

# **PROTECTION OF EMPLOYEES' ENTITLEMENTS IN CASES OF EMPLOYER INSOLVENCY IN MALAYSIA**

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## **ABSTRACT**

The most valuable assets of any country are its employees. It is part of an inevitable fate that befalls employees when their employer files for bankruptcy. This paper examines the principles and practice of redundancy and retrenchment of employees, or rather employee entitlements, in the event of employer insolvency. It further discusses the extent of the protection of workers' security of tenure in employment. In relation to this, reference will be made to retrenchment situations in Malaysia compared with other jurisdictions with special reference to the following questions: 1) if the existing labour legislations and the Company Act, 1965 adequately protects workers' security of tenure in employment and 2) whether workers who were genuinely retrenched from employment are fairly compensated for loss of employment. In summary, it will look into the extent of legal protection given to the employees in the event of employer insolvency.

**Keywords:** employees' entitlement, insolvency, retrenchment, redundancy

## **1. INTRODUCTION**

The most valuable assets of any country are its employees. It is part of an inevitable fate that befalls employees when their employer files for bankruptcy. Their jobs are at risk, and there is a chance that outstanding entitlements will never be recovered or that payments will take a long time to be received. Employees are the creditors most affected by the insolvency of their employers. The employee's position can be contrasted with the position of other creditors who are likely to have other sources of revenue and may have securities or personal guarantees to support their debts. Hence, employees retrenched from employment should be fairly compensated and protected under the law.

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## 2. POSITION IN MALAYSIA

In the majority of international jurisdictions, priority creditor status is the primary form of protection conferred upon employees in the event of corporate insolvency. Employees have long been considered worthy of special protection if a company becomes insolvent. The security of employment and compensation for loss of employment, however, vary under different jurisdictions. (Cahn & Donald, 2010)

In Malaysia, priority creditors include 1) the cost, charges and expenses of the insolvency, 2) employees' wages and entitlements and 3) federal taxes, including goods and service tax. These debts are to be paid in priority to all other unsecured debts but do not rank in priority to the claims of a floating charge holder in either a receivership or a winding-up. The priority is still inferior, however, to the secured creditors. Involuntary court winding-ups can result in a lack of assets for any priority creditor including these costs, charges and expenses.

The courts in Malaysia have equated workers' security of tenure in employment with 'proprietary rights'. For example, in *Hong Leong Equipment Sdn Bhd v Liew Fook Chuan and Anor*, (1996) Gopal Sri Ram JCA observed that 'The legislature has willed that the relationship of employer and workman as resting on a mere consensual basis that is capable of termination by the employer at will with the meagre consequence of paying the helpless workman a *paltry sum* as damages should be altered in favour of the workman. It has accordingly provided for security of tenure and equated the right to be engaged in gainful employment to a *proprietary right* which may not be forfeited save, and except, for just cause or excuse'. It is, however, accepted law that the employer is vested with the prerogative to make commercial decisions in order to improve the viability or effectiveness of their business by, for example, introducing automation or abandoning unprofitable activities and reorganising or restructuring the company. The strength of the workforce in an organisation is their prerogative and when necessary for the efficiency of the undertaking, employers are empowered to discharge their own surplus. (Armour & Payne, 2009)

In *East Asiatic Company (M) Bhd v Valen Noel Yap* (1987), the Industrial Court noted that 'it is the right and privilege of every employer to reorganise his business in any manner he thinks for the purpose of economy or even convenience; and if by implementing a reorganising scheme for genuine reasons ... the employer is entitled to discharge such excess. But this right of the employer is limited by the rule that he must act *bona fide* and not capriciously or with motives of victimisation or unfair labour practice. Nor does this right for instance entitle an employer under the cover of reorganisation, to rid himself of employees who have offended him in some way or to promote the interest of some favoured employees to the detriment of others.' Again, in *William Jacks Co (M) Sdn Bhd v S Balasingam* (1997), it was stated that 'so long as that managerial power is exercised *bona fide*, the decision is immune from examination even by the Industrial Court'.

The emphasis is on the employer to ensure that any retrenchment exercise in an organisation is carried out fairly. It includes consulting or warning affected employees of the impending retrenchment and the manner of selecting those declared to be redundant and possibility of re-deployment within the organisation, amongst others. The exercises need to point to one conclusion: that the employer has acted *bona fide* (good faith).

