The Phoenix Rising

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What is Phoenixing?

The phoenix was a mythical bird of Greek mythology which lived to a great age and whose death was marked by the consumption of its body in flames followed by a regeneration of its form from the ashes which resulted.

In recent times corporate insolvency terminology has used this imagery to describe circumstances where a limited liability company fails and a new limited liability company arises from the ashes of a failed predecessor, in circumstances where control of the new company is essentially the same as the old.[1] The mythology of the phoenix's long life does not form part of modern usage of the term in insolvency!

Beyond the general description given, it is difficult to properly define "phoenixing" since it encompasses a range of activities, some of which are legitimate and lawful, and some of which are an abuse of the privilege of limited liability and illegal,[2] and there are shades of grey between the two. One broad form of categorisation is to distinguishing phoenixing into "honest business rescue" and "illegal phoenixing".[3] Honest business rescue can be viewed as a legitimate part of a modern approach to insolvency, which attempts to preserve value by avoiding the unnecessary destruction of a business which, save for debt burdens, is otherwise viable, thereby allowing productive parts or elements of insolvent businesses to continue operations after the company enters external administration.[4] On the other hand, illegal phoenixing is a form of fraud upon creditors. It takes from the credtitors the potential to make use of the productive parts of the insolvent business to either help satisfy their debts or to take in interest in the furtherance of those parts of the business going forward. As discussed below

[1] Helen Anderson et al., *Defining and Profiling Phoenix Activity*, (2015), 1. As long ago as 1994, the Victorian Law Reform Commission suggested the following definition: "A limited liability company fails, unable to pay its debts to creditors, employees and the State, and at the same time or shortly afterward the same business arises from the ashes of the old with the same directors under the guise of a new limited liability company, but disclaiming any responsibility for the debts of the previous company." Victorian Parliament, Law Reform Commission, "Curbing the Phoenix Company – First Report on the Law Relating to Directors and Managers of Insolvent Corporations", Government Printer 1994.

[2] Australian Commonwealth Government, 'Combatting Illegal Phoenixing' (Consultation Paper, Australian Treasury, September 2017) 7

[3] Ibid

[4] Ibid

it is also detrimental to the function of the economy at large because it has the potential to cause market distortion.

The key difference honest business rescue and illegal phoenixing is the *intention* of the controllers of the company in difficulty. Of course, in every situation of a failing or failed corporation, the interests of the creditors are impaired. That is simply a function of the demise of the debtor's ability to pay its debts. It is where the *intention* of controllers of the failed or failing company is, or becomes, that the rebirth of the company is for the purpose of prejudicing, delaying or defrauding the creditors of that company, that the use of the phoenixing technique becomes illegitimate or illegal. In the usual course this is evidenced by inadequate consideration being paid for the assets sold to the new company.[5]

Attempts to combat illegal phoenixing in Australia have a long history, but the problem of illegal phoenix activity has recently been raised again by the publication of a Commonwealth Government consultation paper late last year titled 'Combatting Illegal Phoenixing'.

This paper will provide some background to the issue in Australia, an overview of the existing legislation and the suggested changes to that regime, and some commentary on the potential utility of those suggested changes.

Recent developments and influences

As noted above, illegal phoenixing returned to public awareness last year when the Commonwealth Government released a consultation paper in September 2017.[6]

That consultation paper is the latest in a line of Australian reports dating back to 1994 when the Victorian Law Reform Committee reported to the Victorian parliament on "Curbing the Phoenix Company".[7]

In 2009 the Treasury issued a paper suggesting that the then current stock of suspected phoenix cases the ATO was in the order of $600 million and was unacceptable.[8] In response the Government announced that it would introduce a suite of reforms to address illegal phoenix activity, one of which was "similar names" legislation modelled on s 216 of the *Insolvency Act 1986* (UK).[9] However this proposal lacked support and was never introduced into Parliament.

The current Consultation Paper continues to reflect concerns of Treasury that phoenixing remains a major drain on the revenue. The Consultation Paper identifies the reasons for

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[5] Helen Anderson, above n 1, 20.
[6] The Australian Government the Treasury, "Reforms to address illegal phoenix activity", September 2017. https://static.treasury.gov.au/uploads/sites/1/2017/09/170928-final-Phoenixing-Consultation-Paper-1.pdf
[7] Victorian Parliament, Law Reform Committee, "Curbing the Phoenix Company: first report on the law relating to directors and managers of insolvent corporations", Government Printer 1994. https://www.parliament.vic.gov.au/papers/govpub/VPARL1992-94No83.pdf
[8] The Australian Government the Treasury, "Action against fraudulent phoenix activity" November 2009 https://archive.treasury.gov.au/documents/1647/PDF/Phoenix_Proposal_Paper.pdf
[9]

suggested reform as being: the increasing sophistication of phoenixing activity; the helping of honest and diligent entrepreneurs; and the high cost of phoenixing to the community.[10] The influence of 'pre-insolvency advisers' is of particular concern within the current reform efforts.[11] These persons or entities are seen as being less regulated than directors and often difficult to find liable for breaches done by directors.

The Shadow Assistant Treasurer, Andrew Leigh has released numerous speeches and media releases criticising the government for perceived inaction on phoenixing. In 2017 he released a media release declaring "you can almost register your dog as a company director",[12] noting and in asking "Why is the Turnbull Government letting dodgy directors off the leash?."[13]

How common is illegal phoenixing in Australia?

The current incidence and cost of illegal phoenixing within the Australian economy is actually unknown, though it is thought to be quite significant. The reason for the difficulty of calculation is due to a variety of factors.

