THEORY AND REALITY IN INSOLVENCY LAW: SOME CONTRADICTIONS IN AUSTRALIA

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ABSTRACT

Insolvency law in Australia provides a bundle of diverse entitlements for different cohorts of creditors. In this paper, the Commissioner of Taxation, unsecured trade creditors and employees are chosen for examination. It is arguable that the allocation of these entitlements does not correspond with the needs of the creditors in question for legislative protection. This paper will begin by looking at the theoretical explanations of three forms of ex post creditor protection mechanisms – the collective recovery regime, lifting of the corporate veil on directors, and encouragement towards corporate reorganisation. This section includes a discussion of Jackson's creditors' bargain model, which seeks to explain the collective bargaining regime by asking what creditors would have agreed to accept in insolvency, had they been asked at the time of making their contracts. It will then examine the reality of the three forms of ex post legislative protection which play an important role in safeguarding the entitlements of the unsecured creditor cohorts chosen. Finally the paper analyses the reality against the theory and asks: what would each of these creditor groups have bargained for if they were given a chance, prior to their dealings with the company, and what legislative scheme would maximise the welfare of the each creditor group as whole?

1 INTRODUCTION

The purpose of this article is to consider the reality of creditor protection for three types of unsecured creditors - the Commissioner of Taxation, unsecured trade creditors and employees - against a backdrop of the theory underpinning corporate insolvency law. [1]

The three main ways in which the welfare of these unsecured creditors is protected are payment of a portion of their claims upon liquidation pursuant to the collective distribution regime; encouragement of their directors to consider corporate reorganisation through voluntary administration (VA); and lifting the corporate veil to impose personal liability on directors. While partial payment upon the cessation of business is common to creditors of bankrupt individuals and partnerships and is, in a sense, the insolvency default position,[2] corporations legislation has provided VA and the imposition of personal liability as additional means of maximising the welfare of creditors and deterring undesirable behaviour by directors.

The article is comprised of five parts. Part II will sketch the theory behind insolvency law and the justifications given by scholars of the three types of recovery. Jackson's 'creditors' bargain model' seeks to explain the collective distribution regime upon liquidation. Its foundation is the notion that creditors as a group should receive in liquidation what they would have agreed upon at the time of making their contract with the company, in exchange for foregoing their individual recovery rights. While the creditors' bargain model has been the subject to considerable debate, nonetheless it throws up a challenging question for the analysis discussion in this paper – if one examines the recovery rights of the three cohorts of creditors selected for examination, what would these creditors have agreed to accept if they had in fact bargained ex ante for their rights?[3] Part II also outlines the theoretical justifications for corporate reorganisation and the imposition of liability on directors. It notes two important objectives – the maximisation of overall creditor welfare and the deterrence of undesirable behaviour.

Part III then looks at the statutory protections provided to the Commissioner of Taxation, unsecured trade creditors and employees. It will be seen that while the Commissioner of Taxation has foregone any priority of payment in a liquidation, it enjoys very strong rights against directors in relation to unremitted taxation instalments. In order to avoid this liability, the only viable option in practical terms is to place the company into VA. Unsecured trade creditors also have no priority in a winding up, but likewise benefit from the imposition of personal liability on directors for insolvent trading. Again, in order to avoid such liability, directors are encouraged to place the company into VA. In contrast, employees are granted some measure of priority in the liquidation, but the ability of the liquidator to seek the personal liability of directors with respect to lost employee entitlements is severely

[1] Tort creditors will not be considered by this paper.

[2] A collective distribution regime upon insolvency is commonly accepted and replaces the rights of individuals to pursue their own recovery entitlements. This is discussed further below.

[3] Voluntary administration has previously been considered in the light of the Creditors Bargain model. See James Routledge 'Part 5.3A of the Corporations Law (Voluntary Administration): Creditors' Bargain or Creditors' Dilemma' (1998) 6 *Insolvency Law Journal* 127. Routledge looked in particular at the position of secured creditors under VA and also at the dominance of the rehabilitation objective over ensuring a greater return to creditors. He concluded in relation to the areas examined that the creditors' bargain was a useful tool.

constrained, and more importantly, there is no encouragement for those directors to avoid liability by placing the company into VA.

Part IV analyses the reality of these rights against the theory which underpins them. As noted above, the creditors' bargain model will be considered in the light of what they have actually received by way of ex post legislative protections. It is contended here that employees, who are creditors with the least opportunity to self-protect against the risk of loss ex ante, would have expected to be treated as well, if not better, than the ultimate diversified creditor, the Commissioner of Taxation. The objectives of creditor welfare maximisation and the deterrence of detrimental behaviour by directors will also be examined and the question asked – given that VA is the only form of external administration of an insolvent company that gives an opportunity for the business to continue and for jobs to be saved, why does the *Corporations Act* encourage VA in relation to some debts owed to the Commissioner of Taxation and unsecured trade creditors, but not in relation to the unpaid entitlements of employees? Part V concludes.

II THEORY

It is well accepted that corporate legislation plays a vital role in providing a set of 'off the shelf' rules to facilitate business.[4] These include the separate legal personality of the corporation, the limited liability of its shareholders, the transferability of their shares, delegated management under a board structure, and shared ownership of the corporation by contributors of capital. While these five basic characteristics of incorporation are not shared by all companies,[5] corporate law provides terms which would otherwise have to be negotiated by contract. The cost of transacting is reduced because these rules do not have to be settled in each contract entered into by the company.[6]

Two of these rules of particular interest upon insolvency are the separate legal personality of a company and the limited liability of its shareholders. Separate legal personality allows companies to own assets, and to pledge them as security to creditors in exchange for debt capital. Companies have the flexibility to finance their activities by debt or equity capital, or a combination of the two. Shareholders, or their personal creditors, have no access to company assets to satisfy their personal creditors,[7] and conversely, company creditors have no access to the personal assets of shareholders. Changes in ownership of shares do not disrupt the operations of the firm as might occur in a partnership. Limited liability shifts some

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[4] Ronald Coase, 'The Nature of the Firm' (1937) 4 Economica 386, 390-91; Robert Flannigan, 'The Economic Structure of the Firm' (1995) 33 *Osgoode Hall Law Journal* 105, 115.

[5] In some jurisdictions, legislation regulating close corporations or individual corporate constitutions may not permit the free transferability of shares. No liability companies do not allow recourse to shareholders' funds, even for amounts unpaid on subscribed share capital. Small companies do not have delegated management.

[6] Transaction cost economics are well summarised by Flannigan, above n 4, 113, 137.

[7] This is the liquidation protection rule, which 'serves to protect the going concern value of the firm against destruction either by individual shareholders or their creditors.' Reinier R Kraakman, Paul Davies and Henry Hansmann, *The Anatomy of Corporate Law* (2004) 7; see also, Margaret Blair, 'Locking in Capital: What Corporate Law Achieved for Business Organisers in the Nineteenth Century' (2003) 51 *UCLA Law Review* 387; Henry Hansmann and Reinier Kraakman, 'The Essential Role of Organisational Law' (2000) 110 *Yale Law Journal* 387.

of the risk of loss from shareholders to creditors.[8] The potential amount of each shareholder's loss is finite and known, which gives the shares a stable price. These factors aid the transferability of shares, encouraging shareholders to invest, and to minimise the risk of doing so by diversifying their share portfolios. [9] By providing these fundamental standard form terms which would otherwise have to be negotiated and contracted for individually, corporate law plays an important role in facilitating the pooling of capital and the pursuit of business objectives.[10]

However, the ability of companies to borrow and purchase on credit, coupled with the limited liability of their owners, leads to a risk of non-payment. This problem is exacerbated if the company is undercapitalised or deeply in debt. The consequences of individual non-payment and the company's insolvency can be dealt with in two ways – ex ante through contract or diversification, or ex post by legislative intervention. Ex ante contractual protection can be afforded by a range of means including charging a premium on the cost of goods or finance to compensate for the risk of loss, and obtaining security. The term 'security' here includes devices such as loan covenants, restricting the company's ability to sell or further pledge its assets, charges over the corporation's major assets, retention of title clauses and personal guarantees from the directors.[11] The ability to demand and receive a secured priority position in a liquidation depends on many factors, including the bargaining power of the lender and the size of the loan.

Ex post legislative protection of unsecured creditors comes in three main forms. The first is a collective allocation regime in liquidation featuring redistribution of assets through the prioritisation of the claims of some creditors over others; the second is the availability of, and encouragement towards, corporate reorganisation; and the third is the lifting of the corporate veil to impose personal liability on others such as directors or holding companies. It should be remembered that while the collective distribution regime is an 'off the shelf' contract term to reduce the cost of negotiating liquidation asset allocation rights individually, as noted above, it can be overcome by express terms to the contrary.[12] However, the imposition of personal liability on directors cannot be avoided through contract.

