AUSTRALIAN INSTITUTE
of COMPANY DIRECTORS

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James Mason
Financial System Division
The Treasury
Langton Crescent
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via email: phoenixing@treasury.gov.au

Dear Mr Mason

Consultation on combatting illegal phoenixing

Thank you for the opportunity to provide input on the proposals outlined in the consultation paper titled 'Combatting illegal phoenixing' (**Consultation Paper)**.

The Australian Institute of Company Directors (**AICD**) is committed to excellence in governance. We make a positive impact on society and the economy through governance education, director development and advocacy. Our membership of more than 40,000 includes directors and senior leaders from business, government and the not-for-profit sectors.

The AICD strongly supports the government's aim of deterring and disrupting phoenixing activity that misuses the corporate form to strip assets from one company to another to avoid paying liabilities. In addition to the damage caused to immediate creditors, employees and stakeholders impacted by specific instances of phoenixing, this illegal activity damages confidence in the corporate model, to the detriment of the vast majority of responsible businesses and directors.

Effective laws, vigorously enforced, and attracting impactful and proportionate sanctions, are essential to combat these destructive illegal activities.

Timely gathering and sharing of information between regulators and other government agencies is also critical to addressing illegal phoenixing. It is for this reason that the AICD has endorsed the government's separate commitment to introduce 'director identification numbers' (**DINs**), as they will allow enforcement agencies to verify and track the relationships between directors and the entities they are associated with.

The AICD's views on the anti-phoenixing measures proposed in the Consultation Paper are summarised below in Section 1, and explored in greater detail in Sections 2 and 3. We have not addressed all of the options or questions posed in the Consultation Paper. In Section 4, we provide further comment on DINs.

1. SUMMARY

In assessing the options outlined in the Consultation Paper, the AICD has considered whether they add significantly to existing laws or whether more vigorous enforcement of current provisions could achieve the same outcomes. We have also considered the potential of the proposed reforms to impact on legitimate business activities and honest business restructuring.

In summary, the AICD:

- Supports a phoenix hotline, with appropriate resourcing and protocols for action;
- Supports the proposal to shift responsibility for notifying ASIC of board changes from the company to directors, provided that ASIC's systems facilitate streamlined lodgement by directors of the relevant forms;
- Believes there is merit in further exploring a mechanism for identifying and designating persons as a high risk phoenix operators (**HRPOs**);
- Supports the proposal to broaden the ATO's power to retain refunds owing to HRPOs in certain situations;
- Recommends that the ASIC Enforcement Review Taskforce consultation on strengthening penalties be expanded to cover the penalties applying in respect of all phoenixing-related breaches; and
- Encourages regulators to prioritise enforcement of existing phoenixing-related laws.

For the reasons set out below, the AICD is not convinced of the effectiveness of proposals relating to a specific phoenixing offence, promoter penalties, garnishee powers or extension of the director penalty notice (**DPN)** regime to GST other than in relation to HRPOs.

2. BROAD REFORMS

2.1 A phoenix hotline

The AICD supports the introduction of a 'phoenix hotline', as proposed in the Consultation Paper. A hotline has the potential to yield useful information on phoenixing activities that would supplement the information provided by liquidators to ASIC under ss 533, 422 and 438D of the *Corporations Act 2001* (Cth) (**Corporations Act**).

The AICD does not have a view on which agency would be best placed to operate the hotline, although ASIC would appear to be a logical choice. To ensure that detection and deterrence of wrongful phoenixing is meaningfully enhanced by the hotline, it would be essential to:

- Appropriately resource the hotline;
- Display the hotline's details prominently on all relevant agency websites, together with information explaining what illegal phoenix activity is, what sanctions may flow from engaging in it, and what avenues of redress may be available to creditors;
- Implement systems to facilitate timely sharing of information with all relevant agencies;
- Establish clear inter-agency protocols and accountabilities for responding to suspected illegal phoenixing; and
- Publicise details of successful enforcement actions.

For the hotline to be effective, the agencies responsible for taking action must be appropriately resourced, and willing, to act.

To ensure transparency around the hotline, the government should consider periodic reporting of the volume and nature of tip-offs provided, together with statistics on the enforcement action taken in response to hotline information. This would also serve to promote awareness of the hotline and profile enforcement action in relation to illegal phoenixing.

