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Dear Mr Krizmanits and Ms Nero

Consultation on reforms to address corporate misuse of the Fair Entitlements Guarantee (FEG) scheme

Thank you for the opportunity to provide a submission on the proposals set out in the Australian Government's exposure draft, *Corporations Amendment (Strengthening Protections for Employees Entitlements) Bill 2018* (Cth) (**Exposure Draft**).

The Australian Institute of Company Directors (**AICD**) is committed to excellence in governance. We make a positive impact on society and the economy through governance education, director development and advocacy. Our membership of more than 43,000 includes directors and senior leaders from business, government and the not-for-profit sectors.

The AICD is very concerned by the rising annual costs of the FEG scheme attributable to sharp corporate practices by some employers and their associates. The deliberate avoidance of employee entitlements by some employers is unacceptable, and should be prosecuted by the relevant authorities. The AICD strongly supports measures to address such reprehensible conduct, provided they are effective and proportionate to the wrongdoing.

1 Executive Summary

The AICD supports the strengthening of civil recovery action, and expansion of civil and criminal penalties available against company directors and other persons who engage in transactions that are directed at preventing, avoiding or reducing employer liability for employee entitlements. However, it is also essential that any reforms are drafted to avoid inadvertent or inappropriate impacts on legitimate business operations, including the ability to genuinely restructure otherwise viable businesses.

Against this backdrop, our views in relation to the key measures in the Exposure Draft are as follows:

- **Director disqualification power:** The AICD fully supports strong action against directors who abuse the FEG scheme. There is no place in Australian business for directors who abuse corporate structures at the expense of employee entitlements and creditors. However, we query whether a new disqualification power is necessary, given ss 206D, 206E and 206F of the *Corporations Act 2001* (Cth) already provide ASIC and the Courts with the power to disqualify directors who act to abuse the FEG scheme. If the existing law were effectively enforced, we could achieve these aims. The AICD's concerns and suggested drafting changes are set out in **section 2** of this submission.
- **Reforms to Part 5.8A:** The AICD supports the Government's proposal to introduce a new offence based on a fault element of recklessness. However, the AICD is concerned that the drafting of the civil penalty provision, particularly combined with the compensation order available under s 596ACA, could result in unjust outcomes for directors who are acting diligently and in good faith, due to the lack of any defence, relief or savings provision. Our concerns are outlined in **section 3** of this submission.
- **Employee entitlements contribution order:** The AICD is of the view that the proposal set out in the Exposure Draft is unnecessary given the anticipated impact of the new offence and civil penalty provision. We are concerned that we may compromise the fundamental concept of the corporate veil without justification. In addition, the AICD is concerned about unintended consequences which may flow from the drafting of this provision. The AICD's concerns are in **section 4** of this submission.

2 New director disqualification grounds

The AICD strongly supports the disqualification of directors who abuse the FEG scheme. We are aware from the previous consultation that the Department of Jobs and Small Business has compiled a list of over 1,000 directors who have been identified as serial abusers of the FEG scheme. These directors should be dealt with swiftly and appropriately, with robust enforcement action, and if they are associated with the AICD, we will take action against them if we are made aware of FEG abuses. There is no place in corporate Australia for directors who misuse corporate structures to avoid paying employee entitlements.

That said, the AICD considers that ss 206D, 206E and 206F already provide ASIC and the Court with the necessary powers to disqualify a director who misuses the FEG scheme. Arguably, s 206E is wider than the proposed s 206EAB, at least with respect to directors who twice contravene the *Corporations Act 2001* (Cth) (see s 2016E(1)(a)(ii)).

While the AICD appreciates the strong public signal that a new FEG-specified disqualification power will send to directors initially, we are not convinced that the introduction of a new disqualification power would represent a meaningful improvement on the existing regime, in contrast to effective prosecution of the available penalties under the Act. The AICD recommends that the Government reconsider the need for this provision versus more robust enforcement of the existing law.

If the Government resolves to legislate a new disqualification power, we suggest the following changes to improve the Exposure Draft:

1. We are concerned that the threshold requirements proposed in ss 206EAB and 206GAA will, in some circumstances, unfairly penalise entrepreneurial directors, or directors who are involved in multiple start-ups over a lengthy period. It is conceivable that directors could be involved with companies that fail with a need to rely on the FEG scheme through no deliberate abuse of the system or misconduct, but because of the risks

associated with start-ups and innovative firms. It would be contrary to the NISA policy objectives to unfairly penalise directors embracing the risks of innovative firms.

