay employee entitlements in the event of insolvency, unless the whole group was to become insolvent.

⁴⁷ See Companies & Securities Advisory Committee, Corporate Groups Final Report, 2000 at page 2, [1.3] ([http://www.camac.gov.au/camac/camac.nsf/byHeadline/PDFFinal+Reports+2000/\\$file/Corporate Groups , May 2000.pdf](http://www.camac.gov.au/camac/camac.nsf/byHeadline/PDFFinal+Reports+2000/$file/Corporate+Groups,+May+2000.pdf)).

In corporate groups which do not operate as a single entity and do utilise an employing entity, if certain group entities obtain economic benefits of the employees' work but are not charged the full-costs related to the employees (for example, by charging a rate to ensure the employing entity had sufficient resources to pay superannuation, and to provide for possible redundancies), insolvency can have the consequence of shifting cost to the FEG scheme.

If the employing entity is placed into liquidation with no assets available to meet employee entitlements, there may be no legal ability to make any of the corporate group's other companies (including those which hold the group's assets) pay or otherwise contribute to the insolvent employing entity's liabilities,⁴⁸ even if they have not paid for the full economic benefits they received. The unpaid employee entitlements will then be passed to the taxpayer by reason of FEG claims made by the redundant workers.

Such an example demonstrates the vulnerability of the FEG scheme to the misuse of certain corporate group structures, where the group may be solvent and able to pay the employee entitlements, but chooses not to pay after not paying the value for the economic benefits of the employees' work received. In such cases, the taxpayer is effectively providing a subsidy to the group to pay the former employees through FEG for costs the group should have paid.

Of particular note, corporate groups which utilise employing entities which are subsequently liquidated resulting in FEG being called upon, is currently a small issue in terms of the number of cases for the FEG scheme. However, the cost impact to the FEG scheme of such cases has been, and is likely to continue to be, disproportionately large.

While FEG continues to provide assistance in all corporate group scenarios without a capacity to recover in select circumstances, there is a risk that use of structures designed to transfer cost to the FEG scheme may become normalised, exposing the Australian Government and the taxpayer to very substantial payouts each year. Without reform, there will be little recourse for recovery of the FEG advances, even where the corporate group has received more benefits than it has paid for and where it could otherwise pay either in part or in full.

Reform in this area is not intended to impact all corporate groups but instead is targeted at those groups which abuse the corporate veil to rely on the FEG scheme.

6.1 Option 5: Corporate groups to provide a contribution equivalent to any unpaid employee entitlements in some limited circumstances

An option to reduce the vulnerability of FEG to corporate group structures would be to reform the law so that certain corporate groups would be required to pay a contribution equivalent to the unpaid employee entitlements of an insolvent group member where FEG has been paid to the redundant group employees.

With such a reform, entities in a group structure would have a shared obligation to meet the unpaid employee entitlements of their related entity, in certain limited circumstances.

There are models in other common law jurisdictions which provide possible design models for such a reform. In New Zealand⁴⁹ and Ireland⁵⁰ the contribution order is a feature of the

⁴⁸ Holding companies can be liable for the insolvent trading of subsidiaries under section 588V of the Corporations Act. A range of provisions are also available to liquidators to void uncommercial transactions. Further, compensation orders may be sought against entities that are accessories to a breach of duties owed to the employing entity.

⁴⁹ Sections 271, 271A and 272 of the *Companies Act 1993* (NZ).

corporate law and allows debts of individual insolvent companies which formed part of a corporate group to be paid by the solvent entities in the group where certain conditions are met.

Unlike this reform proposal (which would be limited to the amount of unpaid employee entitlements where FEG has been relied on and where other conditions are met), contribution orders used in New Zealand and Ireland apply to all outstanding debts of insolvent group members.

With contribution orders, an application can be made to a court by a liquidator, a creditor or a shareholder, for an order against solvent group members to contribute to the outstanding debts of an insolvent member where it is 'just and equitable' to do so.⁵¹

Some factors taken into account in determining whether it is 'just and equitable' to issue the contribution order include the extent to which the related companies took part in the management of the now insolvent company, the extent to which entities of the group have obtained economic benefits from the insolvent entity, the impact the order would have on the creditors of the contributing entities, and other matters as the court thinks fit.⁵²

There is little common law on the operation of contribution orders in New Zealand (where it was introduced in 1980)⁵³ and Ireland (introduced in 1990).⁵⁴ However recent cases in New Zealand have further defined what is 'just and equitable' by the courts:

- undertaking a pragmatic examination of the actual commercial reality of the corporate group in question; and
- observing that a balance is required to be achieved between the policy considerations of the separate legal entity doctrine on the one hand, and avoiding the mischief which may result from an unyielding application of the doctrine on the other.⁵⁵

Potential criteria for a court to consider if a contribution order for employee entitlements was to be introduced into the law in Australia could include:

- the control and management relationship between entities in the group, and whether the insolvent entity had common directors and officers with the related group entities;
- the extent to which entities of the group obtained economic benefits from the labour of the insolvent entity (including whether the insolvent entity had charged a full market rate to the other entities in the group for the use of the employees' services);
- whether assets had been transferred from the now insolvent entity to other entities;
- the efforts directors and officers of the insolvent company had made to ensure the payment of the outstanding employee entitlements; and

⁵⁰ Section 599 of the Companies Act 2014 (Irl). See <http://www.irishstatutebook.ie/eli/2014/act/38/enacted/en/print>.