The next Part will look at how insolvency law in Australia has provided these three forms of protection to three types of creditors. However, in order to make sense of those laws, this Part will examine some of insolvency law's theoretical underpinnings. It is not suggested that these protections have necessarily been enacted in response to the scholarly analysis of insolvency law;[13] rather, the theoretical and philosophical bases for insolvency law provide a useful lens through which one can critically analyse those forms of legislative protection.

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[8] While creditors are paid before shareholders in a liquidation, an insolvent company often cannot pay non-priority creditors in part or in full.

[9] Paul Halpern, Michael Trebilcock and Stuart Turnbull, 'An Economic Analysis of Limited Liability in Corporation Law' (1980) 30 *University of Toronto Law Journal* 117.

[10] See generally, Frank Easterbrook and Daniel Fischel, *The Economic Structure of Corporate Law* (1991) ch 2; Richard Posner, *Economic Analysis of Law* (5th ed, 1998).

[11] Richard Posner, 'The Rights of Creditors of Affiliated Corporations' (1976) 43 *University of Chicago Law Review* 499, 504.

[12] That is, the ex ante contractual protections outlined in the preceding paragraph.

[13] Finch commented that 'the creditor wealth maximisation vision has been highly influential and has been put into legislative effect in some jurisdictions'. Germany is given as an example. Vanessa Finch, *Corporate Insolvency Law; Perspectives and Principles* (2002) 29.

In the absence of sufficient assets to pay all creditors in full, sound and logical insolvency laws are needed to ensure an efficient and fair collection, realisation and distribution of the debtor's remaining assets. The collective distribution regime upon liquidation aims to provide this, and allows for modification of pre-insolvency rights in favour of preferred creditors. One of the earliest and predominant attempts to rationalise this regime was made by Thomas Jackson. In the early 1980's, Jackson attempted to develop a model for shaping rules for creditor distributions, which he called 'the creditors' bargain'.[14] Its basic premise was that there is a notional agreement amongst creditors, comprising terms that they themselves would consent to before any of them entered into contracts with the company. The terms of the agreement deal with how their claims should be treated in the event of the company's insolvency, and creditors are then forced to share the company's remaining assets by the imposition of a collective and compulsory regime.

The advantage of a collectivised debt collection regime is that it takes away the benefits of being the first creditor to claim,[15] and therefore avoids costly and duplicative monitoring of the company's solvency.[16] It also removes the wasteful and potentially inefficient liquidation of the company's assets by individual creditors. A key feature of the collective system is that it leads to administrative efficiencies at the time of liquidation. Many creditors are assumed to be risk averse, and to prefer to receive a more certain, lesser sum than a less certain, greater one.[17] The central tenet of Jackson's analysis is that the collective scheme results in an increased aggregate pool of assets.[18] In other words, the total amount received by creditors *as a group* must be as much or more than the sum of what they would have received if they had enforced the claims individually.[19] In exchange for receiving these benefits, Jackson argued, creditors agree to stay their rights to take individual action.[20]

While the advantages of a collectivised regime are well accepted, scholars have disputed that the rights under that regime ought to be determined by what the parties notionally would have

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[14] Thomas Jackson, 'Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain' (1982) 91(5) *Yale Law Journal* 857. Jackson asserted that 'Bankruptcy law has, for too long, been molded and interpreted without any systematic questioning or understanding of its normative role in a larger legal, economic, and social world. This Article asserts that not only is there a coherent normative theory justifying a bankruptcy system that deals with inter-creditor questions, but also that we would be better able to formulate and apply principled bankruptcy rules if we would give systematic and critical attention to the impact of those rules on non-bankruptcy entitlements' at 907. However, Jackson and Scott later noted 'the inherent incapacity of the legal system to specify ex ante rules for implementing ex post distributional principles'. Thomas Jackson and Robert E Scott, 'On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors' Bargain' (1989) 75(2) *Virginia Law Review* 155, 158.

[15] Jackson calls this 'the race to the courthouse': Jackson, 'Creditors' Bargain', above n 14, 862.

[16] If creditors knew their own ability to recover was based upon being the first to initiate action, they would each spend time and money monitoring the company's solvency. The costs of monitoring would be passed on to the company, making goods and services more expensive. This would affect the profitability of the enterprise or else the company would in turn pass these costs on to their own customers.

[17] Ibid 862-3.

[18] Ibid 864.

[19] See Flessner, describing the capitalist 'common pool' philosophy. He observed that under this philosophy, claimants *in the aggregate* must realise as much as they would have received if they had enforced the claims themselves. Alex Flessner, 'Philosophies of Business Bankruptcy Law: An International Overview' in Jacob Ziegal, *Current Developments in International and Comparative Corporate Insolvency Law* (1994) 19, 23.

[20] It could be argued that debate over the allocation of rights under a collective distribution regime is moot, given the existence of secured interests including floating charges, and sale arrangements including contracts for the supply of goods subject to a hire purchase agreement, sale and leaseback agreements or contracts with retention of title clauses.

agreed to prior to making their contracts.[21] One objection to the model is the fact that involuntary tort creditors cannot by their very nature be included in the creditors' bargain.[22] The assumption that creditors would choose to get less in a collective distribution regime also presupposes that the creditors were identical or near identical. Stronger creditors or 'repeat players' who understand better the risks they face and who can protect themselves by a variety of means are unlikely to chose to forego their natural advantage for the good of the less well protected.[23] Mokal pointed out that

> [s]ince the less influential have little leverage they can give up, it is less likely that the eventual agreement will reflect much of their interests. The rules chosen in the *ex ante* position will be biased towards the interests of the strong. Very weak creditors, who derive bargaining strength only from the possibility of joining a negotiating coalition, and from the fact that they must participate in any final agreement and can hold it up, might find their interests virtually unprotected by the rules chosen.[24]

Another limitation to Jackson's neat reasoning[25] is that as a result of adopting a creditor wealth maximisation approach, the creditors' bargain does not view the protection of non-creditor rights or expectations as a goal of insolvency law. Consequently, while employees have their entitlements as creditors taken into account under the creditors' bargain, their future as employees of a reorganised, ongoing enterprise is not relevant.[26] While Jackson incorporated the idea of reorganisation into later work with Scott, they maintained that 'bankruptcy proceedings such as Chapter XI ... invite dissipation of the common pool by specialists, lawyers, accountants, and economists, who are similarly motivated to secure individual advantage at group expense'.[27]

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[21] For an excellent discussion of this debate and its contributors, see Rizwaan Mokal, *Corporate Insolvency Law: Theory and Application* (2005) ch 2. Flessner also commented that ' it might be wise to respect pre-bankruptcy rights as much as possible but there is nothing to preclude new considerations, peculiar to the situation, being added in the search for appropriate solutions to this kind of business failure. There is no 'logic of bankruptcy' to be derived exclusively from the pre-bankruptcy situation.' Flessner, above n 19, 26. See also David Carlson, 'Philosophy in Bankruptcy' (1987) 85 *Michigan Law Review* 1341; Donald Korokbin, 'Rehabilitating Values: A Jurisprudence of Bankruptcy' (1991) 91 *Columbia Law Review* 717; Finch, above n 13, 28-33.

[22] See Mokal, above n 21, 39. Mokal noted that Jackson and Scott acknowledged that involuntary creditors 'would not fairly be considered participants in a creditors' bargain'. Jackson and Scott, 'Nature', above n 14, 177. See further Lynn LoPucki 'The Unsecured Creditors' Bargain' (1994) 80 *Virginia Law Review* 1887, 1896 -1902 who suggested that involuntary creditors should be given priority over secured creditors. The position of tort creditors is beyond the scope of this paper.

[23] Mokal, above n 21, 54.

[24] Ibid.

[25] Warren has countered Jackson's analysis by offering 'a dirty, complex, elastic, interconnected view of bankruptcy from which I can neither predict outcomes nor even necessarily fully articulate all the factors relevant to a policy decision' Elizabeth Warren, 'Bankruptcy Policy' (1987) 54 *University of Chicago Law Review* 775, 811.

[26] Finch, above n 13, 28. Finch noted that the creditor wealth maximisation objective under the creditors' bargain 'fails to recognise the legitimate interests of many who are not defined as contract creditors; for instance, managers, suppliers, employees, their dependants and the community at large' Ibid 29. For a questioning of the importance of corporate reorganisation legislation, see Douglas Baird, 'The Uneasy Case for Corporate Reorganisation' (1986) 15 *Journal of Legal Studies* 127.