The principle legislation governing the labour and employment relationship in West Malaysia is the Employment Act, 1955 (EA). Pursuant to s 60J of the EA, the Employment (Termination and Lay-Off Benefits) Regulation was enacted in 1980 and it governed termination and lay-off benefits for workers who had lost their employment. For protection under the Act, the Act requires that a person to be under a 'contract of service' as opposed to 'contract for services'. Furthermore, only employees as defined in the First Schedule of the EA are governed by the Regulation. Generally under the Schedule, only those earnings RM1,500.00 and less a month and working manually irrespective of their wages are covered by the Act.

The states of Sabah and Sarawak are governed by a separate set of labour legislation, namely Sabah Labour Ordinance (Cap 67) and Sarawak Labour Ordinance (Cap 76) respectively. There were no provisions on lay-offs and retrenchment benefits in the above Ordinances. However, the rights and benefits as in the Peninsular Act were incorporated into the Sarawak Labour Ordinance in 2008 (Cap 76). The Labour (Termination and Lay-Off Benefits) (Sarawak) Rules 2008 provide for payment of termination, layoff and retrenchment benefits similar to the Regulation in the Peninsular. In consideration of current global economic crisis and the retrenchment, the Ministry of Human Resources ("MoHR") has put in place several measures to mitigate the effects of possible retrenchment. A set of guidelines entitled "Garis Panduan Pengurusan Pemberhentian Pekerja" has been issued to assist employers and employees in dealing with retrenchment. All parties are also reminded to adhere to the provisions in the 'Code of Conduct for Industrial Harmony' in carrying out any retrenchment exercise. It is also a requirement under Labour (Termination and Lay-Off Benefits) (Sarawak) Rules 2008 for the employers to report to the nearest Department before any of the following actions are to be taken: (i) retrenchment, (ii) voluntary separation scheme (VSS), temporary lay-off and salary reduction.

Workers not governed by the EA may have their rights, for example retrenchment benefit, provided for either in a collective agreement or contract of employment. However for a worker not governed either by the collective agreement or individual contract of employment, his entitlement for a retrenchment benefit is purely at the discretion of the employer. (Farheen, 2006)

To recap, redundancy can be defined as a situation where the requirements for employees to carry out work of a particular kind in the place where he or she was employed have ceased or diminished or are expected to cease or diminish. The general principle underlying the existence of redundancy is that redundancy only exists if there is a reduction in the requirements of the business as a whole for employees to carry out a particular type of work (Segaran, 2000). A redundancy situation would also then include a situation where there is a surplus of labour or if there is less work for existing employees. Retrenchment, on the other hand, is basically the termination of a contract of service for reasons of redundancy. Redundancy situation and its consequent retrenchment arise primarily from causes external to the performance and capabilities of the individual employees affected.

### ***2.1. Redundancy and Retrenchment***

There were various reasons given by employers in proving redundancy, thus justifying them to retrench the employees. It is a well accepted principle in industrial law that the employer has

the right to reorganise his business in any manner he deems fit for economic efficiency and in this respect, he may downsize his workforce, as happened in *Maser Sdn. Bhd. v. Yeoh Oon Wah* (1990). Reorganisation of the employer's business is usually the reason for redundancy. In *Nixdorf Computer (M) Sdn. Bhd. v. Tan Hong Yak* (1994), the court held that the reorganisation carried out by the company was genuine, and on the substantial merits of the case, the court ruled that the reasons advanced by the company were good; hence the dismissal was bona fide, lawful and made with just cause and excuse.

The EA (Employment Act 1955) requires the employer to give adequate notice prior to retrenchment. By virtue of section 12(3)(c), the minimum statutory notice period to be given to an employee for the purpose of terminating his employment contract on the grounds of redundancy shall be as per section 12(2). The employer may also make payment in lieu of notice to the employees subject to retrenchment. The amount of payment must be equivalent to the notice given. Failure on the part of the employer to give the required statutory notice or to make payment in lieu of such notice to the employees covered by the EA will render the employer liable for prosecution under section 99A of the EA. Upon conviction, the employer may be fined not exceeding RM10,000. It must be noted, however, that the above statutory requirement for the issuance of minimum notice period or payment in lieu of such notice period only applies to employees within the scope of EA 1955. As for other categories of employees not within the ambit of the EA, the contractual termination clause as provided for in the terms and conditions of their individual service contracts will accordingly apply. The retrenchment exercise caused by reorganisation may be challenged on the following grounds: (1) that it was not a bona fide exercise, (2) there was non-compliance with the collective agreement, (3) there had been statutory non-compliance; or (4) there was non-observance of LIFO principles (Das, 1999).