First, illegal phoenixing is not, at least yet, a specific offence under Australian law.[14] When prosecutions are attempted, directors pursued under existing legislative provisions that capture illegal phoenix activity. These are discussed later but in general terms include the general directors' duties under the *Corporations Act* ss 180-183 and obtaining a financial advantage by deception under the *Criminal Code Act 1995*.[15] Thus where ASIC prosecutions take place, they are recorded under these existing legislative provisions, making it difficult to discern how many of these cases involve illegal phoenixing.[16]

Second, the number of liquidations per year is unlikely to be a good guide to the level of phoenix activing. A phoenixed company does necessarily die through liquidation, it may instead simply become a dormant company[17] which ceases trading, but which is not wound up. The decision by creditors not to wind up a phoenixed company may be completely logical on the basis that they have concluded that the cost reward profile of the the liquidation route is unfavourable. Illegally phoenixed companies typically been stripped of assets and without external funding by a creditor a liquidator appointed to them cannot take any meaningful

[10] Foreword to the Consultation Paper by the Hon Kelly O'Dwyer, Minister for Revenue and Financial Services, page v.
[11]Australian Commonwealth Government, 'Combatting Illegal Phoenixing' (Consultation Paper, Australian Treasury, September 2017) p 3.
[12] Andrew Leigh, 'You can almost register your dog as a company director' (Media Release, 30 May 2017)
<http://www.andrewleigh.com/_you_can_almost_register_your_dog_as_a_company_director_media_release>
[13] Andrew Leigh MP, Shadow Assistant Treasurer, There is nothing magical about phoenixing operations, Transcript (Doorstop, 24 May 2017)
[14] Australian Commonwealth Government, above n 2, 7
[15] Also *Crimes Act 1900* s192E in NSW jurisdiction
[16] Helen Anderson et al., *Quantifying Phoenix Activity: Incidence, Cost, Enforcement*, (2015), 12
[17] Ibid 16

action.[18] Whilst creditors or litigation funders could potentially fund the liquidator to have the illegitimate transfer of assets clawed back for the benefit of creditors, this prospect is rarely cheap or quick meaning that, depending upon the quantum involved, creditors may simply decide to cut their loses rather than double down upon the loss they have suffered. The result is that that many illegally phoenixed companies simply remain as dormant companies statistically invisible for the purposes of disclosing the extent of illegal phoenix activity

The total number of dormant companies per year is uncertain. ASIC may deregister dormant companies which fail to submit required paperwork or pay annual fees,[19] but ASIC does not differentiate how many of total deregistered companies per year did so involuntarily, so calculating the number of dormant companies is difficult. From 2013-2014 the total number of firms deregistered was 109,147, over ten times more than liquidated firms.[20]

The potential for a phoenixed company to die through deregistration rather than liquidation means that the number of liquidations recorded per year is of limited utility in determining the extent of phoenix activity.[21]

Third, the incidence of illegal phoenixing is probably closely correlated with the business cycle. During periods of economic expansion, business conditions are relatively easy, credit is usually freely available, and businesses of marginal viability are able to remain afloat. Creditors, making good profits are often disinclined to pursue bad debts at significant trouble and expense because credit is easy and new profits are easy to make.

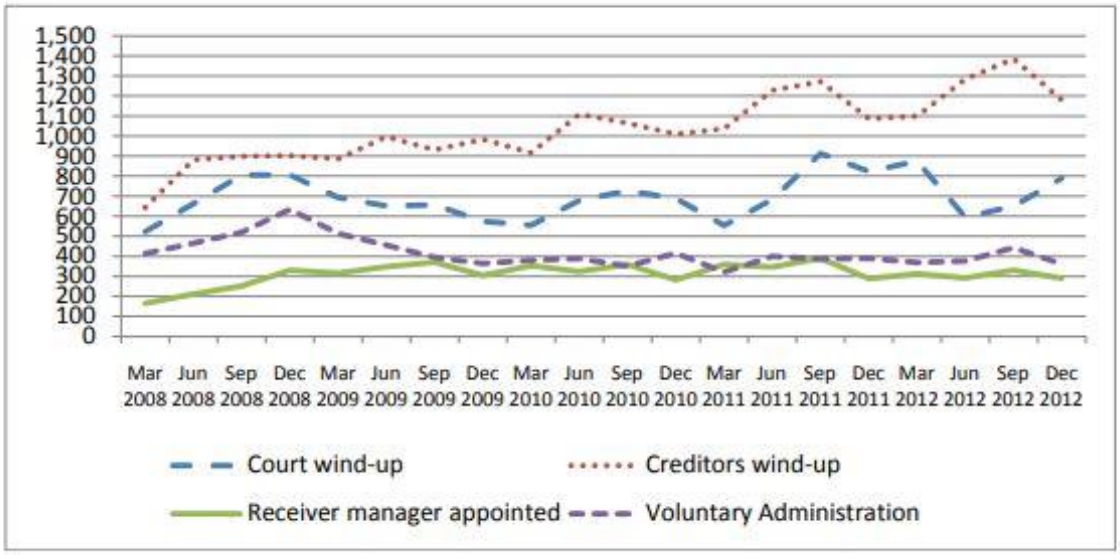
Economic slumps have the reserve effect. Credit tightening and soured business conditions force marginal firms into cashflow crises: a process which economist Joseph Schumpeter referred to as 'creative destruction'. Cash flow crises increases the temptation for controllers of failing companies to engage in illegal phoenixing activity but at the same time creditors facing cash flow crises of their own become increasing vigilant about getting in their debts.

In an economy such as Australia's which has not seen a serious recession for nearly a quarter of a century, these motivations have not been fully played out for a long time. Comparing US and Australian corporate bankruptcy statistics before and after the GFC reveals this divide. US corporate bankruptcies per quarter almost tripled from approximately 20,000 to 60,000,[22] while Australia remained relatively unaffected.[23] The US corporate liquidations revealed the extent of corporate misfeasance: an experience which Australia largely avoided.

[18] Ibid 17
[19] Ibid
[20] Ibid
[21] Ibid 12
[22] Trading Economics, *United States Bankruptcies*, 13/02/2018, Trading Economics, <https://tradingeconomics.com/united-states/bankruptcies>
[23] ASIC Series 1 and Series 2 insolvency statistics, December Quarter 2012.

ASIC Insolvency statistics summary – December quarter 2012

Chart 1— Companies entering into EXAD by quarter and type of appointment



As discussed shortly, the estimated costs of illegal phoenix activity to the Australian economy is thought to be large, however were the business cycle to turn it seem likely that it has the potential to become far more serious. Certainly if illegal phoenixing is a significant problem during good times, it stands to reason that it will be a much bigger problem during bad.

Who is affected by Illegal Phoenix Activity?

Illegal phoenix activity affects creditors of all descriptions but its primary victims are primarily the Commonwealth (in other words the taxpayer generally), employees, and unsecured creditors. In broader terms it has the potential to affect the competitive market itself.