2.2 A phoenixing offence

<u>A specific phoenix offence</u>

The AICD does not support the creation of a specific phoenix offence that prohibits the transfer of property from one company for the main purpose of preventing, hindering or delaying the division of the property among the first company's creditors.

We question whether a new offence is necessary in light of the existing provisions in the Corporations Act that are available to penalise illegal phoenix activity, if enforced, including:

- As acknowledged in the Consultation Paper, conduct which constitutes illegal phoenix behaviour is generally a civil and/or criminal breach of a director's duties (including those in ss 180(1) to 184 of the Corporations Act, and their general law equivalents). Unlike the phoenix offence proposed in the Consultation Paper, these duties apply to all improper phoenix activities, not just those involving asset transfers;
- Section 596 of the Corporations Act sanctions, among other things, conduct intended to defraud the company or its creditors;
- Section 588FE(5) of the Corporations Act empowers a liquidator to claw back property transferred under an 'insolvent transaction' in circumstances where the 'company became a party to the relevant transaction for the purpose, or for purposes including the purpose, of defeating, delaying, or interfering with, the rights of any or all of its creditors on a winding up of the company'. Significantly, such transactions are voidable by the liquidator if they occurred within 10 years prior to the company's winding up. Also, unlike the proposed phoenixing offence, s 588FE(5) does not require that the purpose of defrauding creditors be the main purpose for which the transaction was undertaken; and
- Under ss 588FB and 588G of the Corporations Act, uncommercial property transfers may also trigger the insolvent trading provisions.

Action for breach of the ss 180(1) to 184 duties, or the duty to avoid insolvent trading, may lead to a court imposed disqualification, pecuniary penalties and/or compensation orders against the relevant directors. Persons 'involved' in a director's breach of ss 181, 182 or 183 may be similarly penalised. As discussed above, s 588FE(5) permits assets to be clawed back and contravention of s 596 constitutes an offence.

Given these existing provisions the AICD questions whether a new 'specific offence' is necessary. Similarly, we do not see a clear justification for a new administrative recovery procedure. Existing avenues to claw-back assets or seek compensation for the loss suffered are well established.

In our view, adequate resourcing and prioritising of enforcement action against those involved in illegal phoenix activity will be a more effective response to illegal phoenixing than a new offence.

The AICD does not support the rebuttable presumption proposed for the new phoenix offence and the suggested administrative recovery notice process. These would both unfairly have the effect of reversing the onus of proof.

Finally, we are concerned that the proposed offence, which is predicated on a presumption of insolvency, could risk undermining the insolvent trading safe harbour recently introduced to support reasonable attempts to turnaround financial destressed companies.

Should the government determine to adopt a phoenixing offence, the AICD strongly recommends that this offence place the onus on ASIC to establish the elements of the offence through a Court proceeding, rather than through an administrative penalty.

<u>Designating breaches of existing provisions as phoenix offences</u>

The AICD questions the value of designating certain existing offences, such as breach of the s 286(1) requirement to maintain financial records, as 'phoenix offences'. In our view, the

more appropriate course of action is to review the adequacy of the penalties that may be imposed upon a finding of breach.

Subject to the reservations expressed below in Section 3, we are not opposed in principle to the breach of certain provisions being deemed to trigger a 'Higher Risk Entity' (**HRE**) regime. However, we reserve our final position on this proposal until further details are revealed of the specific provisions to be including as a criterion automatically triggering a HRE designation.

2.3 Addressing issues with directorships

Limiting backdating of director appointments and resignations

The AICD understands that some phoenix operators arrange for the company to lodge the appropriate ASIC form notifying the regulator of a change of director, with the notice backdating the resignation so that they cannot be held liable as an officer of the company for offences committed after the alleged date of resignation.

Of the reform options proposed to address this misconduct, the AICD supports a shifting of the responsibility for reporting director resignations from the company to the individual resigning from office. However, as a practical matter, it would be critical that ASIC first have appropriate systems in place to permit directors to easily lodge relevant forms with ASIC.

The foreshadowed DIN regime may provide an opportunity for this to occur. If this proposal is progressed, it is essential that directors be afforded a convenient means of searching ASIC's records online to regularly verify the status of their directorships, independent of the corporation.