## ***2.2. Employee Entitlements / Termination Benefits***

“Retrenchment benefits” are paid for the loss employment arising from genuine redundancy situations in the company. It is not an additional earning but a compensation for loss of employment, to encourage workers to accept payment without damaging industrial relations. On the other hand, “termination benefit” is a statutory phrase that includes retrenchment benefits and compulsory payments made to employees on closure of business or liquidation. The term “termination benefit” is used in the Employment (Termination and Lay-Off Benefits) Regulations 1980 (the ‘1980 Regulations’), a subsidiary legislation enacted under section 60J of the EA. The 1980 Regulations cover only employees within the purview of the EA. It does not apply to employees outside the scope of the EA. As such, only the categories of employees covered by the EA are entitled to termination benefits as provided for under the 1980 Regulations. The minimum amount of termination benefits payable to these categories of employees is provided for under Regulation 6(1). ( Workmen’s Compensation Act 1952)

Whilst employees covered by the EA are entitled to receive a minimum termination benefit under the 1980 Regulations upon being retrenched, other employees (those not within the ambit of the EA) are basically paid retrenchment benefits at the discretion of the employer. At present, there is no specific legislation in Malaysia governing the payment of retrenchment benefits to those employees outside the scope of the EA. To ensure that employees have better

protection, the Code of Conduct for Industrial Harmony - introduced in 1975 and amended in 2009 – provides in clauses 20 to 24 principles and guidelines to employers and workers in relation to redundancy and retrenchment. There is no legal obligation on the employer to adhere to the contents of the Code. However, the Code has been given its ‘legal teeth’ by virtue of sec 30 (5A) of the Industrial Relations Act 1967 which provides that “in making its award, the Court may take into consideration any agreement or code relating to employment practices ...”. Where an employer does not follow the procedures set out in the Code, the employer in fact commits an unfair labour practice. The Industrial Court has been very consistent in its reliance of the Code in retrenchment cases. Failure to follow the Code can result in a retrenchment being declared as an unfair dismissal. (Industrial Relation Act 1967)

In business restructuring which entails a reduction or downsizing of the manpower, many employers have adopted other alternative plan, the voluntary separation scheme (VSS). Under this scheme, the staff are encouraged to leave the services voluntarily. By the very nature of the scheme, it is on a voluntary basis offered at the discretion of the employer to selected employees, irrespective of their designation, grade or scale in the organisation, calling for their early retirement without having to be forced into retirement. The employer cannot harass or force the employees to accept the scheme. It seems to be the practice that the employees offered with the VSS have limited time to make a decision, either to accept or reject it. In encouraging the employees to accept the offer, the employer usually offers compensation to the employees for loss of employment and the rate of the payment is normally attractive. Usually the VSS rate is higher than the statutory termination benefit, and the payment under VSS is colloquially called ‘golden handshake’.

In *Basf (M) Sdn Bhd v Lee Suan Sim* (2001), the Industrial Court noted that for companies facing difficult times, they should first embark on cost-cutting measures such as salary cuts, stoppage of increments, promotions held in abeyance, trimming down on travel expenses or entertainment claims, amongst others. Unilaterally embarking on retrenchment should be the last resort and where retrenchment is unavoidable, there should at least be evidence of VSS offered to employees. In *Lasalle International Design School Sdn Bhd v Azhari Haltami* (2002), the Industrial Court noted that in manpower rationalisation, the employees must be given notice such as an early warning of the company’s impending retrenchment exercise. The company ought to discuss with the affected employees the possible alternative emplacement or relocations; they ought to consider whether there is an alternative position in the organisation. Failing which - perhaps then to discuss on a VSS and only if the claimant employee finally declines - a unilateral decision to retrench may be resorted to and in doing so, the requirements of Last In First Out (LIFO) principles has to be addressed. Where an employee accepts the VSS scheme, a legally binding contract is thereby concluded. As stated earlier, a contract entered into freely and voluntarily is held sacred and would be enforced by the courts, subject to situations such as undue influence, fraud, duress, misrepresentation or contracts designed to violate criminal law. Hence, in the absence of fraud or misrepresentation, the agreed terms and conditions on VSS shall bind the parties and is enforceable in the court of justice, irrespective of the inequality of their bargaining power.

The courts in Malaysia recognise the employees’ entitlement in the case of company restructuring and the employer’s prerogative to reorganise its business that might result

in employees' retrenchment. Not all employees are accorded legislative protection of retrenchment benefit for loss of employment. Only those governed by the EA are accorded such benefit. The majority of the workforce in Malaysia would have to rely on either their collective agreements or individual contracts of employment. In the absence of a provision for payment of retrenchment benefit for loss of employment, affected employees would be at the discretion of the employers. A retrenched worker not governed either by the EA or collective agreement or individual contract of employment, may institute legal action under section 20 of the Industrial Relations Act 1967 for dismissal without just cause or excuse. Normally, the Industrial Court would not interfere with the *bona fide* exercise of power by the management, which are inherent in them. However, any form of victimisation, arbitrary, perverse or baseless actions on the employee by the management that are unnecessarily harsh, unjust or unfair may warrant the court's interference.

