CREDIT ISSUES

WOODGATE & CO.

Insolvency & Turnaround

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MORE LEGISLATION TO FIGHT PHOENIX ACTIVITY?

Discussion

In September 2017 the Australian Government released a consultation paper setting out proposals to address illegal phoenixing activity. The proposals include:

- setting up a phoeonix activity hotline;
- creating a specific offence in the *Corporations Act 2001* (Cth) ("Corporations Act") to prohibit the transfer of a company's assets to a new entity with the intention of defeating the claims of creditors of the original company;
- limiting the backdating of director appointments and resignations;
- restricting the rights of related creditors to vote at creditors' meetings;
- extending the tax promoter penalty laws to promotors or facilitators of illegal phoenixing activity;
- expanding the director penalty notice ("DPN") regime to include goods and services tax;
- strengthening the effectiveness of the tax security deposit regime;
- improving the targeting of high risk entities;
- in some cases, Liquidators being appointed on a cab rank basis rather than by shareholders' resolution;
- in some cases, reducing the period to act on a DPN from 21 days to zero days; and,
- providing the Australian Taxation Office ("ATO") with the power to withhold tax refunds due to the company.

Some of the proposals in the discussion paper have merit such as limiting the lodgement with Australian Securities and Investments Commission ("ASIC") of back dated director appointment and resignation documents, and providing the ATO with the power to retain refunds otherwise payable to high risk taxpayers. Other proposals such as the phoenix hotline or appointing Liquidators on a cab rank system, suffer from an apparent lack of commercial reality. Even if all of the proposals in the discussion paper were implemented, the impact on illegal phoenix activity may be marginal.

False assumptions?

One of the major problems with the current debate about phoenix activity is the lack of data about the impact of phoenix activity. The discussion paper referred to a report prepared by Price Waterhouse Coopers ("PwC") for the Fair Work Ombudsman in June 2012. That report estimated the cost of phoenix activity at between \$1.8B and \$3.2B, based on information for the year ended 30 June 2010 and a number of assumptions. PwC estimated the costs of phoenix activity to

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employees, business and government, of which the cost to business component was by far the largest at between $1B to $1.9B. The cost to business component was based on a report prepared in 1996 by the former Australian Securities Commission on the costs of phoenix activity and then indexed to 30 June 2010 values. Therefore, the costs of phoenix activity referred to in the discussion paper uses data, the source of which is partially at least 20 years old. It is not known how big or small the problem is currently.

Prior to any proposal to combat phoenix activity becoming the subject of legislation, it would be useful to obtain up-to-date and relevant data as to the incidence of phoenix activity. ASIC could obtain such data through the reports required to be lodged by Receivers, Administrators and Liquidators under Sections 422, 438D and 533 of the Corporations Act. Usually such reports are now filed electronically. Some additional questions could be added to the Schedule B questionnaire, such as:

- Did the investigations detect any evidence of phoenix activity?
- If so, estimate the gross value of the assets transferred from the company to newco.
- Was pre-insolvency advice involved in the transfer of assets to newco?

ASIC has from time to time amended the Schedule B questionnaire, most recently to obtain further data about insolvent trading.

There have been a number of steps taken by government to target phoenix activity, including:

1. in 1993 the introduction of the DPN regime;
2. in 2005 the provision of funding to ASIC to establish the Assetless Administration Fund, which now funds Liquidators to prepare reports in respect of assetless companies;
3. in 2007 the requirement that any company that changes its name six months prior to, or during an external administration, is required to disclose its former name, as well as its current name, on all public documents. Further, Liquidators are required to report misconduct to ASIC, within six months of becoming aware of the possible offence(s);
4. in 2012 the DPN regime was extended to unpaid superannuation guarantee charge as well as unreported and unpaid PAYG withholdings. Further, directors and their associates were also denied credits for PAYG withholdings deducted by a company, which later failed to remit the PAYG withholdings to the ATO; and,
5. in 2014 the ATO, State and Territory revenue offices, and other law enforcement bodies formed the Inter Agency Phoenix Forum to target phoenix activity.