2. In particular, we are of the view that the 10-year period is too long, particularly given the stated aim of capturing individuals who serially abuse the FEG scheme. For this reason, we recommend the following adjustments are made to the threshold requirements:

   (a) The 10-year period in ss 206EAB and 206GAA within which the two contraventions must occur should be reduced to a 7-year period to align with ss 206D and 206F; and

   (b) The trigger for a disqualification under both ss 206EAB and 206GAA be increased from 2 to 3 instances of reliance on FEG within the 7-year period.

3. We recommend that s 206GAA be amended to align with s 206F. The AICD is of the view that it is not appropriate or desirable for ASIC to have the power to disqualify a director for a period greater than 5 years. Some factors to consider include:

   (a) The maximum ASIC disqualification penalty should be consistent across all disqualification powers to avoid circumstances where egregious conduct giving rise to a disqualification under s 206F is subject to a lesser maximum disqualification period than equally egregious conduct resulting in disqualification under s 206GAA.

   (b) There is a significant public interest in disqualification decisions arising from conduct on the more serious end of the spectrum (attracting lengthier periods of disqualification) being determined by a Court, rather than by ASIC, given the greater level of public and legal opprobrium associated with a Court-based order.

   (c) Given the seriousness of the penalty, an ASIC-imposed disqualification of 5 years or more would be most likely followed by an appeal to the Administrative Appeals Tribunal, leading to an unnecessarily lengthy process for all parties.

4. The AICD is concerned that the Court-based disqualification power in s 206EAB does not contain the checks and balances found in ss 206D and 206E to ensure a person is only disqualified when all the circumstances demand that person should be disqualified. For this reason, we strongly recommend amending the provision to specifically enable the Court to have regard to:

   (a) The person's conduct in relation to the management, business or property of any corporation;

   (b) Where the relevant trigger is a contravention by the company itself, the steps a person took to prevent the contravention when they were an officer; and

   (c) Any other matters that the Court considers appropriate.

5. Given that a single commercial failure may result in more than one occurrence of FEG reliance due to the legitimate structuring of the business through multiple corporate entities, a situation such as this should be construed as a single instance of reliance on the FEG scheme for the purposes of the disqualification power.

6. Finally, we recommend including a materiality threshold in relation to the relevant breaches of the *Corporations Act 2001* (Cth) which trigger disqualification under this ground, to avoid circumstances where relatively trivial breaches would technically provide grounds for disqualification.

We also support the introduction of a Director Identification Number (DIN) announced by the government, which should improve the ability for authorities to detect and address illegal phoenixing. The AICD recommends that DIN introduction also accompany the removal of public access to personal information of directors, a separate, but important, policy issue.

3 Reforms to Part 5.8A of the Corporations Act

The AICD supports the proposed drafting of proposed s 596AB, which includes a new criminal offence based on the fault element of recklessness.

While the AICD would, in general, be cautious about new criminal provisions relating to directors, in the case of FEG scheme abuse, we consider this justified.

However, we are concerned that the new civil penalty provision will not achieve the Government's stated aim of avoiding inadvertent or inappropriate impacts on legitimate business operations.

It is an important general principle of corporate law that a director or other officer's decisions should not be penalised for a decision where the decision was made in good faith, for a proper purpose, and in the best interests of the company. This is one of the key policy objectives of the business judgment rule in s 180 of the *Corporations Act 2001* (Cth).[1]

That is, Australia's corporate law must promote high standards of corporate governance, while simultaneously providing company directors with the flexibility to innovate and invest without fear of unwarranted legal liability.

In our view, the proposed civil penalty provision, as currently drafted, is inconsistent with this policy proposition. It could result in a significant civil penalty compensation order being imposed on a director or other officer for business decisions made in good faith and for a proper purpose, where they have acted on information available to them, and in a manner they rationally believed was in the best interests of the corporation.