### **2.3. Entitlement under the Companies Act 1965**

It is broadly recognised that workers' wage claims deserve special protection, since the insolvency of an enterprise and consequently the suspension of payments directly threatens the means of subsistence of employees and their families. Moreover, as employees do not normally have a share in the profits of the enterprise, they should not share in its losses either. The Company Act, 1965 (CA) provides that where a company is in receivership or liquidation, certain claims must be satisfied in priority to debenture holders secured by a floating charge. However, section 292 of the CA specifies in detail the preferential claims which are limited to wages, salary, holiday pay, superannuation, provident fund, retirement benefits and workman's compensation. In particular, section 191(1) of the Act deals with employers on receivership.

Section 191 of the CA (Companies Act 1965), in essence, says that where a receiver is appointed not in the course of a winding up, debts which in every winding up are preferential debts and are due by way of wages, salary, vacation leave or superannuation or provident fund payments and any amount which in a winding up is payable in pursuance of sections 292(3) or (5) of the CA shall be paid out in priority to any claim for principle or interest in respect of the debentures, and shall be paid in the same order of priority as is prescribed by that section in respect of those debts and amounts. In other words, all payments mentioned in section 191(1) of the CA shall be paid in priority to the claim in respect of debentures and they are to be paid in the order of priority as provided by section 292 of the CA. Section 292(1) of the CA on the other hand, concerns the preferential payment when the corporate employer is being wound up. The preferential treatment of wage claims is by far the most widely accepted and most traditional method of protecting service-related claims in the event of the employer's bankruptcy or judicial liquidation of an enterprise. However, other statutory benefits such as monetary compensation for unfair dismissal, retrenchment benefits, maternity benefits and indemnity in lieu of notice are not accorded preferential entitlements. Such claims are considered as unsecured debts. (Segaran, 2000)

Section 292 of the CA governs the payment of certain debts in priority to all other unsecured debts. Although the scheme of preferential debts applies to all types of winding up, the scheme will only be relevant if the company is insolvent and there are insufficient funds to pay to all unsecured creditors in full. The fundamental principle is that each class of debts is paid in

full in accordance to the list of priorities under subsection (1). However, when it becomes impossible to pay a class in full, those creditors' debts will abate in equal proportions between themselves as provided in subsection (2). If this is the case, there is a possibility that the subsequent class of creditors will not be paid at all. (Aishah Bidin et al, 2007; Hanrahan et al 2008)

Costs and expenses properly incurred in the process of winding up are the top rank of priority under section 292 (1)(a) and must be paid first in the event of winding up of a company. Costs and expenses of winding up include liquidator's remuneration in carrying out liquidation process, audit expenses and any costs of applicant who petitioned for winding up.

The second priority debts under section 292 (1)(b) is wages and salary of employees of the company. This refers to services rendered by the employees to the company within a period of 4 months prior to the commencement of winding up of the company and the quantum of salary shall not exceed RM1500 for each employee. Wages and salary of employees are given priority over floating charges by virtue of section 292(4).

Workers' compensation accrues before the commencement of winding up is ranked third under the class of priority debts under section 292 (1). This gives employees direct right of action against insurers specifically under section 21 of the Workmen's Compensation Act 1952 (Revised 1982) on provision for health and safety at work. An employee suffered injuries in the course of his employment is entitled to claim a preferred debt under section 292(1)(c) which is equivalent to worker's compensation under section 21 of the Workmen's Compensation Act 1952. Vacation leave is ranked fifth under the class of priority debts under section 292(1)(d). This refers to amounts in respect of vacation leave of the employee of the company which arose before the commencement of winding up. Amount of vacation leave takes priority over floating charges by virtue of section 292(4).