The Commonwealth government is primarily affected by illegal phoenixing through the non-payment of taxes to the ATO and in compensating employees for lost entitlements under the *Fair Entitlement Guarantee Act 2012* (FEG).[24] Governments are also concerned as they, at least notionally, bear the cost of enforcement and costs to the community generally.

Employees are often owed wages and entitlements by phoenixed companies. Their positions are vulnerable as they cannot typically secure themselves against losses like creditors by working for many employers. They are also typically in a poor position to pursue legal remedies against their fallen employer. In light of this, a public policy decision was made to firstly give employees priority over other unsecured creditors and to afford them some protection under the FEG.[25] Of course, the protection which FEG affords employers merely shifts risks from the individual employee to the Commonwealth and taxpayers generally. Where an employee is eligible FEG potentially entitles an employee to claim up to 13 weeks of unpaid wages, unpaid annual leave and long service leave, payment in lieu of notice of up to five weeks, and redundancy pay of up to 4 weeks per full year of service.

Illegal workers are vulnerable to illegal phoenixing. Often lacking knowledge of their legal rights and working in breach of visa they are unlikely to raise legal issues and would not be eligible for FEG.[26]

However, whilst employees are vulnerable, it is may be that the extent of the problem is disguised by the fact that employees are offered employment with the new company, on the proviso that they do not pursue past wages. It is thus difficult to known to what extent costs to FEG reflect the true extent of illegal phoenixing.

Smaller unsecured creditors are vulnerable in an illegal phoenix situation. They do not have priority in liquidation and have no access to government guarantees of return.[27] They often lack the capacity to properly investigate the credit worthiness of the debtor company and the capacity to take recovery action when defrauded.[28] Unsecured creditor losses can have a ripple effect on in the economy, as crediting companies themselves become insolvent when the illegally phoenixed company does.

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[24] Anderson, above n 1, 39
[25] Ibid 40
[26] Ibid
[27] Ibid 39
[28] Ibid 40

Finally, the competitive market itself is undermined by illegal phoenixing activity. Intangibles such as trust and confidence in the market system are undermined if creditors cannot trust that a company they trade with will not strip away its assets if it liquidates.[29] Further, companies which rely on illegal phoenixing as a business model will have a competitive advantage over those who do not, as they can avoid paying payroll taxes or GST. Corporations which abide by their obligations have the potential to lose business to those that do not, however the extent of this problem is unknown.[30]

What is the cost of Illegal Phoenix Activity in Australia?

As with calculating its incidence, the costs of illegal phoenix activity are difficult to distinguish from honest business rescue. However, specific costs such as lost revenue to the ATO and the costs to the FEG scheme are easier to quantify than more abstract costs, such as costs to disappointed unsecured creditors or the economic costs of undermining a competitive market.

In their recent consultation paper, the Australian treasury estimated the cost of illegal phoenixing to be as high as $3.2 billion annually.[31] However, this figure is sourced from a PwC report released in 2012 and is often quoted in the media.

PwC's methodology begins by segmenting industries by perceived risk (low risk, medium risk, high risk).[32] Which risk pool each industry was classed in was determined through stakeholder feedback and a literature review. The total amount paid to employees after liquidations through GEERS (predecessor to FEG) was then weighted by the industry's 'risk' of illegal phoenixing to estimate the total cost of illegal phoenixing to workers.[33] For instance, restaurants and cafes were deemed 'low risk' and so the percentage of GEERS payments to workers in that industry that was due to illegal phoenixing was estimated at between 0.5-2.5%. Cleaning by contrast was deemed high risk, and it was estimated 3%-10% of losses were due to illegal phoenixing.[34]

These estimates are then largely based on perceived risk of stakeholders, which may be inaccurate.[35] Additionally, as the GEERS payments were only made to employees of liquidated companies, they do not quantify losses in phoenix companies which become dormant.[36] Finally, GEERS entitlements did not cover all employee entitlements, such as workers' compensation premiums.[37]

[29] Ibid 42
[30] Ibid
[31] Australian Commonwealth Government, above n 2, v
[32] PWC and FWO, *Phoenix Activity – Sizing the Problem and Matching Solutions* (June 2012) 14
[33] Ibid 16
[34] Ibid 18
[35] Anderson, above n 8, 47
[36] Ibid 48
[37] Ibid

Despite problems with exact calculations of the cost of illegal phoenixing, there is general agreement it is of considerable cost to the economy.

Intuitively, illegal phoenixing is more likely to go unchallenged, and hence more likely to occur in smaller scale operations since relative cost of pursuing a debt usually falls with the size of the debt owed.

Exploring the grey area between innocent and fraudulent transactions

After extensive study, researchers from the University of Melbourne and Monash Business School have suggested that phoenix activity can be categorised into five classes.[38]

1. Honest Business Rescue

Honest business rescue occurs when a business in financial difficulty enters external administration.[39] The company's controllers transfer the productive assets of the old company to a new company for reasonable consideration. There is no intention to defraud the creditors who are paid a reasonable sum for the assets transferred.

Creditors in this scenario may be better off than if assets were sold to a third party. Some company assets may be almost useless outside their original company, and so sale to a third party would provide limited or no returns.[40] Also, third parties will rarely be willing to buy a failed company's assets *en masse*. Sale to the company's previous controllers may then represent the maximum return for creditors after liquidation.

Employees may also benefit from honest business rescue. Many may be transferred to the new company, with limited need for retraining. In some instances, their entitlements will accrue to the new employer.[41]

Honest business rescue recognises that good businesspeople can nevertheless become insolvent and still be competent to manage companies in the future. If done correctly honest business rescue can save jobs, and maintain assets in profitable pursuits, while directors learn their lesson and become better at finances.[42]

Used in this way, phoenixing gives effect to the rationale which underpins the Chapter 11 process of the United States Bankruptcy Code, which in contrast to the traditional Australian approached that holds that a failed company should be broken down and its pieces liquidated,

[38] Prof. H Anderson, Prof I. Ramsay, Prof M. Welsh, Mr J. Hedges, *Quantifying Phoenix Activity: Incidence, Cost, Enforcement*, (2015)
[39] Anderson, above n 1, 9
[40] Ibid
[41] Ibid 40
[42] Ibid 9

follows the view that where possible the better outcome to the community is achieved where potentially business are given a "second" chance with a reorganised or restricted debt profile.

