

---

# CREDIT ISSUES

---

## WOODGATE & CO.

Chartered Accountant

OCTOBER 2009

---

### ASIC TARGETS ADVISERS OF PHOENIX COMPANIES

---

#### Introduction

The Australian Securities and Investments Commission ("ASIC") defines phoenix activity as when a company:

- (i) fails and is unable to pay its debts; and/or,
- (ii) acts in a manner which intentionally denies unsecured creditors equal access to available assets in order to meet and pay debts; and,

within 12 months of the old business closing, another business commences which may use some or all of the assets of the old business, and is controlled by the same parties or parties related to either the management or directors of the old company.

Often the directors of the old company place the company into administration or liquidation with little or no assets to pay creditors.

Phoenix activity is not itself a specific offence under the *Corporations Act*, ("the Act") but it arises from directors misusing their position, which can be an offence.

The prosecution of directors involved in phoenix activity has long been a priority for ASIC, particularly since the introduction in 2006 of the Assetless Administration Fund. ASIC has now received a welcome and significant boost in the Supreme Court of New South Wales judgments of *ASIC v Somerville* and *ASIC v Somerville (No. 2)*.

Not only did ASIC successfully prosecute the directors of six failed companies, it successfully prosecuted the solicitor who had advised those directors, pursuant to Section 79 of the Act, as a person involved in the directors' alleged breaches. The Court noted that the real aim of ASIC was directed against the solicitor, because of his conduct in advising the other Defendants.

#### Nature of the transactions

In each case the director or directors of the companies had sought advice from the solicitor, because they were concerned that their companies were insolvent or under threat of insolvency.

In each case a new company was formed, usually with a similar name. The old company then transferred its assets to the new company in return for the issue of 100 V class shares in the new company.

---

#### DISCLAIMER:

The material contained in this newsletter is merely general commentary and the comments and information do not represent a legal or professional service. Advice should be sought from Woodgate & Co. in relation to the circumstances of each matter before acting in this area.

In each case, the solicitor's letter of advice was in very similar terms. The only variations arose as to the amount to be paid for the assets transferred and the figure up to which dividends from the new company would be paid to the old company. In all cases, no dividends were ever paid to the old companies.

Most of the documents necessary to effect the transactions, including the formation of the new companies, changes to company names, preparation of returns as to directors and officers and the preparation of resolutions altering the constitutions of the new companies to bring into existence the V class shares, were prepared by the solicitor.

#### *Case one – the furniture removalist*

Facing a statutory demand from the Australian Taxation Office ("ATO") for \$56,362, a winding up application from its workers' compensation insurer, and a separate demand for \$96,000 for unpaid superannuation, a removalist company transferred its assets to a new company in return for V class shares in the new company, with an entitlement to receive dividends totalling \$150,000.

Some four years later the new company received a statutory demand from its workers' compensation insurer and again sought advice from the same solicitor. The new company entered into a similar transaction with a second new company, this time with V class share dividend entitlements of \$50,000. All three companies had the same sole director.

#### *Case two – the IT support provider*

With debts exceeding \$200,000, an IT support company transferred its business in return for V class shares in

the new company, with a dividend entitlement limited to \$100,000. The transfer followed the service of a statutory demand by the ATO on the old company in the sum of \$136,642 and the service of a director penalty notice on its sole director.

Subsequently, the Liquidator appointed to the original company made a claim against the new company for an uncommercial transaction. This was settled for the sum of \$5,000.

#### *Case three – the software supplier*

A company involved in the marketing and servicing of software transferred its business to a new company in return for V class shares with an entitlement to dividends totalling \$100,000.

Only two years later the new company was also experiencing financial difficulties, with tax debts of \$278,000. The director contacted the solicitor again and the new company conducted an almost identical series of transactions with a third company. However, this time the V shares had an aggregate dividend entitlement of \$400,000.

#### *Case four – the furniture shop*

After receipt of a directors' penalty notice in the sum of \$15,255 and a statutory demand from the ATO for \$43,214, the company's business was transferred to a new company in return for V class shares in the new company with an entitlement to dividends totalling \$150,000.

