M J Kooymans

A/g General Manager
Corporate Governance Division
The Treasury
Langton Crescent
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Dear Sir

Priority of Employee Entitlements

I refer to your letter of 30 July 2002.

I thank you for the opportunity to comment on the Government's proposal.

I passed your letter to the Insolvency & Reconstruction Committee of our Business Law Section. This letter sets out the views of that Committee.

In summary, the Law Council strongly opposes the proposal. We think the present position strikes an appropriate balance between the priority enjoyed by both employees for their entitlements, and secured creditors, and should not be changed.

We think that the following matters need to be considered:

1. **Cost to Business**

Under the present law, lenders deciding to lend money to corporate borrowers do not have to undertake a detailed analysis of the entitlements that might be outstanding to its employees. The present law gives them the certainty that, whatever the entitlements may be, they will only be payable out of the assets subject to the floating component of the lender's security, which typically comprises the corporation's cash, debtors and work in progress. Once the amount of these items is known, the lender can proceed safe in the assumption that the employee entitlements (whatever they may be) will only be a call on those assets, and that they look to their fixed security (eg land & buildings, plant & equipment) for the repayment of their loans.

The proposal has the effect of imposing on lenders the cost of undertaking a detailed 'due diligence' on the employee entitlements before making a loan. The experience of our Committee, who see this exercise undertaken after corporations collapse, is that it is difficult and time consuming, involving a detailed analysis of the legal and factual matrix that leads to a determination of exactly what, at any given time, an employee's entitlements may be. Undertaking this task before a loan is made will be a costly and time consuming exercise and increase the cost of loans made to corporations which have a large workforce, which will ultimately be passed on to the borrower. The general costs of monitoring the security position will give rise to significantly greater costs for the secured lenders, which in turn will be passed on to the companies. The increase in costs will be substantial with the inevitable result that many corporations will have to retrench employees.

It is the responsibility of the directors to make sure that employee entitlements are properly provided for. The law imposes duties on directors to avoid insolvent trading, and the effect of these reforms will be to ease the burden on directors and to transfer that responsibility to secured lenders. It may also place pressure on companies to adopt contractor and sub-contractor arrangements rather than employer and employee arrangements to mitigate the effect of the proposed legislation. And in the area of superannuation, APRA should take a role to ensure that contributions are being made. The reforms do not make any provision for superannuation benefits that may not have been satisfied at the time of insolvency occurring. Secured lenders should not be called on to distort their lending patterns to further police this issue.

It is possible that if these reforms were to be introduced, lenders may attempt to avoid the impact of the legislation by insisting on the borrower taking out insurance, a bond or bank guarantee to protect employee entitlements, which may be unavailable generally or to specific borrowers, unless the funds were set aside, with the consequence that it may result in a de facto system of setting aside funds and increased costs and the risk that loans may not be as readily available.

2. **Impediment to last resort lending to corporations in trouble**

The consideration just referred to apply not only when a new loan is being made, but when further facilities are being provided. In the case of a corporation that is nearly insolvent, the best outcome for employees and creditors may be for the corporation to seek to trade out of its difficulties with the support of its secured creditor. In cases where entitlements are substantial, the proposal will (if implemented) result in secured lenders being less inclined to lend support, and precipitate a corporate collapse, in a case where there might have otherwise been a 'work out' for the benefit of all stake holders.

3. **What is the Government's objective**?

The end to be achieved by the proposal is not identified. Our Committee can only assume that the end sought to be achieved by the proposal is to maximise for the Government the prospect of the recovery of amounts paid out under the GEERS scheme. It is to be regretted that much debate in this area has not been supported by a full financial analysis of the precise amounts that have been lost to employees and the amount that is likely to be recovered, either with or without the proposal. It is the view of our Committee that further analysis needs to be undertaken and that it is premature to amend the current legislation until the impact of insolvency upon employee entitlements and the extent to which the Government is required to make payments pursuant to the GEERS scheme is better understood. We note that the Productivity Commission Report issued in December 2001 deals in part with the protection of employee entitlements in the event of insolvency, but contains only limited financial data.

The expectation of our Committee is that the amendment will not substantially improve the amounts that flow back to Government:

- By definition the proposal will have no impact at all when there is no secured lender.
- The insolvency practitioner will still have recourse to the assets subject to the lender's floating charge to recoup their remuneration, and any liabilities

incurred by them in trading on any business. In cases where these items absorb all of the floating charge assets, the proposal will not improve the return to Government.

Again, it is difficult to comment on this aspect without the benefit of a full financial analysis.

4. **The present scheme strikes the 'right balance'**

And in this respect it is also worthwhile to understand that there are many other calls on the priority of a secured lender, noting the 'priority' that is afforded to many other creditors through retention of title, and lease arrangements. While not advocated by our Committee there is no suggestion of the claims of these creditors being deferred to those employees for the payment of their entitlements.

To the extent that lenders may be unable to effect full recovery of their debt upon realisation of the company's assets as a result of the impact of employee entitlements, it can be expected that lenders will have greater recourse to the assets of guarantors.

5. **Small business exemption**

The proposed exemption for small business is not explained. It is noted that section 45A of the Corporations Act already contains a satisfactory definition of 'small business'. If it is suggested that the proposal will cause difficulties or problems for SME's then these will only be amplified in the case of larger businesses. Moreover the exemption appears to be inconsistent with the Government's assumed objective, noting that its own figures suggest that in 2001 corporations with less than 20 employees accounted for 83% of insolvencies where entitlements were unpaid.[1] Further, if the reforms are to be introduced, then they should also extend to subsidiary companies and related companies and their secured lenders. And it is not clear whether the priorities will work against all lenders, including related party lenders.

6. **Claw Back**

The proposal for Liquidators to recover entitlements from secured creditors who enforce their security before liquidation is not explained. This proposal is not supported by logic. If the proposal does proceed additional safeguards will have to be included to make sure that the section does not apply in a case where a loan to a secured creditor is refinanced, and a new lender steps in. If there is any risk of a claw back in such a case, this will impede the refinance, and (in effect) prevent the corporate borrower securing a discharge.

It is not clear why liquidation should act as the trigger for these provisions to apply. Potentially, this could give rise to abuses occurring where the mortgagee may realise assets by way of receivership or through taking possession of the mortgaged assets, and allowing for a six month period to elapse prior to liquidation so as to avoid claw back by a liquidator. Nor is it clear as to how collateral securities will be dealt with in the event of claw back.

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[1] Employee Entitlements Support Scheme, Year One Activity Report, January 2001, page 9

Again, we thank you for the opportunity to comment on the proposal.

If you would like to meet with any members of our Committee to discuss the matter further, can I suggest you contact the Committee Chair Jon Clarke or the Committee's Employee Entitlement Sub-Committee Chair, Ray Mansueto.

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Jon Clarke
Chair
Insolvency & Reconstruction Committee
Business Law Section
Law Council of Australia

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Ray Mansueto
Sub-Committee Chair
Employee Entitlements Committee
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