While we appreciate the intent of the proposals in relation to backdating of director resignations, the AICD is concerned that introducing a rebuttable presumption of liability for misconduct reverses the onus of proof, contrary to accepted principles of law. We believe that further consideration of this proposal is required, including its potential to inadvertently capture directors who have acted appropriately but been let down by administration failures of the corporation. If this proposal is progressed, it is essential that directors be provided with a convenient, real-time means of searching ASIC records to independently verify the status of their directorships. This is most likely to be effective as part of a full DIN system.

Abandoning a company

The AICD acknowledges the challenges relating to abandoned companies. However, we do not support the proposal to deem a resignation ineffective in circumstances where the board is left vacant and the company has not been wound up.

First, abandoning a company would likely constitute a breach of s 180(1) of the Corporations Act, thereby exposing the director to disqualification, a pecuniary penalty or a compensation order under the existing law. The AICD would encourage vigorous enforcement action based on existing penalties as the priority.

Secondly, we are concerned that such a law may perversely incentivise directors of troubled companies to resign early to ensure they do not become the sole director on the board, as so become precluded from resigning. This could have significant unintended consequences. At a time when it crucial that directors are focussing on the company's business and financial position, this could risk encouraging directors to resign prematurely. The insolvent trading safe harbour was recently introduced to alleviate a similarly perverse legislative incentive.

Instead, the AICD recommends that consideration be given to the appropriateness of abandonment as a criterion of being a HRE. To ensure the criterion is objective it would be

necessary to define abandonment so that it captures the concerning elements of phoenixing, for example, resigning in circumstances where the board becomes vacant, the company has outstanding liabilities and the company has not been wound up. The AICD would welcome consultation on this suggestion as a more effective means of achieving the policy aims.

2.4 Promoter penalties

The AICD is strongly of the view that persons who facilitate or encourage others in their engagement of illegal phoenixing activities should be sanctioned.

However, it appears that the accessorial provisions under the *Crimes (Taxation Offences) Act 1980* (Cth) and the Corporations Act already provide sufficient scope to penalise promoters of wrongful phoenixing.

Rather than the new reforms proposed in the Consultation Paper, the AICD urges effective enforcement of the existing laws through appropriate resourcing of regulators and prioritisation of enforcement actions in the phoenix context.

2.5 Extending the DPN regime to GST

The AICD has reservations about the proposal to extend the DPN regime to GST, particularly in respect of newly appointed directors, or directors who are not at high risk of illegal phoenix activity.

The AICD has long argued against the DPN regime's application to newly appointed directors who were not on the board at the time of the corporate breach giving rise to DPN. To impose personal liability for corporate breaches occurring at a time when the new director had no actual or legal ability to influence the conduct of the corporation offends a fundamental tenet of the rule of law. Making anyone liable to a penalty for the actions of another (whether it be a corporation or a natural person) in circumstances where the person was not involved in the breach and had no ability to influence the conduct leading to the breach is entirely contrary to the principles upon which our legal system is based.

We are also concerned that the proposal would make directors personally liable for the company's unpaid GST regardless of the directors' culpability or knowledge, particularly as the regime reverses the onus of proof so that directors are deemed to be liable unless they can make out one of the limited defences available under s 260-35 of the *Tax Administration Act 1953* (Cth).

We would, however, be less concerned about the proposed extension of the DPN regime if it is limited to directors designated as being a high risk phoenix operator (as discussed below in Section 3).

2.6 Security deposits

The Consultation Paper explains that there is no incentive for taxpayers to comply with an ATO demand for security in relation to existing or future tax liabilities that are at high risk of not being paid, in circumstances where the value of the security required exceeds the maximum penalty that could be imposed for non-compliance with the demand.

While recognising that this may be the case, the AICD is concerned about the unintended consequences of the proposal to permit the ATO to garnishee an amount from a third party to cover, in full or part, the amount of requested security. Specifically, the AICD believes that

garnishees may impair genuine business restructures by adversely impacting on the organisation's cash flows.

Instead of permitting garnishees, the AICD urges the government to reassess the appropriateness of the maximum penalty that can be imposed for refusing to provide the requested security. The AICD would support increasing the penalty to address this concern.