A high profile example of this was the 'General Motors' bankruptcy on 1 June 2009.[43] Endorsed by the US government 'New General Motors' purchased the operational assets of General Motors.[44] As part of the restructuring of the company GM reduced its US dealerships from 6,000 to 3,600 and planned to reduce its employees from 88,000 to 68,000.[45] While not ideal for workers, the process maintained manufacturing base within the USA and prevented even larger unemployment.

2. "Problematic Phoenixing" or the incompetent but persistent incorporator

Problematic phoenixing occurs where honest yet incompetent directors create phoenix companies, and continue to engage in the management of corporations which fail to the detriment of both creditors and the community at large.

Since such directors have no intention to defraud the creditors the phoenixing is not illegal phoenixing.

These directors can be profiled by how many failed companies they have run, and how much their failed corporations have cost creditors and employees in each failure. Section 206F of the *Corporations Act* can be used to disqualify these directors from managing corporations, and s 461(k) can potentially be used to wind these companies up.[46] Both provisions allow the ASIC and the Court to consider public interest.

Problematic phoenixing is evidenced in *Quinlivan and Australian Securities and Investments Commission*.[47] Mr Quinlivan was appealing a s 206F disqualification order by ASIC to the AAT. Quinlivan had managed 15 failed companies, but also was the director of 70 companies.[48] The group were broadly involved in marketing and sales but contracted almost entirely between themselves. Mr Quinlivan maintained that the companies' failures were a product of 'external forces', which bankrupted many good businesses.[49] The tribunal however formed the opinion that Mr Quinlivan had managed the companies poorly, and was not just the victim of bad luck, stating:

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[43] Chris Isidore, 'GM bankruptcy: End of an era' *CNN* (online), 1 June 2009, <http://money.cnn.com/2009/05/31/news/companies/gm_bankruptcy_looms/index.htm?postversion=2009053112>
[44] Chris Isidore, ''New' GM is born' *CNN* (online), 10 July 2009, <http://money.cnn.com/2009/05/31/news/companies/gm_bankruptcy_looms/index.htm?postversion=2009053112>
[45] Ibid
[46] Ibid
[47] [2010] AATA 113
[48] Ibid [1]
[49] Ibid [12]

> Many soundly managed businesses struggled during this period for the same reasons. But we think there is enough evidence to conclude that poor management was also a factor in the failure of the companies. The liquidators' reports referred to poor-record keeping and inappropriate use of funds, and there is evidence to suggest the companies unwisely incurred debt during periods of high interest rates when a more conservative approach might be warranted. Given Mr Quinlivan played a central role in those companies, he must bear at least some responsibility for what happened.[50]

The tribunal however distinguished this 'poor management' from any acts of dishonesty, stating:

> The written submissions on behalf of Mr Quinlivan point out there were no allegations of dishonesty made against him. That is true, although ASIC invited us to infer that Mr Quinlivan established and managed the Quinlivan group companies that failed between 2002 and 2007 with a view to avoiding taxation obligations. We concluded we were not satisfied the evidence justified us in going so far: with some hesitation, we accept the evidence establishes Mr Quinlivan's motivations in establishing the group were muddled and his management practices were the product of a want of skill and diligence.[51]

The tribunal however further warned that s 206F must not be misused, with an overly restrictive conception of 'public interest', maintaining:

> The public has other interests which must also be considered. It has an interest in encouraging enterprise and risk-taking, for example. The public interest will not be served if directors become too risk averse out of fear that they will be subject to heavy-handed intervention if things go wrong.[52]

3. Illegal Phoenix Type 1: The intentional avoidance of debts once a company starts to fail

Illegal phoenixing type 1 occurs when a company's directors, while beginning with good intentions, form an intention to avoid debts as the company begins to fail.[53] As the illegality of such actions cover many legislative provisions, this category is necessarily broad.

The hallmark that an intent to avoid paying creditors exists is that inadequate consideration was received for assets transferred. However, adequacy may be difficult to determine in circumstances where the assets have limited market value,[54] and intention to defeat creditors can be a difficult evidentiary issue.

Importantly, however, it is not only directors who can be liable for this type of activity. The case *ASIC v Somerville & Ors*[55] is notable as the only Australian instance of an advising lawyer

[50] Ibid [13]
[51] Ibid [96]
[52] Ibid [79]
[53] Anderson, above n 1, 15
[54] Ibid 16
[55] [2009] NSWSC 934

being found liable for phoenixing.[56] Somerville, a lawyer, advised 8 directors managing 15 companies that were either insolvent or likely to become so.[57] In each instance Somerville advised the directors not to sell the assets in the open market but to transfer them from the insolvent company to a new solvent company. The old company received class 'V' in the new company, with the right to possible dividends. This however was not considered adequate consideration, as Windeyer AJ elaborated:

> In each of the transactions complained of the assets of the vendor company were transferred to the purchaser company. The only consideration was the issue of the "V" class shares. The case of ASIC is that there was no real consideration or that any consideration was illusory. In no case was there a dividend declared on the "V" class shares. Even those purchaser companies which made some payments towards debts owing by the vendor company did so out of their own assets and not by way of dividend. The declaration of dividend out of profits in small companies such as these was, judging by past trading history, unlikely and was properly, I think, described as optional or discretionary.[58]

From this Windeyer AJ considered that there had been "no genuine intention to discharge liability" for non-trade creditors, and subsequently the 8 directors were in breach of s 181(1), s 182(2), and s 183(2) of the *Corporations Act*.[59]

Due to Somerville's extensive involvement in these restructurings he was also found to have breached the same legislative provisions under s 79 of the *Corporations Act*. This provision provides:

Involvement in contraventions

> A person is involved in a contravention if, and only if, the person:
>
> (a) has aided, abetted, counselled or procured the contravention; or
>
> (b) has induced, whether by threats or promises or otherwise, the contravention; or
>
> (c) has been in any way, by act or omission, directly or indirectly, knowingly concerned in, or party to, the contravention; or
>
> (d) has conspired with others to effect the contravention.[60]

Somerville's involvement in the 8 director's breaches was extensive, he had: instructed directors that his solution was the 'only' viable option, registered the new companies, and ensured the transactions were carried out before winding up so as to avoid directors incurring personal liability.[61] Under s 79(c) this was considered to have 'aided, abetted, counselled or procured the contravention'.