It is difficult to believe that none of those steps has not curtailed phoenix activity.

It appears that one of the main drivers to stop phoenix activity, is the pressure on government to minimise the loss of tax revenue.

Books, records and documents

Books and records are often missing in company liquidations, whether phoenix activity has occurred or not. This is notwithstanding Sections 530A and 530B of the Corporations Act which were incorporated following recommendations in the 1988 Harmer Report. Section 530A imposes a positive duty on directors to deliver up the books and records of the company to the Liquidator, whilst Section 530B allows a Liquidator to obtain books and records from third parties, such as solicitors and accountants. As the Corporate Law Reform Bill 1992 noted, those powers were limited to the books and records of the company in liquidation.

Pre-insolvency advisors usually have a

good understanding of the powers of external administrators and the limits to those powers. Sometimes they gain that knowledge from being former insolvency practitioners, whilst others obtain that knowledge from their dealings as directors of failed companies. There is also some awareness in the business community that a Liquidator's power to obtain books and records is limited to the company subject to the external administration. With the increasing complexity of business structures and the effect of privacy laws, this is a significant restriction on a Liquidator's ability to investigate possible phoenix activity, along with other areas that warrant investigation such as insolvent trading.

An additional tool?

Sometimes the Liquidator may have sufficient funds to conduct public examinations and may request the Court to issue orders to third parties for production of documents. The legal costs of conducting a public examination can be significant. The Liquidator's remuneration will be an additional cost. However, more often than not, a Liquidator does not have the funds to conduct a public examination, let alone commence legal proceedings afterwards. Alternatively, if a Trustee in Bankruptcy has been appointed to the estate of the director, the Liquidator may request the Trustee in Bankruptcy to obtain information that assists both insolvency administrations, by issuing notices under Section 77A of *the Bankruptcy Act 1966* (Cth). This assumes a co-operative relationship between the Liquidator and the Trustee in Bankruptcy.

A Trustee in Bankruptcy is not limited to examining the financial affairs of the bankrupt but may also investigate any company, natural person, partnership or trust associated with the bankrupt. Section 77A notices are a relatively low cost way for a Trustee in Bankruptcy to obtain documentary evidence, compared to applications to Court to obtain Orders for Production of documents. This can be very helpful in performing a number of tasks, including tracing of funds. Trustees in Bankruptcy obtained this power as a consequence of the 1987 amendments to the *Bankruptcy Act 1966* (Cth) ("Bankruptcy Act"). The Explanatory Memorandum to the Bankruptcy Amendment Bill 1987 noted that the amendments were made following concerns raised by the 1984 Costigan Royal Commission into the Federated Ship Painters & Dockers Union. Sometimes legislative change can occur via a circuitous route.

Unfulfilled promise?

According to the Explanatory Memorandum to the Insolvency Law Reform Bill 2015, two objectives were to:

1. remove unnecessary costs and increase efficiency in insolvency administrations; and
2. align a range of specific rules relating to the handling of personal bankruptcies and corporate external administrations.

It remains to be seen whether those objectives are achieved, following the *Insolvency Law Reform Act 2016* (Cth) ("ILRA") becoming law. It is a pity that in trying to harmonise the corporate and personal insolvency law in the ILRA, Parliament chose not to provide Registered Liquidators with the tool already available to Bankruptcy Trustees under Section 77A of the Bankruptcy Act.

Perhaps a better way of disrupting phoenix operators is to broaden the powers available to Liquidators particularly to obtain documents which may assist their investigations.

Conclusion

Alternatively, and in light of the judgment in *ASIC v Somerville* [2009] NSWSC

934, why wouldn't ASIC just prosecute the directors and their advisors for breaches of directors' duties and aiding and abetting those breaches? As a further alternative, ASIC could fund Liquidators at commercial rates to conduct public examinations and commence legal proceedings. In any event, does the law need to be strengthened or does the will to enforce it need to be sharpened?

Submissions closed on 27 October 2017.

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