25 October 2017

Mr James Mason
Financial System Division
The Treasury
Langton Crescent
PARKES ACT 2600

By email phoenixing@treasury.gov.au

Dear Mr Mason

CONSULTATION PAPER: COMBATTING ILLEGAL PHOENIXING
LEVI CONSULTING PTY LTD - SUBMISSION

I attach my firm's submission on the anti-phoenixing proposals set out in the above Consultation Paper.

Executive summary

I summarise the key points of our submissions.

1. We support reforms to stop illegal phoenixing including reforms to prevent activities of the pre-insolvency industry that is damaging the insolvency profession.

2. We support the introduction of an administrative recovery notice regime in corporate liquidations (similar to the present s139ZQ of the *Bankruptcy Act 1966* (Cth)), which will provide a more expedient and cost-effective manner of pursuing voidable transactions, including those transactions which reflect illegal phoenix activity.

3. We support measures to prevent directors abandoning companies or 'gaming the system' by backdating resignation notices. We support attaching the responsibility for notification of resignation of directorships to the directors themselves rather than merely the company concerned.

4. Our view is that a cab rank appointment system is an anti-competitive measure which sits in tension with recent law reforms introduced by the *Insolvency Law Reform Act 2016* (Cth) enhancing the rights of creditors to replace external administrators appointed under a voluntary system.

5. We support the limited exclusion of related creditor voting rights on resolutions for the removal and replacement of an external administrator, which will ensure the new and improved ILRA rights of creditors to replace external administrators work better and as intended.

6. We do not support the notion of a Government liquidator to conduct external administrations. The existing profession of private, registered liquidators are better placed – in terms of efficiency, competence, expertise and costs – to conduct external administrations. A Government liquidator would also confront complications borne from the fact that the Commonwealth Government is often a major creditor in external administrations.

7. Rather than creating new administrative (recurring) expenditure through a cab rank system or Government liquidator, Government funding and resources should be devoted to enforcement of present laws and providing liquidators of assetless companies with the funding required to pursue illegal phoenix activity.

8. We are concerned by proposals which seek to elevate the pre-liquidation rights and status of Government creditors (principally the Australian Taxation Office) above those enjoyed by other general unsecured creditors.

Please contact me with any issues.

Yours faithfully

David Levi

Director, Levi Consulting Pty Ltd

[redacted]

1 Broad Reforms

1.1 A Phoenix Hotline

1. *On a scale of one to ten, where one is 'ineffective' and ten is 'highly effective', please rate how well you think this measure will operate to deter and disrupt illegal phoenix activity.*

   We rate the proposed Phoenix Hotline "3" (almost ineffective). The nature of calls will be diverse. It is likely that stakeholders will be unable to correctly identify illegal phoenix activity. Resources have to be employed in order to determine whether what is reported satisfies the elements of illegal phoenix activity.

2. *Are there any other reporting mechanisms which you think would assist people to report suspected illegal phoenix activity?*

   Online reporting must be available at relevant government agencies including the ASIC. The ASIC currently do not have an online mechanism (i.e. via the Registered Liquidator's Portal) for reporting phoenix activity. The ASIC have to put additional resources in place to process reports submitted under sections 533, 422 and 438D of the Corporations Act in a timely manner. There is delayed processing of supplementary reports (i.e. 2 to 3 months turnaround) which in turn delays the finalisation of the external administration. It is very rare for the ASIC to escalate reports which disclosed substantive allegations of misconduct. In the ASIC's Annual Report 2015/2016, the ASIC did not confirm the number of reports which resulted in prosecution of directors.

3. *What are the benefits and risks of a 'phoenix hotline'?*

   We view the hotline as having limited benefits however we acknowledge that it is an information gathering tool. It is also an awareness tool that can encourage the public to report suspected phoenix activity. It is important that each government agency that operates the hotline puts in place procedures to share the information gathered across all relevant government agencies.

4. *Which agency do you believe would be best placed to operate such a hotline?*

   The ATO and the ASIC both have resources. As the corporate regulator, the ASIC appears to be the best placed agency to operate such a hotline.

5. *What public reporting would be appropriate to ensure transparency? What other mechanism could be considered?*

   The statistics released by the ASIC need to show reports received in respect of phoenix activity and action commenced by the ASIC in response to those reports. The ASIC should also consider reporting outcomes achieved by enforcement action arising from the reports, and also details of the offences, the offenders and penalties.