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[56] Anderson, above n 1, 18
[57] *ASIC v Somerville & Ors* [2009] NSWSC 934 [7]
[58] Ibid [42]
[59] Ibid [42]
[60] *Corporations Act 2001* (Cth) s 79
[61] *ASIC v Somerville & Ors* [2009] NSWSC 934 [47]

Windeyer AJ stated:

> I have of course carefully considered the argument of Mr Coles QC that it would be extraordinary if a solicitor just giving advice became liable under s 79 of the Act. That of course may be the position in a normal case, but that depends upon what advice was given… when advice is given by a solicitor to carry out an improper activity and the solicitor does all the work involved in carrying it out apart from signing documents, it seems to me that there can be no question as to liability.[62]

4. Illegal Phoenix Type 2: The Phoenix as a Business Model

In this class of phoenix, it was the intention of the directors to use the limited liability company as a phoenix operation before it was formed.[63] There is no intention for the company to remain solvent in the long term, and subsidiaries are deliberately undercapitalised. Subsidiary companies can be used to pass the business between companies quickly and closely related names of companies may mean that creditors are none the wiser until they attempt to recover their debts.

5. Complex Phoenix Activity

Like Type 2 Illegal Phoenixing, Complex Phoenix Activity uses illegal phoenixing as a business model, it however further complicates the process by adding other forms of illegality, such as false identities, money laundering and fictitious transactions.[64]

The Fyna Group is an illustrative case of Complex Phoenixing. Here the company accountant devised a scheme where employees would be given group certificates with variations of the company's name and incorrect group tax numbers.[65] The ATO then could not match these with correct ABNs and could not track that group tax hadn't been paid. In this way otherwise insolvent companies continued to trade, only paying for materials and net wages.[66]The phoenixing action was estimated by CFMEU national secretary John Sutton as costing over $100 million.[67]

Lodging BAS after a company becomes insolvent to obtain a refund of GST input credits where expenses precede receipts is commonly associated with phoenix activity, as can be the under-declaration of staff numbers or payments to regulators.[68]

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[62] Ibid [49]
[63] Anderson above n 1, 24
[64] Anderson, n 1, 27
[65] Ibid
[66] Ibid
[67] Ibid
[68] Consultation Paper, pages 3-4

The Existing Legal Framework

The existing legal framework is extensive, and by definition, already covers "illegal" phoenix activity (since it would otherwise be lawful). The discussion here is not intended to be anything other than a brief overview.

The Directors' Duties Provisions

Most relevantly section 181 of the *Corporations Act* requires a director or officer to exercise their powers and discharge their duties in good faith in the best interest of the corporation and for a proper purpose, and section 182, which requires that directors, officers or employees of a corporation must not use their position to gain an advantage for someone else, or to cause detriment to the corporation.

Obviously, where a director or officer forms an intention to undertake a transaction to transfer assets of the company to a new entity at an undervalue, that person is breaching, at a minimum both those provisions. Moreover, it is well-established that where a company is facing insolvency, directors in considering the interests of the company need to consider the interest of its creditors.[69]

Moreover, in passing business assets to a new company at an undervalue, a director is prima facie gaining an advantage for "someone else", and at the same time causing detriment to the corporation which is, or is facing insolvency.

Going higher up the level of culpability, section 184 provides that a director of other officer commits an offence, if they are *inter alia* "intentionally dishonest", and fail to exercise their powers and discharge their duties in good faith, in the best interests of the corporation, or for a proper purpose.

The Insolvent Trading Provisions

It is well known that section 588G of the Act creates a duty for a director to prevent insolvent trading. This provision is contravened if a director fails to prevent a company "incurring a debt", if that person was aware that there were grounds of suspecting that the company was insolvent, or a reasonable person in their position would be aware of that.

Importantly, however, under section 588G(1A), the entering into an uncommercial transaction within the meaning of section 588FB of the Act, falls within the definition of "incurs a debt", meaning that to engage in a transaction to sell at an undervalue to business or assets of a company in circumstances of known or reasonably suspected insolvency opens the director

[69] H A J Ford and R P Austin, *Ford and Austin's Principles of Corporations Law* (Butterworths, 7th ed, 1995) 262 [8.100].

to contravention of the insolvent trading provisions and the associated penalties and liabilities (which are amongst the severest in the world).

The Involvement Provisions

As noted above, the *Corporations Act* also contains section 79 which allows a person involved in a contravention of the act by another (relevantly including a director) to be liable. In particular, section 79 provides that a person who has "aided, abetted, counselled or procured, the contravention" to be involved in it.

This provision therefore provides scope to catch pre-insolvency advisors which the Consultation Paper indicates are a focus of concern, with the ASIC v Somerville case providing an example of this process.

The Supervisory Provisions

Section 206D of the Act provides that on application by ASIC, the Court may disqualify a person from managing corporations for up to 20 years if, within the past 7 years the person has been an officer of 2 or more corporations when they have failed, and the Court is satisfied that the manner in which the corporations were managed was wholly or partly responsible for the corporations failing, and the disqualification is justified.

Relevantly, the definition of "failure" include the obvious cases of liquidation or administration, but also circumstances where a corporation "ceases to carry on business and creditors are not fully paid, or unlikely to be fully paid" (section 206D(2)(c)). This provision thus provides a mechanism for the regulation of directors in circumstances of incompetence, but also in circumstances where the company has not proceeded to a liquidator, but has simply become dormant. However, the power of application is available only to ASIC.

Secondly ASIC can exercise an administrative power of disqualification under section 206F where within the preceding 7 years at least two companies of which the person was a director was wound up and there was a liquidator's section 533(1) report lodged.

However, practically speaking ASIC appears to use a "banning order" pursuant to section 920A of the ASIC Act more than those provisions. However the number of bans does not appear to be particularly high, with some research indicating that average number of annual bans relating to "corporate governance" over a 29 year period was only 69.[70]

[70] Hedges, Jasper; Gilligan, George; Ramsay, Ian --- "Banning Orders: An Empirical Analysis of the Dominant Mode of Corporate Law Enforcement in Australia" [2017] SydLawRw 21; (2017) 39(4) Sydney Law Review 501

The Business Record and Assistance Provisions

Section 286 of Act provides that a business must keep written financial records that correctly record and explain its transactions…and would enable true and fair financial statement to be prepared and audited, and for those records to be retained for 7 years after the transaction in question.