[27] Jackson and Scott, 'Nature', above n 14, 204. They also comment that 'reorganisation is necessarily a more complex and attenuated process and inevitably presents many more opportunities for abuse' Ibid at 192.

Jackson is not the only theoretician to attempt to explain corporate liquidation. Others, such as Korokbin, take a 'value-based' approach and consider moral, political, personal, social and economic dimensions of corporate failure. This involves discourse on the manner in which the assets of the company should be distributed in a liquidation, as well as the possible rehabilitation of the company for the benefit of the various parties who would otherwise be affected by its demise.[28] Korokbin noted that

> A corporation, whether in or out of financial distress, is more than [a bankrupt individual]. The law of corporate reorganization developed as a corrective to a bankruptcy jurisprudence that would have ignored a financially distressed corporation's dynamic potential. It reflected a means of bringing the corporation's dynamic personality into public view and regulating not merely its economic division, but the playing out of its moral, political and social values.[29]

Corporate reorganisation is allowed in Australia under the voluntary administration procedure [30] and in many other countries around the world.[31] Flessner observed that in France, insolvency law was reformed in 1985 and 'expressly given the task of rescuing an insolvent enterprise, preserving employment and eliminating liabilities.'[32] While it is not efficient to attempt to save companies with no hopes of rehabilitation,[33] Part 5.3A of the *Corporations Act* aims to improve the chances of the company surviving or increase returns to creditors in the event that it fails.[34] Reorganisation is a viable option for companies which are

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[28] Finch pointed out some of the difficulties associated with the values approach, above n 13 at 34-5. In addition, she explored other visions of corporate insolvency law, including the communitarian vision, the forum vision and the ethical vision. Flessner remarked that 'the enterprise and forum philosophy ... remains vague, however, on the role bankruptcy should play when it comes to taking the final decisions. It is fine to claim relevance for those interests that are not representing capital claims but ongoing and future relations (employees, suppliers, customers, governments) and to let them be heard from in the forum. But the conversation about the situation cannot go on indefinitely. At bottom the insolvency enterprise is in urgent need, not of good intentions, but of money and economic prospects. So, at the end of the day, only those can have a say who are about to lose their money or who are willing to invest money or money's worth for the decisions to be taken about the firm's future. The forum theory does not and cannot give us guidelines for this final stage of bankruptcy procedure.' Detailed exposition of these models is beyond the scope of this paper. Flessner, above n 19, 27.

[29] Korokbin, 'Rehabilitating Values, above n 21, 745.

[30] Part 5.3A of the *Corporations Act* . These provisions were introduced in 1992 following recommendations made by the ALRC General Insolvency Inquiry Report No 45 (1988) (the Harmer Report). In addition to voluntary administration followed by either a Deed of Company Arrangement (when successful) or a liquidation (when unsuccessful), corporate reorganisation can take place via a Scheme of Arrangement under Part 5.1 of the Corporations Act. However, as Schemes involve two separate court hearings, they are rarely used in the insolvency context as they are cumbersome and costly.

[31] Flessner noted that '[t]he American Bankruptcy Act of 1938, with its chapters X and XI, was the first piece of legislation in a capitalist and free-market economy to fully incorporate the idea that bankruptcy law should offer not only straight liquidation but also reorganisation, including a restructuring of debt and equity, as a solution to insolvency. Since then it has become commonplace in modern bankruptcy legislation to provide for alternatives to piecemeal liquidation of insolvent enterprises. In France, the rehabilitation of the insolvent enterprise (le redressement) has even been declared the primary goal of bankruptcy law.' Flessner, above n 19, 20.

[32] Flessner, above n 19, 22.

[33] See Kylie Lightman 'Voluntary Administration: The New Wave or the New Waif in Insolvency Law' (1994) 2 *Insolvency Law Journal* 59, 71: 'It is clear that some businesses become redundant. Insolvency is a means of removing businesses that fail to remove themselves'.

[34] Section 435A provides that: "The object of this Part is to provide for the business, property and affairs of an insolvent company to be administered in a way that:

(a) maximises the chances of the company, or as much as possible of its business, continuing in existence; or

(b) if it is not possible for the company or its business to continue in existence--results in a better return for the company's creditors and members than would result from an immediate winding up of the company.

economically sound but which have failed to meet all their debts 'as and when they become due and payable'.[35] By giving the company a chance to trade out of its difficulties, [36] reorganisation is the solution which is most likely to lead to the rescue of the company or its business, and therefore to the preservation of jobs.[37] It attempts to maximise the return to creditors by ensuring an orderly disposal of assets, rather than the 'fire sale' mentality common to liquidation.[38]

The third form of creditor protection to be discussed here is lifting the corporate veil on those who are behind the company. The term 'veil lifting' refers to the imposition of liability on both shareholders, including holding companies, and directors or other managers of the corporation. The former is problematic for a range of reasons, including the fact that veil lifting on shareholders arguably undermines the rationale for granting limited liability. It increases monitoring costs for shareholders where there is a separation of ownership and management. The theoretical analysis of veil lifting on shareholders will not be discussed further,[39] as there is only very limited legislation imposing liability on shareholders for the benefit of creditors.[40]

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[35] Section 95A *Corporations Act* definition of insolvency.

[36] Explanatory Memorandum to the Corporations Amendment (Insolvency) Bill 2007, available at http://www.comlaw.gov.au/comlaw/Legislation/Bills1.nsf/0/27ACAFAE60ADD5C0CA2572EC000ED970/$file/07099em.pdf, accessed 25th September, 2008, [3.15]. This Bill was enacted in 2007. Its four aims were to improve outcomes for creditors, deter misconduct by corporate officers, improve the regulation of insolvency practitioners and fine-tune voluntary administration. See [2.3] to [2.7] It made no changes of significance to the present discussion.

[37] The Explanatory Memorandum noted that '[i]n 2005, 7,277 companies entered external administration. Of these, 2,636 companies — approximately 36 per cent — entered voluntary administration' at [3.15] … 'The primary purpose of the voluntary administration procedure … is to provide a flexible and relatively inexpensive procedure that enables a company to suspend the payment of its debts, so that it can attempt a compromise or arrangement with its creditors aimed at saving the company or the business or, if that is not possible, maximising the return to creditors. If successful, the compromise or arrangement will be set out in a deed of company arrangement (DOCA), which binds the company and the creditors. If these attempts fail, the legislation facilitates the transition to winding up.' [3.17]

[38] It has been argued that the process of voluntary administration is open to abuse, where it is used to reorganise the debtor without the intention of maximising the value of the organisation's assets. See Intan Eow, 'The Door to Reorganisation: Strategic Behaviour or Abuse of Voluntary Administration' [2006] *Melbourne University Law Review* 11. See also James Routledge 'Voluntary Administration and Commercial Reality: Aligning the Competing Interests' (1997) 5 *Insolvency Law Journal* 125.

[39] For a fuller discussion of veil lifting, see Jason Neyers, 'Canadian Corporate Law, Veil Piercing and the Private Law Model Corporation' (2000) 50 *University of Toronto Law Journal* 173; Stephen Bainbridge, 'Abolishing Veil Piercing' (2001) 26 *Journal of Corporation Law* 479; David Cohen, 'Theories of the Corporation and the Limited Liability Company: How Should Courts and Legislatures Articulate Rules for Piercing the Veil. Fiduciary Responsibility and Securities Regulation for the Limited Liability Company' (1998) 51 *Oklahoma Law Review* 427; Saul Fridman, 'Removal of the Corporate Veil: Suggestions for Law Reform in *Qintex Australia Finance Ltd v Schroeders Australia Ltd*' [1991] *Australian Business Law Review* 211.

[40] While courts will only lift the corporate veil on shareholders in limited circumstances (for example, where the company has been used as a vehicle for fraud or used to avoid a legal obligation under contract or statute), they are more inclined to do so when the shareholder is a holding company. See Phillip Lipton and Abe Herzberg, *Understanding Company Law*, (14th ed, 2007) [2.100] –[2.150] . In addition, holding companies may be liable as shadow directors of the subsidiary, where the directors of the subsidiary are nominee directors who follow the holding company's instructions – *Standard Chartered Bank of Australia Ltd v Antico* (1995) NSWLR 290. Legislation also allows for holding company liability for insolvent trading under s 588V – 588X of the *Corporations Act.* There have also been developments in the pooling of group company assets upon insolvency, which are beyond the scope of this paper. See *Corporations Amendment (Insolvency) Act* (2007).