⁵¹ Section 272 of the *Companies Act 1993* (NZ) and subsection 599(4) of the Companies Act 2014 (Irl).

⁵² Paragraphs 272(1)(a) to (d) of the *Companies Act 1993* (NZ); *Re Dalhoff & King* (1991) 5 NZCLC 66,959; *Lewis Holding Limited v Steel & Tube Holdings Limited* [2014] NZHC 3311.

⁵³ See former sections 315A, 315B and 315C of the *Companies Act 1955* (NZ). These provisions were re-enacted in the *Companies Act 1993* (NZ) as sections 271, 271A and 272.

⁵⁴ See former section 140 of the Companies Act 1990 (Irl) which began operation on 1 August 1991. The provision was re-enacted as section 599 of the Companies Act 2014 (Irl).

⁵⁵ *Steel & Tube Holdings Limited v Lewis Holdings Limited* [2016] NZCA 366.

- any other matters the court thinks fit in each case.

Any measure would need to be appropriately targeted to offset the risk of adversely impacting or discouraging legitimate commercial behaviour.

As an alternative to an employee entitlement specific contribution order, the current pooling of assets provisions (in Division 8 of the Corporations Act) could be modified to achieve a similar result. This could be accomplished by expanding the scope of the existing pooling provisions to allow solvent group entities to provide for the outstanding employee entitlements of the insolvent entity in the corporate group, where particular criteria are met.

Adopting either approach would need to balance maintaining the commercial focus of insolvency laws with recognising the vulnerability of employee creditors in the circumstances.

QUESTIONS (CORPORATE GROUPS):

5. What are the benefits and risks of the above option?
6. What criteria should a court consider when deciding whether it is 'just and equitable' to order solvent corporate group entities to make a contribution? Why?
7. Are there alternative approaches available which would ensure employee entitlements are paid when corporate groups have the capacity to pay? Please outline how these might work.

7. SANCTIONING DIRECTORS AND OFFICERS WITH A TRACK RECORD OF INVOLVEMENT IN INSOLVENCIES WHERE FEG IS RELIED UPON

An examination of all cases in which FEG or GEERS assistance was provided since 1 July 2007 revealed that there are more than 1300 company directors who were directors of two or more companies which had redundant employees paid outstanding employee entitlements under FEG or GEERS. The majority of these 1300 directors serially managed companies which failed.

The examination of the cases involving these directors revealed that recovery through the insolvency process of advances of FEG and GEERS was low, with around 72 per cent of cases providing no return of advances made, with the average return in the cases being about 12 per cent.

Of the more than 1300 directors involved in multiple FEG cases, more than 950 were involved with one or more companies where FEG or GEERS was advanced and no return was obtained through the insolvency process. Further of the 950 directors, more than 600 of those directors were involved in two or more cases where FEG or GEERS was advanced and no return was realised in the insolvency process.

In the FEG and GEERS cases involving the 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. Potential breaches included failures of directors to ensure proper books and records were kept, and failures to comply with taxation law reporting and payment requirements.

Under the Corporations Act, directors can be disqualified from managing corporations in certain circumstances outlined in Part 2D.6 of that Act. Disqualification of persons can occur automatically, by application to a court to order disqualification of a person, or by a determination of ASIC.

Disqualification by the court or ASIC

Under section 206F of the Corporations Act, ASIC may consider a director disqualification order if a company director has been involved in two or more company liquidations within the last seven years, where it has sufficient evidence in relation to the legislative grounds for disqualification.⁵⁶ There is a similar (but broader) power of disqualification given to the courts under section 206D.⁵⁷

A person may also be disqualified by the courts from managing a corporation where:

- the person has breached any Corporations Act civil penalty provision;
- has at least twice been an officer of a body corporate that has contravened the Corporations Act (section 206E); or

⁵⁶ See subsection 206F(2) of the Corporations Act which states that ASIC must have regard for whether any of the corporations were related to one another; and may have regard to the person's conduct in relation to the management, business or property of any corporation; and whether the disqualification would be in the public interest; and any other matters that ASIC considers appropriate.

⁵⁷ Under this section, the court must be satisfied that the manner in which the corporation was managed was wholly or partly responsible for the corporation failing and that the disqualification is justified.

- has at least twice breached the Corporations Act themselves as an officer of a corporation.

Certain contraventions of the *Competition and Consumer Act 2010* (Cth) and the *Australian Securities and Investments Commission Act 2001* (Cth) may also attract disqualification by the court.