#### *Case five – the transport, storage and distribution business*

After two employees commenced legal action in the Chief Industrial Magistrates' Court to recover underpaid employees' entitlements, the sole

the sole director consulted the solicitor. The company transferred its considerable assets to a new company in return for V class shares in the new company with an entitlement to dividends totalling \$2.5M. The transaction occurred after the employees had obtained judgments in excess of \$400,000. Subsequently, the director paid to the Liquidator of the old company the sum of \$150,000 to settle the Liquidator's claims against him.

#### *Case six – the metal finishing business*

After receipt of a statutory demand from the ATO for \$82,127 and a garnishee notice on the company's bank, a company transferred its assets to a new company in return for V class shares with an aggregate dividend entitlement of \$70,000.

#### **ASIC's argument**

In each case, the only consideration for the transfer of assets out of the old company was the issue of the V class shares. ASIC emphasised that in no case was a dividend actually declared or paid. ASIC noted the written advice from the solicitor in case four, which stated that from a practical point of view, the payment of such dividends would be discretionary. ASIC argued that in fact there was no real consideration at all and that any appearance of consideration was illusory.

#### **The solicitor's defence**

The solicitor explained that he had advised a great number of directors of insolvent companies and provided different types of advice, relevant to the circumstances. He said that he had given the advices in these proceedings, as he honestly believed that the creditors would be better off if the businesses could continue to trade

and pay off their creditors over time. The advice he proposed resulted in at least some of the creditors being paid. The Court did not accept this evidence.

#### **Findings**

The Court held that:

- judging by past trading history, the declaration of dividends was unlikely and was properly described as optional;
- it was clear that if a company was insolvent and if the interests of the creditors were disregarded and only the interests of shareholders considered, the directors cannot be acting in good faith;
- the only purpose of the transactions was to keep the benefit of the assets, without the burden of liabilities;
- there was no proper purpose in any of the impugned transactions and accordingly each was a breach of Section 181(1) of the Act;
- in each case the solicitor advised on and recommended the transaction which breached the Act and prepared or obtained all documents necessary and arranged the execution of the documents in all cases, with knowledge of the relevant facts;
- it was clear that the solicitor aided, abetted, counselled and procured the carrying out of the transactions and the transactions would not have taken place but for his involvement; and,
- after finding that the solicitor had given advice to carry out an improper activity and that he had done all the work involved in

carrying it out, apart from signing documents, there could be no question as to liability.

### **Penalties**

Notwithstanding a finding that at least one director had no concept of what he was doing and that some of the wrong doing was not of a particularly serious nature, the Court held that none of the directors had acted honestly. Each director was disqualified from managing a corporation for two years.

The Court specifically declined to accept that the solicitor genuinely held the beliefs that he claimed. The Court noted that in some cases the solicitor's oral evidence was contradicted by his written advice and said it was difficult to accept that the solicitor believed that

his actions were proper and in accordance with the law, because he must have known the consideration for the sale of assets was really a fiction. The solicitor was disqualified for acting as a director for six years.

The Court reserved a Costs Order. However, it indicated that the solicitor was really responsible for the whole of the proceedings and that he should bear a substantial portion of them.

### **Significance of the cases**

The judgments serve as a warning to professional advisors not to become involved in directors' contraventions of the Act and, in particular, to have special regard to the Act when advising directors of insolvent companies.

---

## **WOODGATE & CO.**

*Chartered Accountant and Insolvency Practitioners*

**Business Recovery Services**

Official Liquidator & Trustee in Bankruptcy

Level 14, 25 Bligh Street

Sydney, NSW, 2000

GPO Box 882, Sydney, NSW, 2001

Telephone: (02) 9233 6088 · Facsimile : (02) 9233 1616

[www.woodgateco.com.au](http://www.woodgateco.com.au)

*Associated Offices in*

**Melbourne · Brisbane · Adelaide · Perth**