1.2 A Phoenixing Offence

6. *On a scale of one to ten, where one is 'ineffective' and ten is 'highly effective', please rate how well you think this measure will operate to deter and disrupt illegal phoenix activity.*

   We recognise the merit of creating a phoenixing offence provision and rate this proposed reform "7". A clear-cut provision which renders phoenix activity as an offence rectifies the limited scope of s588FE(5) which does not prohibit a transfer of assets (although it renders such a transfer voidable). The new provision must also clarify whether the offender had an "inferred purpose" similar to that in s121(2) of the *Bankruptcy Act* - the main purpose will be taken to be the purpose prescribed by the provision if it can reasonably be inferred that, at the time of the transaction, the company was insolvent. Statutory defences must be available to safeguard

legitimate transfers of assets (in good faith and for good value) which might be part of a genuine restructure of an insolvent company.

We suggest that creditors be granted the right to sue in respect of phoenix activity directly, similar to the right provided to them by the new provisions on the Liquidator's assignment of the right to sue (for example, for insolvent trading).

Further, we strongly support the introduction of an administrative recovery notice mechanism for liquidations, similar to that which is available in bankruptcy under s 139ZQ of the *Bankruptcy Act*. We consider that this will provide a more cost-effective and expedient process for liquidators to pursue obvious and actionable phoenix transactions under the existing law. The liquidator's power to issue an administrative recovery notice must not be impeded by a liquidator's inability to access books and records. The matter of books and records is significant, not only in terms of a director's obligation to deliver them to a liquidator (ss 530A and 530B) but also in terms of the requirement to keep written financial records under s286 of the Act. Non-compliance with these provisions makes it difficult for a liquidator to investigate and pursue actions to remedy illegal phoenix activity. We recommend that firmer penalties be imposed on directors for non-compliance with these provisions (including personal penalties or consequences for directors in the event of a breach of s 286 of the Act).

7. *What are the benefits and risks of this approach?*

As discussed above, it is useful to have a clear-cut definition in the Act of what constitutes a phoenixing offence.

8. *Should ASIC retain control of the issuing of such notices to ensure that they are not issued inappropriately?*

Our view is that the ASIC should not retail control of the issuing of administrative recovery notices. Registered liquidators and other regulated professionals can appropriately exercise any new power to issue administrative notices to recover compensation or property resulting from illegal phoenix transactions (such as uncommercial transactions). The ability of liquidators to issue notices independently would be beneficial as it will expedite the remedies that could be sought from offenders or beneficiaries of illegal phoenix activity.

9. *Are there other regulators who should also be able to issue such notices (for example the Fair Entitlement Guarantee Recovery Program)?*

The right to conduct recovery action should not be extended to individual creditors but should remain a matter of exercise by the Liquidator of his powers and discretion as an officer of the company and also as a fiduciary obliged to consider the interests of creditors as a whole in conducting the winding up. Interested creditors can always op to support or fund the liquidator to take action to pursue voidable transactions.

10. *Should liquidators have the ability to independently issue such notices in cases where they suspect that illegal phoenixing has taken place?*

Refer paragraph 8.

11. *How long should the law allow for the recipient to respond?*

We recommend a timeframe of 21 calendar days.

12. *What course of action should be pursued where the recipient fails to comply with a notice?*

A liquidator should be able to recover the amount payable under the notice as a debt in the liquidation.

13. *What are the some of the challenges ASIC is likely to face in seeking compliance with the notice?*

The likely challenges include the transfer of assets by the offender/defendant to reduce the capacity to meet a judgment, and also sham applications to set aside notices once they are issued.

14. *Do you think that such an arrangement will reduce the cost of taking recovery action or seeking compensation for the loss suffered?*

    It is our view that an administrative recovery notice regime would reduce the time and costs of taking action to avoid illegal phoenix transactions and obtain compensation for creditors. It will relieve the liquidator from the burden of commencing litigation to claim compensation.

15. *Are there safeguards which should be implemented in respect of the proposal?*

    It is our view that the ability of a recipient to apply to Court to set aside a notice is a sufficient safeguard.

16. *If such a provision were to be introduced, should any of the existing voidable transaction provisions be amended or repealed?*

    None. Refer paragraph 6. It is not necessary to amend or repeal s588FE(5).

17. *Are these remedies appropriate? Are there further remedies or penalties we should consider?*

    Appropriate. No additional remedies or penalties to consider.

18. *If the above amendments are made, should the law also be amended to include a specific provision to the effect that knowing involvement in a contravention of the provision will itself constitute a contravention of the provision (as per sections 181 — 183 of the Act)?*

    N/A. Refer paragraph 16.

19. *What tests can be applied to determine if a person has been involved in the facilitation of illegal phoenix activity?*

    Refer paragraphs 6 to 16. We think there is merit in introducing a new phoenixing offence. To maximise the utility of a new phoenixing offence, there must be enforcement and action, whether by regulators or by liquidators funded and supported by government.