The argument against veil piercing - that it increases monitoring costs - obviously does not hold in the context of directors. Indeed, the principal objectives of imposing liability on directors are to *increase* monitoring of the company's affairs, to deter undesirable behaviour and to provide a measure of compensation if deterrence is unsuccessful. When a company is on the brink of failure, the directors, representing the company's controlling shareholders, may seek to benefit themselves or other companies in the group at the expense of creditors.[41] Grantham argued that normally 'the short-term gain from high-risk activity is more than offset by the long term loss of lender confidence'[42] but that the self-interest of directors which might normally compel them to act responsibly and in the best interests of creditors dissolves on approaching insolvency.'[43]

The problem is particularly acute for directors of small companies, who do not always have reputational incentives.[44] Keay remarked that 'it has become axiomatic that this risk-taking will take place, particularly where the directors are also the owners in the context of closed corporations.'[45] Imposing personal responsibility on directors for improper behaviour deals with the moral hazard occasioned by the separate legal entity principle. It encourages directors to either obey the law or to protect themselves against liability by some other means. This may include taking more care to maintain adequate capitalisation of the company, so that creditors sue the solvent company rather than the directors themselves. Alternatively, they may seek insurance on behalf of the company or themselves.

Insolvency law theory can therefore be seen to explain the three types of ex post legislative protection of creditors. Creditor welfare maximisation is a powerful objective which underpins all three forms. In addition, deterring opportunistic behaviour upon approaching insolvency was also seen to be the aim of lifting the corporate veil to impose liability on directors. The next Part will consider whether these objectives have been realised.

III REALITY

While contractarians generally support market mechanisms to protect against losses in the event of corporate insolvency, it was noted above that three forms of ex post legislative

[41] David Wishart, 'Models and Theories of Directors' Duties to Creditors' (1991) 14 *New Zealand Universities Law Review* 323, 333.

[42] Ross Grantham, 'The Judicial Extension of Directors' Duties to Creditors' [1991] *Journal of Business Law* 1, 1, citing Richard Posner, 'The Rights of Creditors of Affiliated Corporations' (1976) 43 *University of Chicago Law Review* 499, 504.

[43] Scott agreed, noting that 'As long as the debtor's business prospects remain good, a strong reputational incentive deters misbehaviour. But once the business environment deteriorates, the [director] is increasingly influenced by a 'high-roller' strategy. The poorer the prospects for a profitable conclusion to the venture, the less the entrepreneur has to risk and the more he stands to gain from imprudent or wrongful conduct. Robert Scott, 'A Relational Theory of Default Rules for Commercial Contracts' (1990) 19 *Journal of Legal Studies* 597, 624.

[44] This risk is greater with small companies because the directors are more likely to be the controlling shareholders. In large corporations, management is generally separated from ownership, and directors may have a greater incentive to act cautiously to retain their remuneration, reputations and the ability to act as directors of other companies. Breaches of duty may result in civil penalty action under Part 9.4B of the *Corporations Act* and disqualification under s 206C(1) of that Act from managing a corporation for a period of time considered appropriate by the Court.

[45] Andrew Keay, 'Directors' Duties to Creditors: Contractarian Concerns Relating to Efficiency and Over-Protection of Creditors' (2003) 66 *Modern Law Review* 665, 669 (footnotes omitted).

protection play an important role in safeguarding the entitlements of unsecured creditors.[46] Australian corporate legislation does provide for the three types of ex post insolvency protection described above, and this part of the paper will look at the rights enjoyed by three types of voluntary unsecured creditors - the Commissioner of Taxation, unsecured trade creditors and employees.

A *Recovery of Unremitted Taxation Instalments*

The functioning of government is entirely dependent on its ability to raise revenue, and protection of the revenue base is an unquestioned objective of taxation law. In 1993, the Income Tax Assessment Act 1936 (ITAA36) was amended[47] in relation to amounts owing under a number of tax systems dealing with the collection of tax from third parties and subsequent remittance to the Commissioner of Taxation.[48] In accordance with a recommendation of the Harmer Report,[49] the enactment of the provisions coincided with the removal of the Commissioner's rights of priority in the distribution of a company's assets upon its liquidation in relation to unpaid tax instalments.[50] However, this amendment was not intended to, and did not, diminish the protection of the revenue base. Its stated aim was to 'ensure solvency problems are confronted earlier and the escalation of debts will be prevented'.[51] The object[52] of Division 9 of Part VI of the ITAA36 is to ensure that a company satisfies particular income tax obligations or is promptly placed into voluntary administration or liquidation. It seeks to achieve this by imposing a duty on directors,[53] to take specified actions or to face a 'penalty' equal to the company's tax liability.

Four actions are specified: to cause the company to comply with its payment obligations, to enter into a payment agreement,[54] to appoint an administrator[55] or to commence winding up

[46] Kraakman et al noted the importance of insolvency protection legislation providing standard form default terms into the contracts of certain creditors. They describe these default terms as 'essential when parties cannot negotiate protections for themselves, because too small, too naive, or when collective action problems prevent creditors from obtaining terms that might benefit all creditors ex ante'. They observed that the risk of shareholder opportunism is particularly likely when the corporate debtor approaches insolvency.[46] Kraakman, Davies and Hansmann, above n 7, 72-3.

[47] *Insolvency (Tax Priorities) Legislation Amendment Act 1993* (Cth). The provisions are contained in Division 8 (ss222AFA to 222AMB) and Division 9 (ss 222ANA – 222AQD) of Part VI of the ITAA36.

[48] These included the Pay as You Earn System, the Prescribed Payments System, the Reportable Payments System, and the Withholding Tax System. These were formerly contained in ss 221A – 221YAA of Division 2, ss 221YHA – 221YHZ of Division 3A, ss 220AA- 220AZH of Division 1AA, ss 221YJ – 221YY of Division 4, and ss 221YHZA – 221YHZZC of Division 3B, all of Part VI of the ITAA36. The various taxes to which the directors' liability provisions apply are now contained in Division 12 of Schedule 1of the *Taxation Administration Act 1953* (Cth) (hereinafter referred to as the TAA53).

[49] ALRC General Insolvency Inquiry Report No 45 (1988) (the Harmer Report) at [741].

[50] ITAA36 s 221P. The statutory priority of the Commonwealth to receive a priority in corporate insolvencies had been abolished from 1 November 1979 (Act No 134 of 1980) except in relation to tax instalment deductions and withholding tax - Sections 221YU and 221P of the ITAA36. The history of the removal of the provisions is outlined in Christopher Symes, 'Reminiscing the Taxation Priorities in Insolvency' [2005] *Journal of the Australian Tax Teachers Association* 23.

[51] The Minister for the Arts and Administrative Services, Second Reading Speech to the Insolvency (Tax Priorities) Legislation Amendment Bill 1993.

[52] Section 222ANA(1) of the ITAA36 provides that 'The purpose of this Division is to ensure that a company either meets its obligations under Division 1AAA, 3B, 4 or 8 of this Act or under Subdivision 16B in Schedule 1 to the TAA53, or goes promptly into voluntary administration under Part 5.3A of the *Corporations Act 2001* or into liquidation .'

[53] ITAA36 ss 222AOB and 222APB.

[54] ITAA36 s 222ALA .

proceedings.[56] The directors are given a written notice specifying details of the unpaid amounts and given 14 days to comply. If this duty is not complied with in the specified period,[57] the directors are personally liable to pay a penalty[58] equal to the amount of the unpaid tax or estimated amount of unpaid tax.[59] The liability[60] of directors falls due immediately upon the failure by the company to pay the tax due on the prescribed date, if one of the three other options are not taken up. Some defences to liability are provided by the legislation, although they are difficult to establish.[61] In addition, directors remain liable as an accessory to the taxation offence. [62] A range of other means of recovery by the Commissioner of Taxation also exist, [63] which are beyond the scope of this paper.