Superannuation, provident fund contribution and retirement benefit scheme are ranked sixth under order of priority under section 292(1)(e). This refers to any contributions by the company for the benefit of its employees accruing over the past of 12 months prior to the commencement of winding up. Section 292(4) gives priority to contributions to provident funds and scheme of retirement benefit over the floating charges. Federal taxes under section 292(1)(f) occupy rank seventh in the order of priority. This includes but not limited to income and sales taxes and excise and customs duties which have been assessed before the time fixed for the proving of debts has expired. The trend in the earlier case shows that judges are more inclined to regard federal taxes takes priority over subsequent debts by reason of section 10 of the Government Proceedings Act 1956. (Government Proceeding Act 1956, Revised 1988)

The trend, however, has now changed where the court has ruled that section 10 of the Government Proceedings Act 1956 (Revised 1988) is only a general provision and must be read subject to special exception contained in section 292(1)(f) of the CA 1965 that is federal taxes rank sixth in priority amongst preferred creditors in the winding up process of a company.

In *Indo Malaysia Engineering Co Bhd (In Receivership) v. Muniandy Rengasamy and Ors.* (1990), the defendant was under receivership and as a result, the plaintiffs contract of service

was terminated. The plaintiff claimed for the non-payment of termination benefits, pro rata bonus, leave pay and indemnity *in lieu* of notice. The issue arose whether such claims ranked in priority over debenture holders under the CA, 1965. The High Court held in the affirmative. The Court noted that section 292(1) (c) of the CA has used general words capable of wider interpretation. The said provision provided that all amounts due in respect of a workman's compensation accruing before the commencement of winding up shall be paid in priority. However, on appeal, the then Supreme Court overturned the High Court's decision. It held that the priority accorded under the CA must necessarily be categorised either as wages, salary, vacation leave, superannuation or provident fund payment. It was further stated that the pro rata bonus or bonus was not wages in respect of services.

The contracts of employment of the company's employees are not automatically terminated when an out of court receiver is appointed. The effect of a receiver's appointment upon the contract of service is determined by the mode of the appointment and the nature of his agency. The appointment by the debenture holders of a receiver and manager as agent of the company, not being an appointment under an order of the court, does not of itself automatically terminate contracts of employment previously made and subsisting between the company and all its employees. However, where a court appoints a receiver and manager at the instance of the debenture holders, the appointment itself may dismiss the company's employees. In *Rafina Oil Products Sdn Bhd v. S Jayabalan* (1984), the claimant - an expatriate from India - was recruited as Managing Director to work in the company's head office in Kuala Lumpur. The company went into receivership and his services were abruptly terminated by the duly appointed Receivers. The issue before the Industrial Court was whether the appointment of the Receivers amounted to dismissal without just cause or excuse. The Court answered the above question in the negative. It was stated that the claimant's services were terminated by operation of law and therefore the appointment of Receivers did not amount to a dismissal without just cause or excuse. Similarly, a liquidator appointed by the court in a compulsory winding-up order automatically terminates the existing contract of employment.

In *Glaspec (M) Sdn Bhd v. Azman bin Ujang and Ors.* (2006), the Industrial Court had raised concerns in relation to the inadequate protection of workers statutory entitlements which includes the award of the Court in favour of the claimant when their employer goes into liquidation. In the above case, the Chairman of the Court stated that where a winding up order has been made against the company, the monetary award of the Court in favour of the claimant whose dismissal was held to be without just cause or excuse becomes somewhat a "useless paper award". This is primarily because such an award is not accorded statutory priority over the other secured or unsecured creditors. In particular the learned Chairman stated; "In this country when a corporate employer becomes insolvent the unpaid employees with awards from the Industrial Court for monetary compensation are not given statutory priority over the other secured or unsecured creditors of the Company". He further stated: "In order to mitigate the plight of the employees from getting a "useless paper award" from the Industrial Court in the event the Company goes into liquidation, it is hoped that concerned parties and our representatives in Parliament seriously look into the following proposals in order to provide more social justice to our workers. It is suggested that the rights of workers should rank ahead in priority to secured creditors, if not at least *pari passu*, in the distribution of assets when the Company is in liquidation.



In essence, an employee's preferential debts are restricted to wages, salary, holiday pay, superannuation, retirement benefits, provident fund and workman's compensation. It does not include the monetary compensation for unfair dismissal. Therefore, it is suggested that section 292(1) of the CA, 1965 be amended to provide that all unpaid wages and other dues payable to an employee, including the monetary award of the Industrial Court for unfair dismissal should have priority over claims of any secured creditor in the event of the insolvency of the employer.