Section 1307 makes conduct that results in the concealment, destruction, mutilation or falsification of any books affecting or relating to the affairs of the company an offence, subject to limited defences of honesty and the circumstances of the case.

Moreover, under section 530A(1) officers of the company have a duty to deliver up all books in that officer's possession relating to the company to the liquidator as soon as practicable after the winding up, and to tell the liquidator where other books relating to the company are. There is a more general duty under section 530A(3) for officers to do whatever the liquidator reasonably requires them to do to help in the winding up.

The Employee Entitlement Provisions

Under section 596AB of the Act, a person must not enter into an agreement or transaction with the intention of preventing the recovery of the entitlements of employees of a company, or significantly reducing the amount of the entitlements of the employees of a company that can be recovered. Under section 596AC, a person who contravenes section 596AB is liable to compensate the liquidator of a company which owes the employee entitlements, or even the employees themselves for the contravention. Thus, in circumstances where the original company is in liquidation, this provision opens up the new phoenix to liability for the employee entitlements which are not payable by reason of the phoenix activity.

The Voidable Transaction Provisions

The transfer of business assets can fall within various of the classes of voidable transaction.

Most obviously it would be an insolvent transaction of the company which is an uncommercial transaction (section 588FE(2), 588FE(3) in combination with section 588FC) either without being entered into a with a related party of the company.

More generally, under section 588FE(5) an insolvent transaction (in this case being an uncommercial transaction) is a voidable transaction if:

> "the company became a party to the transaction for the purpose, or for purposes including the purpose, of defeating, delaying or interfering with, the rights of any of all of its creditors on a winding up of the company"

This description of the purpose of the transaction fits very well with the modern interpretation of illegal phoenixing activity as *intention* based, and the voidable transaction provisions provide a method for the transaction in question to be unwound by the Court.

Section 37A of the Conveyancing Act

Section 37A of the *Conveyancing Act 1919* (NSW) and its interstate equivalents, is also a potential remedy to the problem of illegal phoenixing. It provides, *inter alia,* that every alienation of property… with intent to defraud creditors, shall be voidable at the instance of any person thereby prejudiced, but that it does not extend to any estate or interest in property alienated to a purchaser in good faith not having, at the time of the alienation, notice of the intent to defraud creditors.

In this way, section 37A gives "persons prejudiced" (not just a liquidator or ASIC), a right of redress against the new phoenix company. Within an illegal phoenixing operation, the new company would ordinary not be in a position to show that it was a purchaser in good faith without notice, since the essence of phoenixing is the commonality of control and this imputed knowledge between the two entities.

Criminal and Taxation Legislation

It is beyond the scope of this paper to explore the criminal and taxation offences which are potentially triggered by a phoenixing transaction. They are, however of course, substantial as they potentially involve defrauding creditors, and the Commonwealth as well as failure to comply with taxation obligations.

The Suggested Reforms

The consultation paper makes various suggested reforms to the existing framework, some of which are substantive and some of which relatively minor.

The "Phoenixing Offence"

Perhaps most significantly, the consultation paper proposes amendments to the Corporations Act to specifically prohibit the transfer of property from one company to another if the "main purpose" of the transfer is to prevent, hinder or delay the process of that property becoming available for division amongst creditors. Suggested wording of the provision have not been provided, but it is suggested that it there would be a rebuttable presumption of insolvency, and that such a transaction would be void against the liquidator.

According to the Consultation Paper the offence would give rise to a right in creditors and liquidators (and ASIC) to sue for compensation for the loss caused by the conduct of those who engage in the prescribed conduct, as well as those who are knowingly involved in that conduct under section 79 of the Corporations Act

It is also suggested that failing to keep books and records and failing to assist the liquidator could be a "phoenixing offence".

However, in light of the existence of the existence of section 588FE(5) which already provides a mechanism for the voidability of a transaction in those circumstances, the provisions regarding directors duties, in particular section 184 which makes intentional, dishonest or reckless breaches of the director duty of good faith and proper purpose an offence, the utility of a new provision which is overlaid upon those provisions is unclear.

In a sense, such a provision would just be a more specific provision of what is already well covered by existing broader provisions. Perhaps it might be speculated that by creating a specific offense, that directors might be made more aware of their obligations not to engage in illegal phoenixing activity, however, on one view this is more a matter for education of directors rather than a justification for adding yet another section to the Corporations Act, which is already voluminous.

Moreover, if more specific provisions were added the question would remain whether or not they would be enforced with vigour, or would simply be added to a bundle of provisions which could if desired by used to prosecute illegal phoenix activity but are not. In particular, the Consultation Paper does not assert that attempting to enforce existing provisions has been unsuccessful or that the new offence would somehow overcome evidentiary disadvantages which a prosecutor attempting to prevent illegal phoenixing faces. In that sense it may be that the devotion of more resources to the prosecution of illegal phoenixing under the existing legislative framework would be more successful. Perhaps however the intention is both to add further provisions and then to increase the prosecution of illegal phoenixing activity.

A New Administrative Notice Regime

Linked to the proposal for the creation of a phoenixing offence is a proposal that where ASIC (or perhaps a liquidator) "suspects" that the assets of a company have been transferred to a new company at no or less than market value that ASIC can issue a notice to the new company requiring that company to deliver up property or money (presumably to the wronged company).

This proposal is based upon the existing section 139ZQ of the *Bankruptcy Act* which was insert in 1992 and it provides an administrative mechanism for the recovery, *in personam*, of transfers void against a trustee. If properly issued, and if not set aside by the Court upon application within 60 days of the recipient becoming aware of it, the amount claimed is recoverable by the trustee as a debt.[71] Under the Bankruptcy Act regime the "void"

[71] *Permfox Pty Ltd v Official Receiver for the Bankruptcy (NSW)* [2002] FCA 1564

transactions covered include undervalued transactions (s 120), transfers to defeat creditors (s 121) but also preferences (s 122). Anecdotally it would seem that the Official Receiver issues around 25 to 40 such notices a year.