B *Recovery of Unsecured Trade Creditors' Debts*

Unsecured trade creditors do not have the benefit of any priority under s 556 of the *Corporations Act*. However, they are afforded a degree of statutory protection under s 588G.[64] This section imposes on directors a duty to prevent trading by the company which causes insolvency or occurs during insolvency, when there are reasonable grounds for suspecting insolvency and the director or a reasonable person in the director's position would be aware of these grounds. Contravention of this section allows recovery from directors by the liquidator by means of civil proceedings.[65] The money recovered is payable to the company and is available for distribution to all unsecured creditors, not just those whose debts were incurred during the period when the director had reasonable suspicions of the company's insolvency. However, in creditor-initiated actions, which are permitted with the liquidator's consent,[66] the amount recovered is payable to the unsecured creditor.[67]

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[55] *Corporations Act* pt 5.3A.
[56] *Corporations Act* s 459A.
[57] ITAA36 s 222AOE(b).
[58] ITAA36 s 222AOC or s 222APC.
[59] ITAA36 s 222ANA(2) .
[60] Directors have a continuing exposure, both jointly and severally with the company, for these amounts, which arises on the date that the tax liability on the company became due and payable.
[61] ITAA36 subs 222AOJ(2) – (4) provides defences. The defences are that the director establishes that he did not take part in the management of the company at any time while a director because of ill health or some other good reason, or that the director took all reasonable steps to ensure that one of the four actions referred to above was taken, or alternately there were no such steps that the director could reasonably have taken in all the circumstances. For a discussion on the difficulties in making out these defences, see Helen Anderson, Directors' Liability for Unpaid Employee Entitlements – Suggestions for Reform Based on their Liabilities for Unremitted Taxes (2008) 30(3) *Sydney Law Review* 470, 488-9 .
[62] *Crimes Act 1914* (Cth) s 21B and TAA53 s 8Y.
[63] These include imposing liability on a director if the company's liquidator has clawed back from the Commissioner of Taxation a payment which amounts to a voidable transaction: *Corporations Act* s 588FGA(2); It is also possible for the Commissioner of Taxation to obtain priority of payment over secured and unsecured creditors in certain circumstances, through the operation of garnishee provisions. This is achieved by the service of a notice under TAA53 s 260-5, Schedule 1, Subdivision 260-A, (formerly s 218 of the ITAA36), requiring payment from a person or company which holds money on behalf of the company that owes unpaid taxes. The result of such a notice is the creation a fixed charge[63] in favour of the Commissioner against the taxpayer company's assets, rendering the tax office in effect a secured creditor. This negates much of the benefit for unsecured creditors of the Commissioner withdrawing as priority unsecured creditor under s 556 of the *Corporations Act*. An additional advantage for the Commissioner is that the notice avoids the requirement placed on other secured creditors to obtain a judgment or a warrant of execution from the court.
[64] This section was introduced by the *Corporate Law Reform Act 1992* (Cth).
[65] Corporations Act s 588M.
[66] *Corporations Act* s 588R.

Action against directors for insolvent trading requires the company to be wound up, rather than one of a range of alternatives to liquidation, such as a voluntary administration followed by a deed of company arrangement. Removing the chance of liability for insolvent trading was deliberate and was intended to encourage directors to find alternatives to liquidation, to the benefit not only of themselves but also of creditors.[68] This encouragement towards corporate reorganisation will be discussed further in Part IV. ASIC retains the right to initiate proceedings for insolvent trading in the absence of the company's liquidation.[69] Recovery of compensation is pursuant to s 588M(2) and (3). Section 588G(3) creates the criminal offence of insolvent trading where the person's failure to prevent the company incurring the debt was dishonest.[70]

Various other provisions work to deter director behaviour which adversely affects creditors and to increase the pool of assets available to unsecured creditors upon liquidation. Voidable transactions, including unreasonable director-related transactions, can be avoided under Part 5.7B Division 2 of the *Corporations Act*. A range of sections are civil penalty provisions[71] and pursuant to s 1317H, a court can order the director to pay compensation to the company for breach.[72] In addition, where a person is knowingly concerned in the doing of an act by a company with the intention of defrauding creditors of the company, they may be convicted of an offence under s 592(6).[73] Under s 598(2), compensation can also be recovered from a person who is guilty of fraud, negligence, default, breach of trust or breach of duty in relation to a corporation, where the corporation has suffered, or is likely to suffer, loss or damage as a result.

C *Recovery of Unpaid Employee Entitlements*

The *Corporations Act* provides a number of protections to employees.[74] Section 556(1) provides priority for wages and superannuation contributions of employees,[75] leave entitlements and retrenchment payments[76] with limits applicable to directors and their spouses.[77] In addition, under s 561, payment of employee entitlements must be made in

[67] Section 588Vof the *Corporations Act* also permits recovery by the liquidator from a holding company for the insolvent trading of its subsidiary. See note 40 above regarding liability of holding companies.
[68] Abe Herzberg, 'Why are There So Few Insolvent Trading Cases?' in Ian Ramsay (ed), *Company Directors' Liability for Insolvent Trading* (2000) 148, 158.
[69] *Corporations Act* s 588J(1).
[70] The prosecution is launched by the ASIC, with a criminal court able to order compensation to be payable to the company benefiting all creditors - s 588G(3) and s 588K of the *Corporations Act*.
[71] These are specified at s 1317E, and include insolvent trading – s. 1317E(1)(e).
[72] However, any pecuniary penalty ordered (up to $200,000) is payable to the Commonwealth – *Corporations Act* s 1317G.
[73] This offence is punishable by a fine of 100 penalty units or imprisonment for 2 years or both.
[74] In addition to the provisions outlined in this Part of the paper, there is also a possibility of liability being imposed on directors under s 1317H for breach of s 181 of the *Corporations Act*, which requires directors to act in good faith and in the best interests of the company. The interests of employees can be considered in performing these duties, but only where this would also be in the company's and the shareholders' interests. Employee concerns cannot be placed ahead of those of shareholders. In particular, a company is not permitted to make redundancy payments to employees in the context of a business closure, where this would reduce the funds available for distribution to shareholders. *Parke v Daily News Ltd* [1962] Ch 927; see also *Hutton v West Cork Railway Company* (1883) 23 Ch D 654.
[75] *Corporations Act* s 556(1)(e).
[76] *Corporations Act* ss 556(1)(g) and (h) respectively.
[77] *Corporations Act* s 556(1A) refers to excluded employees, which is defined in s 556(2) of that Act.

priority to the claims of the holders of a floating charge and may be made out of property subject to that charge.[78] This priority also exists when the company is placed into receivership by the holder of a floating charge.[79] However, the payment of employee entitlements rank behind a number of categories of administration expenses of the winding up, and each must be paid in full before later categories receive anything. Riley commented that 'the first bite of nothing is still nothing'.[80] It is likely therefore in many situations that employees will not receive their full entitlements as a result of their statutory priority in a winding up.

There are also provisions which impose personal liability on directors. Legislation was introduced following the Waterfront Dispute of 1998, which saw a corporate restructure to facilitate the sacking of waterside workers and their replacement with non-union employees.[81] The legislation, the *Corporations Law Amendment (Employee Entitlements) Act 2000* (Cth), inserted Part 5.8A into the *Corporations Act*, and also amended Part 5.7B of that Act. It provides two avenues for recovery of employee entitlements. The first is s 596AB(1), which states that

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

A new offence was created to penalise employers engaging in this behaviour, [82] with a harsh penalty including a maximum term of imprisonment of 10 years. The section provides for compensation to be payable in action taken by the company's liquidator[83] or by the employees with the consent of the liquidator.[84] In the absence of liquidator consent, employees can also seek the right to sue with leave of the court,[85] pursuant to provisions similar to those found in the insolvent trading legislation.[86] However, despite the apparent breadth of the section, there have been no successful prosecutions or actions by liquidators or employees. This can arguably be attributed to the fact that the section requires proof of a *subjective* intention on the part of the directors to prevent or significantly reduce the recovery of employee entitlements.

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[78] Sections 558 and 560 also clarify the priority of certain payments to employees.
[79] *Corporations Act* s 433.
[80] Joellen Riley, 'Bargaining for Security: Lessons for Employees from the World of Corporate Finance' (2002) 4 *The Journal of Industrial Relations* 491, 499. Mokal maintained that in the United Kingdom, the lower priorities relate to 'non-distribution' as there is rarely enough funds to satisfy the higher categories of priority payment. Rizwaan Mokal, 'On Fairness and Efficiency' (2003) 66 *Modern Law Review* 452, 459.
[81] *Maritime Union of Australia v Patrick Stevedores No 1 Pty Ltd* (1998) 27 ACSR 497. The previous decade had also seen a number of prominent corporate failures and restructures, which resulted in large numbers of employees either losing or having threatened their unpaid entitlements to annual leave and long service leave, as well as missing out on redundancy payments prescribed in industrial awards and agreements. The more well known of these include Ansett Airlines, Oakdale Collieries, Grafton Meatworks, Cobar Mines and National Textiles.
[82] *Corporations Act* s 596AB.
[83] *Corporations Act* s 596AC. Any amount recovered by the liquidator has priority under sub-ss 556(1)(e) to (h) and is regarded as a preferential debt owed to employees.
[84] *Corporations Act* s 596AF.
[85] *Corporations Act* s 596AH.
[86] *Corporations Act* s 588T.