### 3. INTERNATIONAL EXPERIENCE

The majority of other jurisdictions which afford employee entitlements priority ranking in liquidation limit the amounts that employees are able to claim as priority unsecured creditors. If employees are owed anything above the set limit, they rank as normal unsecured creditors for that amount. In New Zealand, each employee is entitled to a maximum of \$15,000 total priority ranking. In addition, employees are only entitled to claim unpaid wages for the four months preceding insolvency as a priority debt. In the United Kingdom there is no fiscal limit on employee entitlement priority, but wages are limited to wages earned in the four months preceding insolvency, unpaid pension contributions from the employer to a maximum of twelve months, unpaid employee contributions to a maximum of four months and redundancy payments are afforded no priority at all. In the United States of America each employee is entitled to a maximum of US\$4,650 in priority ranking and only entitlements which accrued in the 90 days prior to the filing of the bankruptcy petition are claimable with priority.

These fiscal and temporal limitations are an attempt to reconcile the *pari passu* concept with the provision of some levels of priority for employees. While employees are vulnerable and worthy of protection, it can be perceived as unfair that one class should have the potential to receive all of the money owed to them at the expense of others who receive less or nothing at all in some cases.

#### 3.1. *The International Labour Organization*

Since 1948, the members of the International Labour Organization (ILO) decided upon adoption of certain proposals concerning the protection of wages in the form of an international convention in which it addressed the effect of insolvency on workers' wages. The 1949 Protection of Wages Convention (No. 95) spells out the widely recognised principle that workers' wage and their service-related claims, regarding a certain period of service or up to a prescribed amount as may be determined by national laws and regulations, should be treated as privileged debts in the event of the bankruptcy or judicial liquidation of an undertaking. It further requires that wages constituting privileged debts must be paid in full before ordinary creditors can be paid even in part. The Convention, however, leaves it to ratifying States to determine the relative priority of wages constituting a privileged debt and the limits within which such claims are to be given preference. In 1992, having met its 79<sup>th</sup> Session on 3 June, ILO stressed the importance of the protection of workers' claims in the event of the insolvency of their employer. Article 11 of the Convention was partially revised by the Protection of Workers' Claims (Employer's Insolvency) Convention (No. 173), which was adopted in 1992, with a view to improving the protection provided for in 1949 in two ways: first, by setting

specific standards concerning the scope, limits and rank of the privilege, which are scarcely addressed in Convention No. 95, and secondly by introducing new concepts, such as wage guarantee schemes, designed to offer better protection than the traditional privilege system. Recalling the provisions on this subject in Article 11 ILO noted that since the adoption of the said Convention, significant developments have taken place in the law and practice of many Members which have improved the protection of workers' claims in the event of insolvency of their employer. ILO adopted the Convention No. 173 on the Protection of Workers' Claims (Employer's Insolvency) Convention, 1992 which came into force on 8 June 1995.

Article 1(1) of the Convention states that the term insolvency refers to situations in which, in accordance with national law and practice, proceedings have been opened relating to an employer's assets with a view to the collective reimbursement of its creditors. Article 1(2) further provides that for the purposes of this Convention, a Member may extend the term "insolvency" to other situations in which workers' claims cannot be paid by reason of the financial situation of the employer, for example where the amount of the employer's assets is recognised as being insufficient to justify the opening of insolvency proceedings. Article 5 provides that in the event of an employer's insolvency, workers' claims arising out of their employment shall be protected by a privilege so that they are paid out of the assets of the insolvent employer before non-privileged creditors can be paid their share. Article 6 provides that the privilege shall cover at least: (a) the workers' claims for wages relating to a prescribed period, which shall not be less than three months, prior to the insolvency or prior to the termination of the employment; (b) the workers' claims for holiday pay due as a result of work performed during the year in which the insolvency or the termination of the employment occurred, and in the preceding year; (c) the workers' claims for amounts due in respect of other types of paid absence relating to a prescribed period, which shall not be less than three months, prior to the insolvency or prior to the termination of the employment; (d) severance pay due to workers upon termination of their employment.

Supplementing the above Convention is the Recommendation No. 180 entitled "Protection of Workers' Claims (Employer's Insolvency) Recommendation, 1992". Clause 1(1) provides that for the purposes of this Recommendation, the term insolvency refers to situations in which, in accordance with national law and practice, proceedings have been opened relating to an employer's assets with a view to the collective reimbursement of its creditors. Clause 1(2) provides that for the purposes of this Recommendation, Members may extend the term "insolvency" to other situations in which workers' claims cannot be paid by reason of the financial situation of the employer, and in particular to the following: (a) where the enterprise has closed down or ceased its activities or is voluntarily wound up; (b) where the amount of the employer's assets are insufficient to justify the opening of insolvency proceedings; (c) where, in the course of proceedings to recover a worker's claim arising out of employment, it is found that the employer has no assets or that these are insufficient to pay the debt in question; (d) where the employer has died and his or her assets have been placed in the hands of an administrator and the amounts due cannot be paid out of the estate. Clause 1(3) further provides that the extent to which an employer's assets are subject to the proceedings referred to in subparagraph (1) should be determined by national laws, regulations or practice.

