Corporate insolvency

Editor: Helen Anderson

LABOR'S POLICY TO DEAL WITH PHOENIX ACTIVITY AFFECTING EMPLOYEES

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INTRODUCTION

On 1 February, 2016, the Australian Labor Party released its workplace relations policy entitled Protecting Rights at Work. This policy became a private members bill called the *Fair Work Amendment (Protecting Australian Workers) Bill 2016* (Cth) (the Bill), introduced into the Senate on 15 March 2016. Of interest to corporate lawyers is the Bill's attempt to tackle the adverse consequences of phoenix activity for employees through labour law rather than corporate law, with the Fair Work Ombudsman (FWO), rather than the Australian Securities and Investments Commission (ASIC), as the responsible regulator.

THE BILL

The Bill's main provision of relevance – draft s 545A of the Bill – imposes liability on executive officers of employer companies for unpaid employee entitlements where they become an executive officer of a "phoenix" company which is registered within 12 months after the failed company is wound up. The draft section mandates the imposition of the compensation order (the court must order that the liable person pay) subject to exempt circumstances where the court can excuse the person. However, while the draft provision is well-intentioned, it risks a number of pitfalls.

Of most concern is the lack of a definition of phoenix company, other than the surrounding circumstances that a company failed, an executive officer of the failed company becomes an executive officer of the phoenix company, and the phoenix company uses the assets of the failed company. In addition to all the improper instances of phoenix activity that breach directors' duties, this definition captures every legitimate business rescue where the controllers of a failed company try again through a new corporate entity that buys the assets at a proper value. The reverse onus operation of the provision is designed to assist employees and follows the pattern of other sections of the *Fair Work Act 2009* (Cth) such as the general protections.[1] It excuses those who have acted honestly and who ought fairly to be exempt having regard to all the circumstances of the case. However, the reverse onus means that the government, trying to remove the stigma of business failure,[2] is highly likely to find it unpalatable.

There are also temporal problems with the compensation provision. Terminology is used somewhat loosely, so that the contemplated timeline is that a company fails to pay an entitlement, the company is then wound up, and the executive officer of the failed company becomes an executive officer of the new company, called the phoenix company, which is registered "within 12 months after the failed company was wound up". Does the provision mean the start or the end of the liquidation process? There are problems either way. If it means the start, then the liability provision is likely only to capture the failure to pay wages and superannuation, which usually occurs before the company

[1] The general protections contained in Pt 3-1 of the *Fair Work Act 2009* (Cth) involve a person acting for a particular reason (for example, an employer dismissing an employee for being a member of a union: s 346(a)). In action by the employee for a remedy, it is presumed that the employer acted for that reason, unless the employer proves otherwise: s 361.

[2] National Science and Innovation Agenda, "Welcome to the Ideas Boom", <http://www.innovation.gov.au/page/insolvency-laws-reform>: "More often than not, entrepreneurs will fail several times before they make it and will usually learn a lot in the process. We're reforming insolvency laws to strike a better balance between encouraging entrepreneurship and protecting creditors. Over time, these changes will help to reduce the stigma associated with business failure."

enters liquidation. The failure to pay "accrued but not yet payable" leave, payment in lieu of notice and redundancy only happens when the liquidator has insufficient company assets to distribute at the conclusion of the liquidation process. In the event that "wound up" means the end of the process, the executive officer will escape liability if the phoenix company is registered *during* the liquidation period – in other words, not "within 12 months *after* the failed company was wound up". To avoid the provision under either interpretation, the failed company's executive officer can set up the phoenix company *and* become its executive officer immediately before the collapse of the failed company. These problems could be overcome by defining the liable person as one who "*acts* as an executive officer of a company (the phoenix company) that is registered under the [*Corporations Act 2001* (Cth)] within 12 months *of the appointment of a liquidator or provisional liquidator to the failed company*." This would capture both the periods before and after the company enters liquidation.

However, that change would not overcome all the draft provision's problems. A further lack of precision occurs with the expression that "the phoenix company uses any of the assets that were used by the failed company before it was wound up", without placing any time limit on this use. Does this mean indefinitely? More troubling is the reference to company assets, as the liability provision will only apply where the failed and phoenix companies share assets. Many instances of phoenix activity involve no asset transfers, where, for example, the labour hire entity that accrues employee entitlements, superannuation and unremitted tax liabilities owns or leases nothing by way of premises or equipment. The real business is conducted through a separate company which owns or leases the necessary assets and which uses the labour from the workers employed by the labour hire entity. When the failed labour hire company is placed into liquidation, a new labour hire entity is established and the phoenixing continues.