The second way in which employee entitlements are protected by the amending legislation is by the amendment of the uncommercial transaction provisions.[87] This legislation added a category of 'deemed debts' to the insolvent trading provisions. When a company takes any of the actions listed in s 588G(1A) of the *Corporations Act*, it is automatically deemed to have incurred a debt for the purposes of the directors' duty to prevent insolvent trading under s 588G of that Act. One of these debts is entering into an uncommercial transaction.[88] The effect of this amendment is to give the liquidator the ability to recover from directors the value of assets deliberately dispersed by directors, for the purpose, inter alia, of defeating employee claims, but without having to prove the requirement under Part 5.8A of the *Corporations Act* of an actual intent to prevent or significantly reduce recovery of employee entitlements.[89]

The statutory protections of employees have proved insufficient to ensure full recovery of their entitlements. For this reason, the General Employee Entitlements and Redundancy Scheme ('GEERS') was introduced.[90] GEERS enables employees of insolvent companies to claim recovery of their unpaid entitlements from a government fund.[91] The Government enjoys a statutory right of subrogation[92] to stand in the shoes of employees and claim their statutory priority [93] in the winding up of the company. However, it operates subject to a number of important limitations, including an overall 'cap' on the level at which entitlements

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[87] Under s 588FB(1) of the *Corporations Act*, 'A transaction of a company is an uncommercial transaction of the company if, and only if, it may be expected that a reasonable person in the company's circumstances would not have entered into the transaction, having regard to:
(a) the benefits to the company of entering into the transaction;
(b) the detriment to the company of entering into the transaction;
(c) the respective benefits to other parties to the transaction of entering into it; and
(d) any other relevant matter.

[88] The Federal Minister for Financial Services and Regulation , the Honourable Joe Hockey, in 'More Protection for Workers' Entitlements' (Press Release, 28 June, 2000), said that the amendment regarding uncommercial transactions would 'ensure that directors don't use asset stripping techniques to avoid paying employees their proper entitlements'.

[89] It should also be noted here that, prompted mainly by the One.Tel collapse in 2001, the *Corporations Amendment (Repayment of Directors' Bonuses) Act 2003* was passed. The legislation inserted section 588FDA into the *Corporations Act* to enable the recovery by a liquidator of excessive bonuses that have been paid to directors in circumstances where a company is in no financial position to make such payments. This legislation has the effect of increasing the pool of assets available to employees upon liquidation.

[90] GEERS replaced the Employee Entitlements Support Scheme (EESS), which was introduced by the Federal Government on 8 February, 2000. It adopted the recommendations of the Commonwealth of Australia Ministerial Discussion Paper, 'The Protection of Employee Entitlements in the Event of Employer Insolvency' (1999). Its purpose was to provide a safety net for employees who lose their jobs due to the insolvency of their employers. The EESS scheme involved a 50% contribution from the states collectively, but support from the states was not forthcoming. The alternative proposal for an insurance scheme for the recovery of employee entitlements contained in that Discussion Paper was rejected. A special scheme to pay the employment entitlements for former Ansett employees was also introduced, funded by a levy on airline tickets: *Air Passenger Ticket Levy (Collection) Act 2001* (Cth) and the *Air Passenger Ticket Levy (Imposition) Act 2001* (Cth).

[91] Note that employees of a company that went into voluntary administration on or after 1 November 2005, and which became subject to a Deed of Company Arrangement, are not eligible for payment under GEERS until and unless the company goes into liquidation. The ability of employees to make a claim under GEERS is affected if the liquidation has been preceded by a deed within 12 months of the liquidation, and the deed had a different priority for payment of outstanding employee entitlements to that in a liquidation.

[92] *Corporations Act* s 560.

[93] *Corporations Act* s 556.

paid out under the scheme are to be calculated.[94] The scheme is also discretionary, and there is no legislative obligation on present or future federal governments to operate the scheme.[95]

This Part of the paper examined three cohorts of creditors in terms of their rights under the collective distribution regime, encouragement towards voluntary administration and imposition of liability on directors. Employees rank best in terms of priority upon a liquidation distribution, with unsecured trade creditors and the Commissioner of Taxation having their recovery postponed until after the payment of all categories of priority creditor. However, unsecured trade creditors and the Commissioner of Taxation fare best in terms of lifting the corporate veil on directors to deter their undesirable behaviour and encouraging the directors to place the company into voluntary administration. No such provisions exist in relation to the protection of employee entitlements. The next Part will analyse these various rights to determine whether they are appropriate and whether they accord with the theory of insolvency law described in Part II above.

IV ANALYSIS

It is not the purpose of this article to critically analyse the creditors' bargain model or other models which seek to explain insolvency law. The idea of a collective insolvency regime is not questioned. Nor is it suggested that creditors necessarily should get what they want. Rather, the concept of the creditors' bargain simply provides a useful focus for comparing the recovery rights of three prominent cohorts of voluntary creditors – the Commissioner of Taxation, unsecured trade creditors and employees – and poses an interesting question: if these creditors had considered, prior to entering into their dealings with the company, what would happen to their debts if the company became insolvent, what would these three cohorts of creditors have bargained for? And do creditors generally get what they would have been prepared to agree to?

Not surprisingly, the law in Australia was not drafted to comply with Jackson's creditors' bargain model. Corporate reorganisation and lifting the corporate veil to impose liability on directors were not part of Jackson's theory.[96] As noted above, Jackson's seminal article has been the subject of extensive scholarly debate,[97] and Jackson himself qualified the concept of the creditors' bargain in later work.[98] The model was developed to be both positively descriptive of collective distribution regimes, as well as to be normatively useful in developing the law in the future, but Jackson and Scott conceded that 'reconciling the

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[94] For further details, see the current version of the GEERS Operational Arrangements (OAs) available at: http://www.workplace.gov.au/workplace/Programmes/EmployeeEntitlements/GEERSV2, accessed 26th September, 2008. The cap is called the Maximum Annual Wage for the purposes of the OAs, and is specified in the Workplace Relations Regulations 2006. The Maximum Annual Wage is indexed each year, and is available at www.workplace.gov.au.

[95] The Operational Arrangements state that 'While these OAs set out the general policy basis for the administration of GEERS, any Advance is made without any legal obligation on the part of the Commonwealth to do so.' Ibid clause 5(c). See further Samantha Kinsey, 'A Triumph of Labour Over Capital: Employee Entitlements in Insolvency in the Wake of the Ansett Collapse' (2002) 10 *Insolvency Law Journal* 132, 141-142.

[96] As noted at n 27 and accompanying text, Jackson did address the issue of reorganisation in later work with Scott but did not consider it a useful mechanism for ensuring creditors would receive their pre-bankruptcy entitlements.

[97] Above n 21.

[98] Jackson and Scott, 'Nature', above n 14.

tensions among the individual interests of claimants of an insolvent debtor poses an obvious problem, one unlikely to be resolved collectively without legal intervention'.[99] While they considered that 'whichever course the law encourages parties to take, maximising the total welfare of the group will necessarily be the central objective'[100] they admitted that 'the dilemma ... is that the law cannot ensure that the interests of any particular group of claimants will coincide with the interests of the whole'.[101]

It is somewhat simplistic to say, as Jackson does, that the motivation behind insolvency law necessarily has as its central objective to maximise the welfare of the creditor group as a whole. The law as drafted is a result of many influences, including political, economic, practical, and evolutionary factors. Significant here are the political influences, such as pressure from interest groups and institutions,[102] comprising business associations, trade unions, employer groups, and consumer organisations. Responses to corporate scandals can result in knee-jerk legislative reform tailored to the particular situation.[103] The government can use corporate law to achieve its own revenue-raising ends. Generally, the call will be for laws to deter conduct designated as undesirable by penalising the offenders through such measures as the imposition of personal financial liability, or criminal or civil sanction. Personal liability has the added advantage of providing a degree of compensation to be distributed to the parties affected by the conduct.

Nonetheless, if one were to assume that maximising the welfare of the creditor group as a whole is the objective of insolvency law, it is interesting to look at the three types of creditor protection to see how this might best be achieved. Simply prioritising employees in a collective distribution regime does nothing to ensure that there are more assets in the aggregate for all concerned – while the employees might be better off than under an individual enforcement regime, they might benefit even more if there is strong encouragement towards voluntary administration, backed up by stringent director liability laws.

The following discussion will concentrate on answering these two questions – what would these creditors have bargained for if they were given a chance, prior to their dealings with the company, and what legislative scheme would maximise the welfare of the creditor group as whole? It is the contention of this paper that the answer to the two questions is the same.

To establish what the various unsecured creditors examined in this paper would have bargained for, their precontractual positions must briefly be examined. The Australian Taxation Office (ATO) is a powerful and persuasive advocate in its own cause when demanding rights of recovery in corporate insolvencies. One can therefore presume that the ATO received exactly what it bargained for and what it wanted when the law was amended.