Clause 3(1) provides that the protection afforded by a privilege should cover the following claims: (a) wages, overtime pay, commissions and other forms of remuneration relating to work performed during a prescribed period prior to the insolvency or prior to termination of the employment. This period should be fixed by national laws or regulations and should not be less than 12 months; (b) holiday pay due as a result of work performed during the year in which the insolvency or the termination of the employment occurred, and in the preceding year; (c) amounts due in respect of other types of paid absence, end-of-year and other bonuses provided for by national laws or regulations, collective agreements or individual contracts of employment, relating to a prescribed period, which should not be less than 12 months, prior to the insolvency or prior to the termination of the employment; (d) payments due *in lieu* of notice of termination of employment; (e) severance pay, compensation for unfair dismissal and other payments due to workers upon termination of their employment; (f) compensation payable directly by the employer in respect of occupational accidents and diseases. Clause 3(3) provides that the claims enumerated in subparagraphs (1) and (2) that have been awarded to a worker through adjudication or arbitration within 12 months prior to the insolvency should be covered by the privilege regardless of the time-limits specified in those subparagraphs. Hence, employees are generally constituted as a favourable class within the priority section in the event of liquidation of the employer.

### **3.2. European Union**

In contrast to the ILO requirements, the European Union (EU) directives are binding on members. In 1980, the Council of the European Communities issued a Directive regarding the protection of employees in the event of the insolvency of their employer. It was amended by the European Parliament in 2002. Section I, Article 1 states that the Directive shall apply to employees' claims arising from contracts of employment or employment relationships and existing against employers who are in a state of insolvency within the meaning of Article 2(1). Section II, Article 3.1, requires that guarantee institutions secure employees' outstanding claims relating to their employment. Section II, Article 4.2, compels member states to ensure that outstanding claims from the last 18 months are paid. Nonetheless, Section II, Article 4.3, authorises member states to set limits on the liability for employees' outstanding claims as long as the states notify the Commission of the methods they used in order to reach those limits. Council Directive 98/59/EC requires that any employer considering collective dismissals consult with workers' representatives first, with a goal of reaching an agreement and thereby curtailing the need for such measures.

This Directive aims to consolidate existing legislation on the protection of employees in the event of the insolvency of their employer in order to create clear, consistent legislation in EU countries. It sets out to guarantee payment of outstanding claims to employees and requires Member States to establish an institution to guarantee payment of such claims. It also lays down procedures which apply when a cross-border employer becomes insolvent.

### **3.3. Insurance Funds**

One way to ensure the payment of employee entitlements, while maintaining market confidence, is through an insurance fund. This concept has been widely adopted throughout the developed

world. Insurance funds can reduce the burden of the unemployed on the state for interim social protection, although they would not entirely displace the necessity of providing protection for purposes of unemployment, retraining and other needs. On an economic level, an insurance fund may provide a higher degree of reliability to the markets while at the same time affording stronger protection to employees to fulfill social objectives. The most effective are those that establish a guarantee fund as a backstop to the payment of employee claims in bankruptcy.

The guarantee fund models rely on a “bankruptcy payment first” concept that requires employees to wait for a period of time (in some cases, months or even years) before they can top up the shortfall in their recovery from the guarantee fund. Many employees and their families can be left destitute while they await the accrued entitlements they are owed. This hardship can be magnified if there is a lengthy delay for payment on back wages and claims. Rather than forcing employees to linger during a potentially drawn out liquidation process where assets have to be identified, realised and distributed, consideration should be given to establishing an immediate right of payment from the insurance or guarantee fund to settle worker claims up front. Upon satisfaction of the claims, the guarantee fund would be subrogated to the employee’s claims against the debtor to recoup any distributions to which the workers would be entitled. For example, if an employer in Belgium is unable to pay entitlements within fifteen days of the close of the business, the Fund for Closures immediately commences payment on its behalf.