3. DEALING WITH HIGHER RISK ENTITIES

3.1 Targeting higher risk entities

The AICD agrees that there is merit in exploring a mechanism for identifying and designating persons as a HRPO for the purpose of imposing restrictions on their activities or increasing the avenues for redress against them for illegal conduct.

While we support the concept of a two-step approach to HRPO designations, additional parameters should be imposed in relation to the second step, namely, the ATO's power to administratively declare a HRE as a HRPO.

The AICD considers it essential that any HRPO declarations be open to merits review. For a review process to be meaningful, the parameters imposed on the ATO's administrative declaration power would require careful construction.

Despite our general endorsement of HRPO designation, the AICD urges the government to carefully consider and consult further on the disclosure issues arising in relation to the proposal. These issues include consideration of whether notice should be given of HRE designation, and the implications of a HRPO designation on an entity's continuous disclosure obligations (if any). These complex issues require further consultation and review.

3.2 Removing the 21 day waiting period for a DPN

We note that removing the 21 day waiting period for a DPN would have the effect of rendering HRPO directors personally liable for any unpaid PAYG(W), superannuation guarantee or GST. The AICD questions the practical impact that this proposal would have in disrupting illegal phoenix activity as sophisticated HRPOs are unlikely to retain substantial assets in their names. In contrast, it is important that HRPOs that are not intentionally seeking to unlawfully phoenix be afforded an opportunity to take corrective action in response to a DPN.

The AICD suggests that other more impactful mechanisms be explored such as those proposed by Professors Anderson, Ramsay, Hedges and Welsh in their submission to this consultation dated 9 October 2017. The AICD would welcome consultation on their proposals.

3.3 Providing the ATO with power to retain refunds

The AICD is supportive in-principle of the proposal to broaden the ATO's power to retain refunds that otherwise would have been refunded to a HRPO in circumstances where the HRPO has an overdue lodgement or notification capable of affecting their tax liability. This is predicated on HRPO designation being subject to merits review.

4. DIRECTOR IDENTIFICATION NUMBERS (DIN)

The AICD supports the introduction of DINs. The effective implementation of a DIN system would make it easier for regulators and other stakeholders to track the corporate history of individual directors. An effective DIN system would also support proposals to shift the

responsibility for reporting resignations from the company to individual directors and support further targeted anti-phoenixing measures.

As with any electronic identification system, information confidentiality and security issues will be of paramount importance in creating and implementing the DIN regime. The AICD urges the government to take the opportunity of introducing DINs to remove directors' personal information from public display.

In particular, we note that the ASIC company register displays the following personal information about each director: given (and former) names and family names; date and place of birth; and residential address. The introduction of a DIN regime would allow the removal of this personal information from public registers, with a more effective signifier introduced.

Given cybersecurity and privacy concerns, the AICD does not support the continued public availability of such a wide range of directors' personal information on the register. While there is some consideration in the areas of personal safety through a 'silent enrolment' from the Australian Electoral Office, this will not be appropriate for the vast majority of Australian directors and the current regulatory framework does not address the cybersecurity issues, such as identity fraud, arising from directors' personal information being publicly available.

Australian directors are far more exposed than their international counterparts in terms of the degree of public accessibility of personal information. The United Kingdom recently acted to reduce the risk to directors of identify fraud by requiring that only directors' month and year of birth be displayed on the companies register. Further, the UK companies register also does not display the place of birth and directors can opt for the publication of a 'service address' in place of a residential address on the public register.

The AICD recognises that there could be a case for access to personal information of company directors in circumstances where there is a public interest justification. Examples could include access by lawyers for legal notices or relevant legal research, or access for journalists for public interest journalism. The AICD recommends that the government use the introduction of DINs to investigate ways to enable access to personal information in relevant circumstances, for example through application to ASIC for defined or public interest purposes.

The AICD also supports the publication of a 'service address' in place of a residential address, on the ASIC companies register. This would enable legal practitioners and process servers to carry out their duties without the need to apply for information which is critical to commencing proceedings against directors.

If you would like to discuss any aspect of this submission, please contact Lysarne Pelling, Senior Policy Adviser, on (02) 8248 2708 or at lpelling@aicd.com.au.

Yours sincerely

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