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[99] Jackson and Scott, 'Nature', above n 14, 159.
[100] Ibid 160.
[101] Ibid.
[102] Henry Hansmann and Reinier Kraakman, 'The End of History for Corporate Law' (2000) 89 *Georgetown Law Journal* 439, 453.
[103] Jennifer Hill, 'The Persistent Debate about Convergence in Comparative Corporate Governance' (2005) 27 *Sydney Law Review* 743, 750: '[P]ost-Enron regulatory developments are a potent reminder that corporate events of this magnitude can generate new divergence in laws'. Hill cited here the introduction in the United States of the Sarbanes Oxley legislation, and in Australia, of CLERP 9. 'The architecture of these laws often directly tracks the contours of local scandals.' Ibid 751. See further Jennifer Hill, 'Regulatory Responses to Global Corporate Scandals' (2005) 3 *Wisconsin International Law Journal* 367.

The Explanatory Memorandum for Insolvency (Tax Priorities) Legislation Amendment Bill indicated that the proposed legislation was primarily for the purpose of improving the Commissioner's own recovery rights. The criminal nature of the earlier provisions was inhibiting this recovery.[104]The Explanatory Memorandum concluded that '[i]f company directors were made liable for unremitted amounts, which are currently subject to the priority, solvency problems would be confronted earlier and the escalation of debts in respect of those amounts could be prevented.'[105] Yet arguably, the Commissioner of Taxation is the least in need of additional forms of ex post compensation. The risk of significant revenue shortfalls from non-payment by particular company taxpayers has been reduced through diversification by virtue of the fact that taxation money is owed by a huge number of parties.[106]

It is tempting to generalise about unsecured trade creditors as vulnerable and in need of legislative protection. Their needs are not identical and what they would have bargained for under the creditors' bargain model cannot be specified with any accuracy. Unsecured trade creditors with a strong bargaining position[107] may retain title over their goods, demand pre-payment, obtain a personal guarantee from directors, require a negative pledge that restricts the company's right to borrow further, insist upon minimum capitalisation, diversify away their risk of loss, or price protect against it.[108]

However, many small trade creditors lack the bargaining power to insist on contractual protections ex ante, and competition may prevent them from charging a premium on the supply of goods or services to compensate for the risk of non-payment. In addition, small trade creditors may not possess sufficient information about the creditworthiness of the company to price protect effectively and indeed, the risk of loss may increase after the credit has been extended. Lo Pucki rejects the assumption that 'voluntary creditors contract for

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[104] The Explanatory Memorandum stated: 'Under the current law, the combined operation of section 8Y of the Taxation Administration Act 1953 and section 21B of the Crimes Act 1914 can result in company directors being convicted in relation to their company's non payment of amounts deducted. … If convicted, company directors can be ordered by a court to pay reparation equal to the amount of the deductions unpaid. This recovery process results in extensive delays in recovering debts for unremitted tax amounts. The joint Ministers' announcement of 2 December 1992 noted that the Commissioner's priority only operates when a business is put into some form of insolvency administration. As a result, the current operation of the priority puts no pressure on the persons liable to pay unremitted amounts when due. … The proposed amendments will allow the Commissioner to take more effective recovery action for unremitted amounts and will remove the need to have a conviction as a prerequisite to recovery' Available at http://law.ato.gov.au/atolaw/view.htm?DocID=NEM%2FEM93005%2FNAT%2FATO%2F00001, accessed 30th September, 2008.

[105] Id.

[106] This point was made in the Harmer Report, which was the catalyst for the taxation reforms discussed in this paper. The Harmer Report noted the Report of the Senate Standing Committee on Constitutional and Legal Affairs *Priority of Crown Debts* (AGPS, Canberra, 1978) which referred to estimates by the Commissioner of Taxation for the financial year 1976-1977. It showed that while financial receipts of taxation were $15,884 million, the amount of tax to which the Crown could have claimed priority in a winding up was $10 million, or approximately 0.06% of the total amount. ALRC General Insolvency Inquiry Report No 45 (1988) (the Harmer Report) at [735]. While the amounts in question would have increased significantly in the years since, there is no reason to suppose that the relative percentage would have changed.

[107] Steven Schwarcz, 'Rethinking a Corporation's Obligations to Creditors' (1996) 17 *Cardozo Law Review* 647, 663. Schwarcz commented that 'many trade creditors are themselves major corporations, such as IBM …'.

[108] Dale Oesterle, 'Corporate Directors' Personal Liability for "Insolvent Trading" in Australia, "Reckless Trading" in New Zealand and "Wrongful Trading" in England: A Recipe for Timid Directors, Hamstrung Controlling Shareholders and Skittish Lenders' in Ian Ramsay (ed), *Company Directors' Liability for Insolvent Trading* (2000) 19, 22. See also Justin Dabner, 'Trading Whilst Insolvent – A Case for Individual Creditor Rights Against Directors' (1994) 17 *University of New South Wales Law Journal* 546, 569.

unsecured status with a full awareness of the consequences when in fact they contract under varying degrees of coercion with varying levels of awareness.[109]

The disparity of creditors' ability to self-protect against the risk of loss has been one of the major flaws identified in the creditors' bargain model.[110] In addition, creditors are unaware of the terms on which others contract. Whincop notes that 'virtually everything depends upon the sequence of moves, the information available to, and the beliefs of, the parties, the ability to verify information, the cost of verification and so on.'[111] Therefore, it is impossible to say with any degree of certainty what unsecured trade creditors would have agreed to under the creditors bargain model.

While it is also tempting to generalise about employees' vulnerability, it must be conceded that the status of the employee in the company may allow some degree of self-protection, both prior to accepting employment as well as during employment.[112] Also, the past experience of employees may allow them some knowledge of business closures and retrenchment entitlements. The fallout from business failures and job losses are often highlighted both in the media and in Parliament, particularly if large numbers of workers are involved or if they are represented by a vocal union. However, it is probable that when looking for work, most people would focus on their pay, conditions, chances of promotion and other benefits, rather than their entitlements as unsecured creditors if the company foundered. Indeed, employees are unlikely to characterise themselves as creditors of the company at all. It is even more unlikely that employees would have more than a vague knowledge of their rights vis a vis the rights of other unsecured creditors.

The vulnerability of employees and the extent of their potential losses should not be overlooked in this analysis. Unlike other creditors, employees generally do not have the ability to diversify their risk.[113] Davis and Burrows estimated that employees' accrued entitlements in Australia 'probably exceed $50 billion, an amount equal to total lending by all

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[109] LoPucki, above n 22, 1893. Ramsay reasoned that excessive risk-taking by directors may not be foreseen by the creditor and thus not paid for by the company. 'Shareholders in a leveraged company have incentives to invest the company's resources in risky projects: if the project is successful, the excess return will be distributed among the shareholders as dividends but will not be shared with the creditors who are only entitled to a fixed return on their investment. Company losses, however, are shared among both creditors and shareholders' Ian Ramsay, 'An Overview of the Insolvent Trading Debate' in Ian Ramsay (ed), *Company Directors' Liability for Insolvent Trading* (2000) 1, 9. He then acknowledges that 'even sophisticated creditors cannot foresee all contingencies and contract for protection against them'. Ibid 10.

[110] See Mokal, above n 23and accompanying text.

[111] Michael Whincop, 'The Economic and Strategic Structure of Insolvent Trading' in Ian Ramsay (ed), *Company Directors' liability for Insolvent Trading* (2000) 43, 49.

[112] Davis commented that 'employees have relatively little information regarding their employer's financial condition and are therefore not in as good a condition to monitor their employer as are other creditors. Although this rationale does not apply to all employees, since senior management will clearly be in the best position to obtain information about the corporation's financial situation, it is applicable to the vast majority of employees who are not privy to corporate financial information. Thus, though some employees are in a better position to monitor the corporation's financial state than its creditors, it is these same employees' actions (as the management of the corporation) that the creditors and shareholders are trying to monitor in order to reduce managerial slack. Ronald B Davis, 'The Bonding Effects of Directors' Statutory Wage Liability: An Interactive Corporate Governance Explanation' (2002) 24 *Law and Policy* 403, 412.

[113] Paul Halpern, Michael Trebilcock and Stuart Turnbull, 'An Economic Analysis of Limited Liability in Corporation Law' (1980) 30 *University of Toronto Law Journal* 117, 149.

finance companies'.[114] Ansett employees were owed $686 million upon its insolvency.[115] In the case of National Textiles, the employees were owed approximately $11.1 million in unpaid wages, accrued leave entitlements and redundancy payments. [116] Oakdale Collieries' employees were owed $6.5 million.[117] In 2003 the ACTU estimated that around 19,000 employees lose up to $500 million in unpaid entitlements each year.[118]

With the vast majority of employees, there is no pre-contract bargaining taking place with their employers over appropriate compensation for the risk of non-payment or their entitlements upon insolvency. Rank and file employees would most likely be unaware of the existence of specific secured creditors, although they would know from their own experience that valuable assets can be mortgaged. Cynically, they might expect the Taxation Commissioner to have a higher priority in a winding up than they do, but as noted above, they would be wrong. They would not be aware of the weakness of their statutory protections compared particularly to those of the Commissioner of Taxation. They would not be aware that the law actively encourages directors to place a failing company into voluntary administration, to allow an opportunity for the business and jobs to be saved, when companies owe PAYG debts to the Commissioner of Taxation or when there is a risk of insolvent trading liability being imposed, but not where there is a risk of loss of employee entitlements.