However, the power to issue the notice is conditioned upon the existence of the facts and circumstances that lead to the Official Receiver's opinion to issue the notice, not upon the mere existence of the Official Receiver opinion or satisfaction that the transaction is void.[72]

> "Accordingly…where [the Recipient of a notice]….has by direct or circumstantial evidence made out a *prima facie* case that either the alleged facts and circumstances set out and relied upon in the challenged notice do not exist or (if they do exist) they do not disclose a voidable transaction, then the onus of adducing evidence shifts to the [Official Receiver]."[73]

The proposal to extent this type of regime to the Corporations Act, but limited only to phoenixing offences, seems like to be apt to streamline the process of recovery of phoenixed assets in some cases. Of course, since under the Bankruptcy Act regime a notice can be set aside upon the basis of a prima facie case being made out that the transaction in question was not void, and since in those circumstances the onus of proving the transaction is void falls upon the Official Receiver, the existence of the notice does not change the onus of proof.[74]

A risk profiling approach to focus regulatory activity

A further suggested reform is a type of risk profiling or filtering approach where by entities are classified as high, or "higher" risk, thus presumably enabling regulators to better target phoenix operators.

The proposal suggested is a two-tiered approach whereby firstly "higher risk entities" (presumably mostly directors) can be designated as such based on objective facts, for example:

- previous disqualification
- having committed a "phoenix offence"
- having been an officer of two companies in liquidation within 7 years where:
  - books were not kept or properly provided to the liquidator
  - an insolvency practitioner has lodged a report under s 533(1) of the Act (i.e. guilty of an offence, or misapplication or property, or unsecured creditors get less than 50c in $1)
- having been an officer of a company with poor compliance history for example a claim on the FEG Scheme.

However, being a "higher risk entity" would, of itself, have no impact of the director or officer.

[72] *Halse v Norton* [1996] FCA 1512 at [24]
[73] ibid at [25]
[74] ibid at [30]

The second tier would be an administrative declaration by the Commission of Taxation that the "higher risk entity" is also a "High Risk Phoenix Operator", meaning that the administrative declaration could only be made in respect of entities who are already "Higher Risk Entities", and would be subject to review, although it is not clear by whom.

The consequences of that declaration are also not really clear, but the Consultation Paper suggests they might include:

a. that where a director is a "High Risk Phoenix Operator" that a company which they are a director must have a randomly selected liquidator (presumably to prevent the director using a liquidator who will not fulfil his or her duties properly) – a so called "cab rank"
b. alternatively that a "government liquidator" be used (these would need to be created, of course as they do not currently exist);
c. that the usual time period of 21 days for a director to rectify a director penalty notice be removed (because a high risk phoenix operator director may use that time to dispose of their assets); and
d. that tax refunds where BAS or tax returns are not up to date be withheld (that is, effectively creating a presumption of indebtedness to the ATO);

Security Deposits

Currently the ATO is able to require a bond or other security from a business for existing or accrue tax liabilities that are a high risk of not being paid, those circumstances include a history of phoenixing. However, the penalty for failing to provide the security is only $21,000, and hence there is no incentive to provide the security. Pursing a Court penalty decision by the ATO takes time providing the business in question time to phoenix.

The Consultation Paper suggest an extension of the ATO's statutory garnishee power to include recovery of a security deposit. It is suggested that this change will disrupt and deter businesses that are suspected of phoenix behavior, however on the other hand, if the ATO's suspicion proved to be incorrect, the business in question would potentially fail by reason of being starved of funds in any event.

Used in very selective circumstances such an extension might be warranted, however on its face it does seem to give the ATO the power to destroy a business should it wish to. Moreover, a wrongly targeted business in those circumstances may lack the resources to apply for judicial review of the garnishee notices.

Extension of Director Penalty Notices to include GST

Some phoenix operators exploit the time difference between when GST is collected from customers and when it is payable to the ATO, fail to comply with GST reporting obligations so

as to purloin funds which would otherwise be payable to the ATO, with the directors pocketing the GST for personal gain.

A Director Penalty Notice ("DPN") is a Notice that the ATO can send a director which currently makes that director personally liable for two types of tax debts of a company - Pay As You Go tax and Superannuation Guarantee Charge liabilities.

The Consultation Paper suggests that the Director's Penalty Notice regime be extended to include company's outstanding GST obligation to allow the ATO to cover penalty amounts equivalent to the GST, making the directors personally liable to pay the amount of the unpaid GST. In circumstances where the practice occurs the extension of the DPN regime to this area would appear sensible.

The "Phoenix Hotline"

Research done by ASIC's predecessor in the 1990s indicated that 80% of respondents who had experienced phoenix activities did not report it to the authorities.[75]

Another proposal is that there be a "phoenix hotline" for members of the community to report their (apparently including anonymous) concerns regarding phoenix activity. There are existing "hotlines" at ATO and ASIC – but the Consultation Paper has concerns that reports not coordinated between agencies. The thought apparently being that if the hotline were consolidated to one agency rather than two, follow up might be better.

Of course, whether or not the hotline would yield any real benefit would naturally depend on the community being aware of it and perhaps more importantly for the agency which ultimately administers it to take action based upon the information received.

In this regard the current experience is not particularly inspiring. Liquidators are already required to report suspected misfeasance, and misconduct by directors to ASIC in their reports and the statistics indicate that they do so with great regularity. Nevertheless, the follow up on these suspected and reported cases by ASIC appears to be very low. ASIC's most recent report on external administrators indicated that registered liquidators lodged 9,465 reports in the 2015-16 financial year.

Of those:[76]

- possible misconduct was reported in 82% of cases;
- insolvent trading was reported in 61% of cases;
- six reports alleged a criminal breach involving more than 200 creditors;
- failure to keep financial records was reported in 42% of cases
- failure to assist a liquidator in 13% of cases

[75] ASC research paper, Phoenix Companies and Insolvent Trading, No. 95/01 (July 1996) pp2-5
[76] Submission by ARITA to the Treasury dated 30 October 2017, in relation to the Consultation Paper: https://www.arita.com.au/ARITA/News/Submissions/ARITA_submission_on_combatting_illegal_phoenixing.aspx citing ASIC Report 507, July 2015 to June 2016.

- breach of directors duties in 38% of cases.