In addition, any phoenix liability provision that attempts to penalise directors acting improperly around the time of liquidation will necessarily fail to address phoenix activity through the abandonment of a company which remains dormant until it is eventually deregistered by ASIC. In 2014–15, 7,044 companies entered liquidation, 6.2 per cent of the 112,714[3] companies that were deregistered in that year.[4] ASIC data[5] indicates that of the remaining companies, there are 42,059 that are deregistered at ASIC's instigation. Of these, about 89.4 per cent, or 37,600 companies, are believed to be wound up for failure to pay fees.[6] If even half of these companies have engaged in phoenix activity for the purpose of avoiding payment of debts, that would mean that about 18,800 companies a year are escaping proper scrutiny through the liquidation process and are outside the scope of the proposed liability provision. These are not unreasonable guesses, given that phoenix activity by its very nature usually involves the failed company being left with little or no assets, in other words, with nothing much to pay a liquidator, let alone the company's creditors. The added disadvantage for employees is that they are not eligible to apply for the Fair Entitlements Guarantee relief unless their employer company is in liquidation.[7]

The Bill goes beyond dishonest phoenix activity to touch on other infringements of workers' rights[8] that have recently been highlighted by government inquiries[9] and the media.[10] While it is laudable that Labor wishes to protect employees from the adverse consequences of phoenix activity,

[3] Australian Securities and Investments Commission, *Annual Report 2014–15* (ASIC, 2015) 66.

[4] Note that the year of liquidation and the year of deregistration may not correspond exactly. However, these statistics give a sense of the scale of liquidations compared to deregistrations.

[5] Data supplied by Adrian Brown of ASIC to the author, email dated 18 March 2016.

[6] *Corporations Act 2001* (Cth) s 601AB.

[7] Under the *Fair Entitlements Guarantee Act 2012* (Cth), an "insolvency event", which entitles the employee to an advance, happens when a liquidator is appointed: s 5.

[8] These are migrant workers' rights and sham contracting.

[9] See, eg, the inquiry of the Senate Standing Committee on Education and Employment, *The Impact of Australia's Temporary Work Visa Programs on the Australian Labour Market and on the Temporary Work Visa Holders* (report due in 2016); Senate Economics References Committee, *I Just Want to be Paid: Insolvency in the Australian Construction Industry* (2015).

the Bill's provisions can also be interpreted as a political statement about the protection of employees' rights more generally. Seen in this light, the question remains whether there is a need for a phoenix compensation provision at all. At present, there are three avenues by which compensation could theoretically be obtained.

DO WE NEED THE BILL?

The first is the civil penalty action for breach of their directors' duties under the *Corporations Act 2001*. These include the s 181 duty to act for a proper purpose, and the s 182 duty not to misuse their position to make a gain for themselves or someone else or to cause loss to the company. In these circumstances, the provisions are actionable by ASIC or the company's liquidator, and as civil penalty breaches, the court may award a compensation remedy to the company pursuant to s 1317H. The second avenue is s 596AB of the *Corporations Act 2001*, a criminal provision that allows ASIC to prosecute directors who enter arrangements with the intention of depriving employees of their entitlements. Compensation can be ordered under s 596AC where the company is being wound up. The third is s 545 of the *Fair Work Act 2009*, which is the target of Labor's amendments. It allows a court to order a compensation remedy[11] against a company's director who is an accessory[12] to the non-payment of wages by the company.[13]

However, none of these three measures operate effectively to provide compensation to employees. In relation to phoenix activity, ASIC only brings the directors' duty action in the most exceptional circumstances such as *Australian Securities and Investments Commission v Somerville*.[14] Its enforcement policy makes it clear that its priority is to benefit the public generally, not as a supplement to inadequate private enforcement.[15] Liquidators are left to commence recovery action but are frequently constrained by a lack of resources[16] or the necessary proof to justify spending the company's few remaining dollars on litigation. When ASIC brings enforcement action against errant directors in phoenix circumstances, it usually uses the administrative disqualification provision, s 206F, where a director has been involved in the management of two or more failed companies in the previous seven years. These average about five per year.[17]

[10] See, eg, Nick Toscano, "One in five migrant workers on 457 visas could be underpaid or incorrectly employed", *Sydney Morning Herald*, 29 May 2015; Max Newnham, "Companies forcing employees to become sham contractors beware", *Sydney Morning Herald*, 24 November 2015.

[11] *Fair Work Act 2009* (Cth) s 545(2)(b).

[12] *Fair Work Act 2009* (Cth) s 550 treats the involvement of an accessory in the same way as a contravention of the Act.

[13] *Fair Work Act 2009* (Cth) ss 45, 50 – non-payment in contravention of modern award or enterprise agreement respectively.

[14] *Australian Securities and Investments Commission v Somerville* (2009) 77 NSWLR 110; [2009] NSWSC 934.

[15] Australian Securities and Investments Commission, *ASIC's Approach to Enforcement*, Information Sheet 151 (September 2013) <http://download.asic.gov.au/media/1339118/INFO_151_ASIC_approach_to_enforcement_20130916.pdf>.

[16] Note that under s 545 of the *Corporations Act 2001* (Cth), liquidators are not obliged "to incur any expense in relation to the winding up of a company unless there is sufficient available property" apart from their statutory obligation to report to ASIC. The funding available under the Assetless Administration Fund is also limited, both in amount and in the circumstances under which it will be available: Australian Securities and Investments Commission, *Assetless Administration Fund: Funding Criteria and Guidelines*, Regulatory Guide 109 (November 2012).