It is contended here that in terms of the notional creditors bargain, employees would have bargained for and agreed to accept a recovery regime that was as strong, if not stronger, than that protecting the Commissioner of Taxation and unsecured trade creditors. It is also contended that the weakness of most employees' bargaining position and their lack of experience and skill in protecting themselves through contract lies at the heart of their relatively inferior rights.[119] Jackson's 'creditors' bargain' may be a notional explanation of the collective distribution regime upon insolvency and be flawed in its analysis, but it highlights the almost Darwinian nature of insolvency law in general – that those who are the

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[114] Kevin Davis and Geoff Burrows, 'Protecting Employee Entitlements' (2003) 36 *Australian Economic Review* 173, 173. Campo noted that '[t]he Woodlawn mine left 160 workers owed $6 million, the Cobar mine left 270 workers with $6 million in unpaid entitlements, the Sizzler chain of restaurants left 2000 primarily casual and part time workers with $2 million in unpaid entitlements, Exicom left its 680 workers $17 million out of pocket, Braybrook Manufacturing left 70 workers owed $1.3 million, 157 Rockhampton and Yeppoon nurses were left with $1.4 million owing …' Robbie Campo, 'The Protection of Employee Entitlements in the Event of Employer Insolvency: Australian Initiatives in the Light of International Models' (2000) 13 *Australian Journal of Labour Law* 1, 8.

[115] Justice Simon Whelan and Leon Zwier, 'Employee Entitlements and Corporate Insolvency and Reconstruction' *Centre for Corporate Law and Securities Regulation, University of Melbourne,* available at http://cclsr.law.unimelb.edu.au/go/centre-activities/research/research-reports-and-research-papers/index.cfm, 33.

[116] Riley, above n 80, 495; David Noakes, 'Corporate Groups and the Duties of Directors: Protecting the Employee or the Insolvent Employer?' (2001) 29 *Australian Business Law Review* 124, 126 – 130. The Federal Government eventually paid their entitlements under a Deed of Company Arrangement.

[117] These employees were eventually paid their full entitlements after accessing money from a coal industry fund: Michael Reynolds 'The *Corporations Law Amendment (Employee Entitlements) Act* 2000 (Cth): To What Extent Will It Save Employee Entitlements?' [2001] *QUT Law and Justice Journal* 9, 12.

[118] Explanatory Memorandum to the Corporations Amendment (Insolvency) Bill 2007, [3.14] available at http://www.comlaw.gov.au/comlaw/Legislation/Bills1.nsf/0/27ACAFAE60ADD5C0CA2572EC000ED970/$file/07099em.pdf, accessed 7th October, 2007.

[119] It should be recalled that while employees benefit from some statutory priority and the current existence of GEERS, the provisions deterring directors from depriving employees of their entitlements (Part 5.8A) have not resulted in a single successful action, In addition, there is no incentive for directors to seek VA which may benefit those employees.

least powerful have little leverage to get the protective legislation of their choice so they are virtually defenceless by the rules chosen. What comes out of this survival of the fittest regime is a series of ad hoc, politically motivated provisions which are not necessarily what the weaker creditors would have expected. The existence of the taxpayer funded GEERS masks the severity of this position and the necessity for reform, but the downturn in the economy causing an increase the number of firms in financial distress, as well as reduced government revenues may well bring this anomalous position to greater prominence.

The aim of VA is to save firms or else increase the return to all creditors, satisfying the theoretical aim of maximising their overall welfare. Ironically, the laws pertaining to the protection of debts given to the Commissioner of Taxation and unsecured trade creditors will give employees more of a chance of saving their jobs through VA and the rehabilitation of their firms than the law specifically designed for their own protection. As noted above, laws which encourage directors to place their companies into VA have the advantage of providing scope for additional creditor recovery, the chance to save jobs and an avoidance of penalty for the directors.

The effectiveness of the liability mechanism for encouraging directors towards VA has been established by the decline in actions for insolvent trading, following the introduction of VA.[120] A empirical study by James, Ramsay and Siva[121] has looked at the prevalence of insolvent trading actions, and noted that there have been only 103 cases since 1961.[122] Interestingly, there were more cases[123] during the 11 years when the previous, more lenient legislation[124] applied, than the 11 years of the current legislation.[125] The latter time period coincides with the availability of voluntary administration. An empirical study by Routledge also noted some positive outcomes of VA in terms of the number of firms salvaged, either through rehabilitation of the existing company or sale of its business as a going concern. Returns to creditors from firms which could not be saved also improved.[126]

It is therefore submitted that this legislative device should be used more widely and in particular with respect to laws relating to the protection of employee entitlements. In order to be effective, it is necessary to ensure that the provisions imposing liability on directors are more severe than the present Part 5.8A, where the requirement to prove a subjective intention to deprive employees of their entitlements has rendered the law ineffective.

V CONCLUSION

[120] See Herzberg, above n 68, 158. The Parliamentary Joint Committee on Corporations and Financial Services, Parliament of Australia, *Corporate Insolvency Laws: A Stocktake* (2004) noted that voluntary administration is now the most commonly used form of insolvency administration in Australia, accounting for over 40% of all new appointments in 2003, at [2.28]. See also Colin Anderson and David Morrison, 'Was Elliott Rescued and Will He Recover? Rescue Versus Recovery in the Australian Insolvency Context' (Paper presented at the Corporate Law Teachers Association Conference, Sydney, 7 February, 2005).

[121] Paul James, Ian Ramsay and Polat Siva, 'Insolvent Trading – An Empirical Study', Clayton Utz and Centre for Corporate Law and Securities Regulation, The University of Melbourne (2004).

[122] The study noted that this statistic excludes actions which were settled, or where the directors pleaded guilty to insolvent trading charges. Ibid at 14.

[123] The study noted 61 during this period. Ibid 17.

[124] *Companies Code* s 556 and *Corporations Law* s 592.

[125] There were 19 cases noted by the authors. James, Ramsay and Siva, above n121, 17.

[126] James Routledge 'An Exploratory Empirical Analysis of Part 5.3A of the Corporations Law (Voluntary Administration)' 16 *Company and Securities Law Journal* 4, 11.

This paper began with an overview of the theoretical perspectives of insolvency law and outlined the arguments which support the collective recovery regime, encouragement towards corporate reorganisation and the lifting of the corporate veil on directors. While broad support for insolvency laws which, ex post, maximise the recovery of creditors as a whole, there was some disagreement amongst scholars as to the best way to achieve this. Thomas Jackson's 'creditors' bargain' provided, for the purpose of this paper, a useful lens through which insolvency laws could be considered for three specified cohorts of creditors. This led to two questions being posed - what would these creditors have bargained for if they were given a chance, prior to their dealings with the company, and what legislative scheme would maximise the welfare of the creditor group as whole?

The Commissioner of Taxation was observed to be the ultimate diversified creditor who arguably does not need ex post protection. Nevertheless, it was seen that while the priority in relation to tax liabilities was removed in 1993, the Commissioner enjoys considerable rights of recovery from directors, in addition to other entitlements. This provides a strong incentive to directors to encourage placing a financially troubled company into voluntary administration, which may enable the company to be saved. Unsecured trade creditors, while considerably more vulnerable than the Commissioner, also benefit from the imposition on directors of a duty to prevent insolvent trading. Again, directors can escape civil liability by placing the company into VA.[127]

Employees were identified as the most defenceless of the three groups. They have little ability to diversify away their exposure to the company's failure, and stand to lose both jobs and unpaid entitlements. While they enjoy a measure of priority in a winding up, the provisions imposing liability on directors for depriving employees of their entitlements have not yielded a single successful case. Moreover, the legislative provisions giving protection to employees do not include an incentive for directors to seek VA. This paper therefore recommended that the employee entitlement protections be reformed to include such an incentive. This would contribute towards achieving the insolvency law objectives of creditor wealth maximisation as well as deterring behaviour detrimental to the interests of this vulnerable creditor group.

[127] Note that if the company subsequently goes into liquidation, the liability for insolvent trading revives.