Critics of insurance funds claim that they are expensive to run, punish successful companies, and benefit only certain employees. However, all these accusations are difficult to substantiate empirically, as a pure entitlement insurance fund system does not appear to have been comprehensively tested as yet. Although there may be greater cost burdens for business, the burden of the risk of insolvency would appear to be better carried through an insurance fund system prior to insolvency rather than the employees (or the general creditors) afterwards. Shifting the risk to the business and taxpayers in protecting employees is more consistent with the responsibilities and obligations assumed by the debtor and the state. There are a number of ways in which a country considering such a system can attempt to reduce the cost burden to business. The existing forms of insurance already used widely throughout the developed world (albeit usually in a hybrid system that requires some alteration to be made to the order of priority in bankruptcy) are a good example of this. Some countries may require compulsory insurance through a government-run commission, while other countries require companies to have private insurance to cover workers’ entitlements in the case of bankruptcy. Still others require contributions by employees, although the question remains as to whether the workers themselves are best placed to bear these costs.

Another alternative used by many countries to minimise the cost of such a scheme to business (and particularly to small business) is to limit compulsory insurance to only companies with a predetermined minimum number of employees, e.g. businesses larger than 20 employees. Some countries do not have workers’ entitlement insurance that covers some or all of an employee’s unpaid wages or retirement claims. In times of crisis, the absence of such “safety nets” may create additional hurdles to recovery and may need to be supplemented with an economic stimulus package as opposed to immediate satisfaction of back claims. The absence

of social safety nets or adequate programmes where claims are not likely to be covered in a bankruptcy by the available assets makes for a high wire act of rectifying the past or building for the future. Countries with more scarce resources would no doubt find little justification to adopt the scheme.

Notwithstanding the above, an ideal employee entitlement insurance system would allow for the prompt repayment of 100% of worker entitlements owing. But in the initial stages of building this fund from scratch to a point where it could withstand a major insolvency may take considerable time. To overcome this problem, one solution may be the Australian model, which consists of a temporary government fund designed to cover entitlement payouts until the newly implemented insurance system has built sufficient capital to operate in its own right. A major consideration of any insurance system is the form of corporate governance it will possess. Ideally, it would be administered entirely by the private sector, but this may be unrealistic in countries with undeveloped financial markets. If it were to be controlled by a state – and indeed in many countries, the social security administration may be best institution to operate such a fund – there would nonetheless need to be a very tight control in place to ensure that such a fund is free from corruption.

Consequently, a country looking to implement an insurance scheme would need to consider whether such a scheme should also cover outstanding payments to pension funds, or whether this scheme would be considered too great a cost burden. In addition, while not addressed in detail above, many countries also provide a substantial role for worker unions in determining the most appropriate way to deal with mass redundancies and ensuing workers' entitlements. There remains room for further discussion as to how a collective bargaining insolvency agreement would affect the order of creditor priority and, indeed, whether they would be necessary under an insurance scheme such as the one proposed above.

#### **4. CONCLUSION**

Currently there does not seem to be a perfect legal scheme for handling employee entitlements in the event of employer insolvency. Some are clearly more effective than others. Each of the schemes examined in this paper are flawed in certain ways, as 100 percent of employees' entitlements are never fully protected. Employees in insolvency proceedings tend to be treated as neither creditors nor equity holders, with no vested financial stake in the bankrupt entity (outside of the employees' stock option plans). Yet, employees are the most to lose, as their families' livelihood generally depends upon their wages and benefits for work performed.

The CLRC (Corporate Law Reform Committee) recommended increasing the quantum for wages and salary of employees entitled to priority in a winding up from the present RM1,500 to RM15,000. The increase is expected to enhance the social obligation of companies towards the well being of their employees. The CLRC feels that the proposed quantum is not only reasonable but fairer to employees, especially those in the lower income category who will be mostly affected in the event the company goes into liquidation. The CLRC also proposed in the said Report the introduction of a new definition of "wages and salary of employees" which shall include payment in lieu of notice of termination of employment and payment of gratuity for termination of employment by reason of winding up. The Malaysian Government wants

to reform the labour market in the 10<sup>th</sup> Malaysian Plan (10MP). During the plan period, the labour legislation will be reviewed towards ensuring that Malaysia adopts an optimal balance between labour market flexibility and job stability, and which provided for efficient and speedy settlement of labour disputes. A sum of RM80 million will be allocated to the Relief Fund from 2010 to 2012 to provide financial assistance to retrenched workers who do not get due compensation from their employers. The eligible retrenched workers will receive RM600 per month for a maximum of six months so long as they continue to be unemployed.

This paper does not aim to suggest that an entitlement insurance fund is a cure-all in times of large corporate redundancies. Clearly, such a system needs to be supported by active labour market programmes, such as retraining, job search assistance and public works programmes. Insurance or guarantee fund systems, however, could significantly increase the potential for employees to realise their entitlements for retrenchment benefits. Definitely, it will lessen the burden on the Government. A revision of priority creditors may help to achieve a better understanding of the purposes of insolvency in Malaysia.

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