[17] See H Anderson, A O'Connell, I Ramsay, M Welsh and H Withers, *Quantifying Phoenix Activity: Incidence, Cost, Enforcement* (Centre for Corporate Law and Securities Regulation, 2015) [4.2.1.4]. The report found that over the period 1 January 2004 to 30 June 2014, 32 ASIC media releases reported that 51 directors were disqualified under *Corporations Act 2001* (Cth) s 206F in circumstances involving phoenix activity. There were 165 companies involved in these 51 disqualifications. ASIC does not publish statistics on disqualifications in phoenix circumstances.

The inadequacy of s 596AB is well-known.[18] The Commonwealth Director of Public Prosecutions has never brought a case, possibly because the criminal burden of proof – proving beyond reasonable doubt that directors intentionally deprived employees of their entitlements – is simply too much.

The *Fair Work Act 2009* provision allowing compensation has not led to any orders being made because the FWO has not sought this remedy.[19] Their reluctance to do so may be based on a statement in the Explanatory Memorandum to the Bill indicating that directors should not be required to pay compensation for company debts.[20] A form of de facto compensation has been possible through the court's ability to order that a penalty be payable to the company's employees rather than into consolidated revenue[21] but this is frequently unsatisfactory because the amount of the penalty is low compared to the amount of the unpaid entitlements. The penalty for individuals is one fifth of that for companies.[22] Phoenixing a company and paying a modest personal penalty can be seen as the cost of doing business for a small business owner seeking to shed the company's debts to employees and to start again. It is pleasing to see that in 2015, the FWO commenced two test cases[23] to establish their right to seek these orders.

Therefore, it can be argued that Labor's reforms are needed to overcome the inadequacies of the current laws or of their enforcement. Nonetheless, the drafted phoenix provision is not the solution. Even if the provision passed despite opposition from the Coalition and from the business lobby because of its reverse onus mechanism, courts may struggle to implement its terms and achieve its desired objectives for the reasons set out above. A simpler solution would be to leave s 545 of the *Fair Work Act 2009* in its current form, without adding any additional references to phoenix companies. The word "may" would be retained so that the court can assess each case on its merits. This allows the court to distinguish genuine business rescues from illegal phoenix activity. The legislation should be amended to confirm that a compensation order is available against accessories, and consideration should be given to increasing the penalty for individuals to the same level as for companies.

The Bill also contains a draft provision to increase penalties for the company deliberately failing to pay wages and other entitlements.[24] While superficially appealing, this provision is, in my opinion, flawed. First, it proposes to exempt small business employers, who, anecdotally at least, are the most likely to engage in phoenix activity.[25] Secondly, it speaks of intentionally breaching the entitlements provision, which makes it as difficult to prove as s 596AB of the *Corporations Act 2001*, discussed above. Thirdly, the heavier the penalty on the company, the more incentive the directors have to place the company into liquidation to avoid its payment.

The Bill's final provision of relevance to employees of insolvent companies is draft s 546A, which would allow courts to disqualify directors as accessories under s 550 of the *Fair Work Act 2009* for breaches by the company of any of the Act's provisions, including the obligation to pay employee entitlements, where it is just and equitable. This echoes the powers of the Australian Competition and

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[18] See H Anderson, *The Protection of Employee Entitlements in Insolvency: An Australian Perspective* (MUP Academic, 2014) 38–45 and references cited therein.

[19] See H Anderson and J Howe, "Making Sense of the Compensation Remedy in Cases of Accessorial Liability under the Fair Work Act" (2012) 36 *Melbourne University Law Review* 335, 350.

[20] Explanatory Memorandum, *Fair Work Bill 2009* (Cth) [2177].

[21] *Fair Work Act 2009* (Cth) s 545(3).

[22] *Fair Work Act 2009* (Cth) s 546(2), (3)(c).

[23] *Fair Work Ombudsman v Nobrace*, filed on 31 August 2015 and *Fair Work Ombudsman v Step Ahead Securities*, filed on 14 September 2015. This was noted in their submission to the Productivity Commission inquiry into the Workplace Relations Framework, released on 4 August 2015.

[24] Draft provision s 546(2A).

[25] Treasury, *Action against Fraudulent Phoenix Activity*, Proposals Paper (2009) [2.3] 6; PriceWaterhouseCoopers and Fair Work Ombudsman, *Phoenix Activity – Sizing the Problem and Matching Solutions* (2012) 58, 61.

Consumer Commission.[26] Allowing court disqualification, rather than an administrative power as ASIC has,[27] overcomes any suggestion that the FWO lacks the expertise to determine who should be disqualified. This provision would remove multiple handling of a matter by taking away the need for the FWO to refer a complaint to ASIC for follow-up. The draft provision could be improved by omitting the words "on application" ("the court may, on application, order") so that a court, based on its own expertise and experience, can choose to order a disqualification even where the FWO does not seek it. This would mirror the current *Fair Work Act 2009* remedies provision, s 545(4), that allows the court to make an order "on its own initiative, during proceedings before the court; or … on application".

[26] *Corporations Act 2001* (Cth) s 206EA, picking up s 86E of the *Competition and Consumer Act 2010* (Cth).

[27] *Corporations Act 2001* (Cth) s 206F.