Whilst relying on publicly available information it is impossible to determine how many actions were brought based upon that type of information, ASIC's report 536 enforcement outcomes January to June 2017 includes the following table.[77]

Table 6: Corporate governance—Results by misconduct type

Type of misconduct	Criminal	Civil	Admin	Enforceable undertaking	Negotiated outcome
Action against directors	2	1	1	0	0
Insolvency	0	1	0	0	0
Action against auditors	0	0	1	0	0
Action against liquidators	1	0	0	1	1
Other corporate governance misconduct	0	0	1	0	0
Total	**3**	**2**	**3**	**1**	**1**

Whether or not with simply providing more material to either ASIC or ATO by laypersons would result in better regulation of illegal phoenixing would obviously depend on if those entities are properly funded to follow up upon that information, and their litigious appetite to do so.

Director Identity Number proposal

One reform touched upon in the foreword to the Consultation Paper is the 2015 proposal of the Productivity Commission to issue company directors with identity numbers,[78] a move which was supported by the Governance Institute of Australia. The problem at issue being the use of fictitious names and addresses which made it impossible to identify directors who are engaged in repeat phoenixing activity.

Although there is an existing requirement for directors to be identified under section 117, including name, date of birth, place of birth and address of the *Corporations Act,* these details have hitherto never been verified, the proposal by the Productivity Commission suggested there be

- 100 point identity check to confirm the identity of the director;
- that registration be obtainable online from ASIC
- a requirement that the prospective director verify that he or she has read materials on director's legal responsibilities that would be provided as part of the director registration process.

[77] ibid
[78] Productivity Commission 2015, Business Set-up, Transfer and Closure, Final Report 75, Canberra.

ASIC expressed concern at the costs of building and implementing an authentication process. In its July 2015 response to the Productivity Commission recommendations ASIC noted that it would need to modify registers, portals, machine to machine services with software developers and that it could not support in-person interactions at their offices.[79] Accordingly the objections appear to be mostly funding related and it is unclear to what extent the government will accommodate to this need.

The aim of the identification number process is to curtail phoenix activity by better identifying the directors of failed businesses, as the use of fictitious names would be eliminated.

Of course, identification number process, without more, could not overcome the use of "dummy directors" (for example relatives who do not understand how their names are being used) or identity theft. Not canvassed by the Productivity Commission nor the Consultation Paper is any form of restriction upon becoming a director based upon passing an examination upon directors' obligations or duties. In that sense the mere requirement that a prospective director verify that they have read materials on directors' duties might be a start but would hardly give much comfort that those materials had been understood.

Combating the fraudulent backdating of director resignations

Currently the obligation to report the resignation of the director of company to ASIC falls upon the company itself than the director who is resigning.

This obligation can be exploited by a director attempting to avoid liability for the actions of the company by fraudulently backdating the notice of resignation to a date before the offences in question occurred thereby seeking to avoid liability for them.

Similarly, a company may backdate the commencement of a "dummy" director prior to the occurrence of offences thereby shielding to true controller.

The proposal involves amendment to impose a rebuttable presumption that where a change in director notice is lodged more than 28 days after the date of the purported resignation, that the director could still be held liable for misconduct that had occurred up to the point of lodgment.

Additionally there is, what appears the more straightforward and useful proposal, of shifting the onus of notification from the company to the director.

Ultimately, of course, the law already allows the Court to look beyond who is a de jure director at the time of offences to who is a de facto or shadow director, however given the additional expense and evidentiary burden in doing so, the proposals in this regard seem to have merit.

[79] ASIC, Productivity Inquiry into business set up, transfer and closure: ASIC's supplementary submission, July 2015 https://www.pc.gov.au/__data/assets/pdf_file/0007/190924/subdr058-business.pdf

Prevention of "abandonment" of the company by its directors creating "zombie" companies

It is currently possible for a sole director to resign leaving the company without a board. Phoenix operators can, absent the de facto director principles, attempt to take advantage of this by having a company undertake unlawful phoenix activity at a time when the company has not directors at all.

As a result, the company may not make the necessary director resignation lodgements with ASIC, and nor can it appoint a replacement director (since it now has no human agents). The company is thus abandoned until such time it is placed into external administration by a creditor via court proceedings or is deregistered or administratively wound up by ASIC.

Nevertheless, the Consultation Paper indicates that phoenix operators can undertaking trading for a period of time with no directors in place, strip the company of any assets, leave behind unpaid debts and place the company into external administration.

The suggest reform is therefore to prevent a sole director resigning from the company by means of a provision which deems resignations in those circumstances to be invalid, thus leaving the incumbent director with only the option of either finding a replacement or winding up the company. There is also a suggestion that the abandonment of a company could become an offence.

Prevention of "vote stacking" to prevent removal of an external administrator

Presently whilst a liquidator or external administrator can be removed by a simple majority of creditors, those creditors can include related party creditors. Before a creditor can vote at a meeting, they must provide details of their claim to the external administrator. The Corporations Act however does not provide a level of proof which the external administrator must use to determine eligibility to vote. It is therefore possible for an external administrator to who wishes to remain in the position to permit votes by purported creditors whom he or she know will vote against his or her removal, and related party creditors of the directors who appointed the external administrator can use such votes to the prevent the removal of an external administrator who will potentially facilitate illegal phoenixing activity.

The proposal suggested is that the legislation be reformed to require an external administrator to disregard "related creditor" votes in respect of a resolution to remove and replace the external administrator. Whilst a relatively simple reform, it does seem like it could be effective in lessening the capacity of related parties to those who appointed the EA being able to entrench that EA's position.

Conclusion

Phoenixing is an ongoing problem within the Australia economy, and one which may well increase if and when Australia enters an economic downturn. The Consultation Paper from the Treasury represents the latest in a long line of attempts to reform the law in order to eradicate the practice.

However, whilst there are a number of specific areas where it would appear that improvements could be made to close loopholes used by phoenix operators, it is difficult to see why the existing broad provisions which already exist, and have always existed in modern company law, are not adequate to deal with the problem of phoenixing. Whether adding yet more provisions to the already voluminous *Corporations Act* would make any significant difference to the incidence of phoenix activity is far from clear. Ultimately it may be that what is more important is the more rigorous enforcement of the provisions which already exist rather than the augmentation of legislation, which may well require more resources to be provided to regulatory agencies to carry out these functions. Ultimately whilst a focus of the Consultation Paper seems to be to increase deterrence, no legislation can act as a deterrent if wrongdoers do not expect it will be enforced against them.