Unlike provisions such as *Corporations Act 2001* (Cth) ss 180(1) (duty of care and diligence), 588FB (uncommercial transactions), or 588G (duty to prevent insolvent trading), the proposed s 596AC contains no defence or relief provision. This is despite the fact that a compensation order may, in some circumstances, result in a penalty many times higher than could be the case for a breach of s 180(1), along with other *Corporations Act 2001* (Cth) provisions. The flow-on effect of this will be that the policy objective of the business judgment rule, and the objectives of the Corporate Law Economic Reform Program, is undermined.[2]

The following example highlights our concern with the provision, and the way it could impact on directors acting in the best interests of the company, in good faith and for a proper purpose.

Example

The directors of Chief Pty Ltd (a small technology company with limited assets) decide to expend a significant portion of their liquid capital on the acquisition of a new real estate smartphone app, Alpha. The investment in Alpha involves a degree of risk, as it is relatively untested in the market. However, the directors, having appropriately informed themselves of all the relevant and available information, including internal and external advice, are satisfied it is in Chief's best interests, having considered the opportunity cost of doing nothing, and the possible consequences to Chief of allowing Alpha to be purchased by a competitor.

At the time, the directors do not intend to make the transaction to reduce or avoid paying employee entitlements. They form a reasonable view, based on the evidence, that Alpha will enable them to expand their operations. They do not believe that they are taking an unjustifiable risk that would result in the payments being significantly reduced or

[1] Corporate Law Economic Reform Program 1998, 'Commentary on Draft Provision', 37.
[2] Explanatory Memorandum Corporate Law Economic Reform Program Bill 1998

unrecoverable. However, they are aware that Alpha's prospects are relatively untested, and Alpha will need to take on some additional debt to fund the acquisition. Their risk assessment, formed at the time from available information, provides them with comfort that the risks are manageable, a view largely supported by internal and external advice and projections.

The directors resolve to purchase Alpha. Unfortunately, after six months, Alpha proves to be unsuccessful due to an unusual and unanticipated market downturn in the sector, and a liquidator is appointed to Chief. Despite the best efforts of Chief's directors to ensure that all employee entitlements are paid, the employees have some unpaid entitlements that cannot be satisfied by Chief's assets, which have depreciated rapidly given the downturn. FEG is called on.

The liquidator decides to pursue the former directors of Chief Pty Ltd on the basis they were accessories to Chief's breach of 596AC, and are therefore persons liable to compensate Chief's employees under s 596ACA(1). As Chief's directors mortgaged their properties to start Chief, they will be bankrupted if they are found to have breached s 596ACA(1).

In proceedings, the liquidator successfully persuades the Court that a reasonable person would have viewed the investment in Alpha, in all the circumstances, as a relevant agreement or transaction that was reasonably likely to significantly reduce the amount of entitlements of employees, assuming that Chief's investment fails and a liquidator is appointed. The directors are unable to effectively argue against hindsight review despite the due care and diligence they applied to their informed decision, taken in the interests of the company at the time.

We anticipate that the example we have provided illustrates our concern with the operation of the proposed civil penalty provision. For this reason, we strongly recommend the design of this section is revisited by the Government to improve protections for directors and others who are acting rationally, in good faith and for a proper purpose. An appropriately framed defence is essential to ensure the civil penalty provision operates in accordance with the government's objectives, including not to discourage legitimate risk-taking by business.

We suggest one or both of the following amendments to address these concerns:

(a) The Exposure Draft be amended to explicitly provide a due diligence defence. For instance, a new section could be inserted that provides that a director is not liable under s 596AC(1) where they (a) made all inquiries (if any) that were reasonable in the circumstances, and (b) after doing so, rationally believed that the relevant agreement or transaction would not prevent or significantly reduce the amount of employee entitlements that can be recovered; or

(b) The Exposure Draft be amended to enable the Court to give consideration of the following factors before imposing liability:

    (1) The intended benefits (if any) of the relevant agreement or transaction on the company's ability to meet its employee entitlement obligations;

    (2) The detriment of the relevant agreement or transaction to the company's ability to meet its employee entitlement obligations;

    (3) Any legitimate purposes of the business in entering into the relevant agreement or transaction;

    (4) Any other relevant factors.

With regard to suggestion (b), we have drawn on the wording of the factors in s 588FB of the *Corporations Act 2001* (Cth), along with the suggested drafting put forward by the Law Council in their submission dated 16 June 2017. We believe these new factors will give the Court greater scope to consider the circumstances of the relevant agreement or transaction, thereby enabling the Court to exercise a sensible degree of discretion.