Automatic disqualification

A person is automatically disqualified from managing a corporation if they have been convicted:

- of any indictable offence concerning a substantial part of the business of a corporation or significantly affecting a corporation's financial position; or
- of any offence involving dishonesty that is punishable by at least three months imprisonment; or
- under a law of a foreign country punishable by at least 12 months imprisonment; or
- of any offence under the Corporations Act punishable by at least 12 months imprisonment.

A person who is an insolvent under administration (e.g. bankrupt) is also automatically disqualified.

Mitigating impacts on the FEG scheme

The existing disqualification provisions are not tailored to specifically mitigate behaviours which impact the FEG scheme.

Reform to this area of the law could help prevent serial insolvent company directors who inappropriately rely on FEG from continuing to operate in the market.

7.1 Option 6: Specific FEG sanctions for directors in Part 2D.6

Under this option, the current director disqualification powers of ASIC in section 206F of the Corporations Act and of the court, including sections 206D and 206E of the Corporations Act, would be amended to allow disqualification of directors who otherwise engage in behaviour which repeatedly results in improper reliance on the FEG scheme.

To ensure entrepreneurship and innovation is not hindered and alignment is maintained with the Australian Government's improvements to insolvency laws under the National Innovation & Science Agenda, the specific FEG sanction for directors would require:

- other contraventions of the Corporations Act or other laws be present as a pre-requisite for either the court or ASIC to disqualify the person (such as a failure to maintain proper company books of account or other records, or a failure to deliver such books and records when called upon, or failure to comply with employment laws, or failures to comply with relevant payment and reporting obligations under taxation laws); and
- reliance on the FEG scheme two or more times to pay redundant workers their outstanding employee entitlements; and

- in each case of reliance on the FEG scheme, minimal or no return of the FEG advances made being able to be recovered in the insolvency process.

As an anti-avoidance measure, it may be appropriate to structure the third criteria (no or minimal return of FEG advances) as an adjustable threshold.

The current provisions could also be amended to extend automatic disqualification to convictions of company officers of employee entitlement related offences other than under the Corporations Act (for example, under the *Fair Work Act 2009*).

QUESTIONS (REFORMS TO DIRECTOR DISQUALIFICATION):

8. What are the benefits and risks of the option outlined above?
9. Are there alternative approaches which would sanction those with a track record of involvement in insolvencies where FEG is relied upon? What are they?

8. OTHER RELATED REFORMS

Some other reforms are also proposed to resolve existing uncertainty in the law governing the priority of creditors.

8.1 Option 7: Reform the law regarding trust assets where an insolvent company is a corporate trustee

The law could be amended to make it clear that the priorities under section 556 in the Corporations Act (order of priorities for unsecured creditors) apply when distributing the surplus from the realisation of the trust assets of a company which is a corporate trustee.

A divergence in recent judicial authority⁵⁸ has led to uncertainty as to whether the ordinary rules governing the distribution of funds in a liquidation under section 556 apply to trust property in the liquidation of a company which is a corporate trustee.

In the cases where section 556 was found not to apply to the trust property (which may have been all of the assets in the liquidation), this has resulted in employee entitlements not receiving their ordinary priority ahead of other unsecured trust creditors, thus reducing their eventual payment.

8.2 Option 8: Clarify the priority of employee entitlements under sections 433 and 561 of the Corporations Act and align the sections

Sections 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.⁵⁹

There is currently uncertainty regarding the priority of employee entitlements over the claims of the security holder and the general remuneration, costs and expenses of a liquidator or receiver from the realisation of assets covered by a circulating security interest. The priority order is governed by section 433 (for receiverships) and section 561 (for liquidations). This uncertainty is reflected in the case law (including recent cases) on the provisions.

Notwithstanding that there are key differences between the two provisions, the policy intention underpinning both provisions is to provide a priority for the repayment of employee entitlements.

As such, amendments are proposed to better align the two provisions. This alignment should include amending section 433 to remove the word 'debenture' which should be replaced with another term which makes it clear that it is a reference to any debt owed by the

⁵⁸ A recent decision of the New South Wales Supreme Court held that liabilities of a trustee managed company were incurred in the course of acting as a trustee, and so the trustee was entitled to be indemnified from the trust assets of the company. Due to this, the order of priorities under section 556 of the Corporations Act did not apply in respect of trust assets (*Independent Contractor Services (Aust) Pty Limited ACN 119 186 971 (in liquidation) (No 2)* [2016] NSWSC 106). In contrast to this, the Victorian Supreme Court made a determination that trust assets were property that belong to the trustee managed company, and that accordingly, they be dealt with pursuant to the priorities in section 556 (*Re Pharmore* [2016] VSC). In *Re Amerind Pty Ltd (receivers and managers apptd) (in liq)* [2016] VSC 127, Robson J of the Victorian Supreme Court followed the decision in *Independent Contractor Services* and held that section 433 did not apply.

⁵⁹ General costs refers to costs other than those incurred associated with the realisation of the relevant assets.

company, rather than the more limited term 'debentures' as defined in section 9 of the Corporations Act.

QUESTIONS (OTHER RELATED REFORMS):

10. What are the benefits and risks of the above options?

11. Are there other issues raised by the interactions of sections 433 and 561 which should also be addressed?