4 Employee entitlements contribution orders

The AICD considers that the introduction of new penalties and disqualification powers (or, preferably, more rigorous enforcement of existing disqualification powers), will offer an effective response to the abuse of the FEG scheme. Given this, we consider the proposed employee entitlements contribution order in Part 2 of the Exposure Draft to be unnecessary.

The AICD is always cautious about proposals that risk piercing the corporate veil, and caution legislators against unintended consequences from undermining our corporate model.

In our view, the proposed civil penalty provision and new recklessness-based offence will, if legislated, represent a considerable enhancement to existing provisions and reduce inappropriate reliance on FEG. These measures should, if vigorously enforced, curb abuses of the FEG scheme.

For this reason, the AICD does not believe there is sufficient justification for the imposition of a contribution order regime on corporate groups to share liability to meet unpaid employee entitlements.

In addition, given the number of relatively novel concepts incorporated in the Exposure Draft, the AICD is concerned that Part 2 may lead to unintended consequences and a significant degree of uncertainty and trepidation amongst directors. Some of the AICD's concerns relating to unintended consequences are as follows:

(a) The AICD is concerned that the notion of "single economic group" in s 588ZA(4) will, in some circumstances, lead to an undue reluctance by companies to engage commercially with start-ups and financially distressed businesses due to a perceived risk of being found to be part of a "single economic group" should that business later become insolvent. By way of example, venture capital firms considering investing in a portfolio of start-up businesses will need to consider the financial risk posed by prospective employee entitlement contribution orders in the event those start-up businesses fail, given the possibility that that they could be deemed to be "related" to the start up under the five tests in s 588ZA(4)(a) to (e) – regardless of the steps they may have taken to ensure employee entitlements were assessed as secure. The AICD is concerned that this could lead to directors of private equity firms and venture capital funds being more hesitant to engage with riskier businesses, such as start-ups, thereby depriving them of an important potential source of growth capital.

(b) The AICD is concerned that directors of start-ups and smaller companies may, as a condition of obtaining valuable contracts for work, be required to provide personal undertakings or guarantees to indemnify larger companies for liability for employee entitlements contribution orders should their businesses fail. This, in turn, will have a chilling effect on the growth and success of Australia's start-up economy, contrary to the objects of the NISA.

(c) The AICD is concerned that the notion of "benefit" in s 588ZA(2)(a) could result in spurious claims being made by liquidators in relation to the economic value of the benefits generated by the work done by employees of an insolvent entity. For example, the AICD is concerned that a liquidator could make claims made regarding the value of the goodwill generated by work done by employees which could be dubious at best, but difficult to disprove.

(d) The AICD is concerned that the costs associated with employee entitlements contribution orders will lead to an increase in D&O and other insurance costs for companies who utilise group structures.

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Given these concerns, the AICD suggests that the Government reconsider the need for the proposed employee entitlements contribution order, or at least, conduct a more comprehensive cost-benefit analysis of the proposal before proceeding with the proposal.

However, should the Government proceed with Part 2 of the Exposure Draft, we recommend the following changes to the proposed legislation:

(a) Given the possibility for unintended consequences outlined above, we recommend removing the concept of "single economic group" to ensure the legislation does not unfairly impact on small businesses, financial distressed businesses, and start-ups.

(b) To avoid the possibility of a claim being made that the "benefit" obtained by an entity which vastly exceeds the original market cost of the labour, the AICD recommends that the definition of "benefit" be more tightly defined in the Exposure Draft to ensure that the contributing entity will only be liable for the proportion of the cost of the labour which is *directly* attributable to the benefit being received by the contributing entity.

(c) We recommend that the legislation (rather than the explanatory materials) set out the factors for the Court to consider in determining whether it is "just and equitable" to make the order.

(d) To avoid confusion, we recommend that the legislation itself explicitly defines the meaning of the phrase "other than arms-length terms", and the explanatory materials provide appropriate examples of how this term might operate in practice, and circumstances in which it would not operate in practice.

5 Next steps

We hope our comments will be of assistance to you and look forward to providing further input on these issues in due course. If you would like to discuss any aspect of this submission, please contact Matt McGirr, Policy Adviser, on (02) 8248 8431 or at mmcgirr@aicd.com.au.

Kind regards

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