20. *On a scale of one to ten, where one is 'ineffective' and ten is 'highly effective', please rate how well you think this measure will operate to deter and disrupt illegal phoenix activity.*

    Refer paragraph 6. We graded this measure "7".

21. *Which existing breaches of the law, if any, should be designated as phoenix offences?*

    Refer paragraphs 17 to 19.

1.3 Addressing issues with directorships

22. *On a scale of one to ten, where one is 'ineffective' and ten is 'highly effective', please rate how well you think this measure will operate to deter and disrupt illegal phoenix activity.*

    We rate this measure "8".

23. *Do you agree that there should be a rebuttable presumption that a director should still be held responsible for misconduct if the required notice is not lodged with ASIC in a timely way?*

We agree with the proposed rebuttable presumption. A director must be responsible for reporting the resignation and cannot abrogate the reporting obligation to the company, which may be an assetless shell. We support a similar approach to the existing s 286 of the Ac (obligation to keep financial records).

There is value in the directors subscribing to a portal or register which can be searched by the public to verify whether an individual is a director of any company (including directorships of which the individual in question may not be aware).

24. *What are the benefits and risks of this approach?*

There is benefit in preventing abuse of the law by directors who backdate resignations to avoid responsibility and accountability. We cannot identify obvious risks or downside to this proposed measure.

25. *What is a reasonable period to allow for the requisite notice to be lodged with ASIC?*

We submit that 14 calendar days (or 10 business days) is a reasonable period for a director to notify the ASIC of their resignation.

26. *Should the onus for reporting to ASIC be placed on the individual director, rather than the company? If so, would this constitute a significant compliance burden?*

Refer paragraph 23. The onus should be on the individual director who has resigned. We do not think this constitutes a significant compliance burden as the individual director benefits from this reporting regime – he or she can obtain certainty that his or her resignation has been acknowledged and recorded. It will also empower directors to protect themselves while at the same time reducing the risk of phoenix activity. A system of mutual reporting or accessible system of record which aligns with the introduction of the 'Director Identification Number' (DIN) must be established. Directors to whom the responsibility would attach also require adequate information.

27. *How should the above measure be enforced? For example, by application to court or ASIC taking other administrative action?*

We submit that the presumption (ie, that a director whose resignation is lodged late may be held liable for misconduct that occurred up to the date of lodgement) should only be capable of being overturned or rebutted upon application to Court. We presume that the director who is the subject of the late lodgement of notice of resignation would remain (post-resignation) subject to the usual statutory and general law directors' duties unless the director obtained a court order overturning this position

28. *On a scale of one to ten, where one is 'ineffective' and ten is 'highly effective', please rate how well you think this measure will operate to deter and disrupt illegal phoenix activity.*

We grade this measure "8".

29. *Should sole directors be able to resign without appointing a liquidator or deregistering the company?*

We do not think this should be allowed. The importance of a director's obligations contradicts allowing such practice.

30. *What are the benefits and risks of this approach?*

We cannot identify any risks. There is a clear benefit – namely, limiting the proliferation of 'zombie' companies and their potential use in perpetrating phoenix activity.

We do note the potential situation which may arise if there are only two remaining directors of a company. If one of those directors resigned, this would leave the remaining sole director unable to resign unilaterally. Therefore, consideration might be given to whether a director, whose resignation would leave a company with a sole director, must first give a period of notice to the other director who stands to be the sole remaining

director after that resignation takes effect. This would at least give the prospective sole remaining director some advance notice of the situation in which they will soon find themselves by reason of their fellow director's resignation.

31. *Should abandoning a company instead be an offence?*

No. We submit that the law should prevent the resignation of a sole director taking effect unless the director has first either arranged for the appointment of a replacement director, appointment of a liquidator, or deregistration (deregistration would of course require the usual declaration from the director as to the company's assets and liabilities).

32. *Should a company with no director for a prescribed period be automatically deregistered? If so, what would be an appropriate period before deregistration should commence?*

We note that this scenario should become rare if the proposed measure was implemented. However, there would be cases where a company may, for instance, be unintentionally abandoned due to the death of a sole director. In such instances we submit that ASIC should have the power to administratively wind up the company or deregister it.

We note that ASIC presently has the power to administratively wind up 'dormant' or 'zombie' companies which may assist employees who have the ability to make claims under the Fair Entitlements Guarantee ('FEG') Scheme if their employer enters liquidation: s 489EA of the Act.

33. *What other options are available for consideration?*

We have no other submission to make on this point.

1.4 Restrictions on voting rights

34. *On a scale of one to ten, where one is 'ineffective' and ten is 'highly effective', please rate how well you think this measure will operate to deter and disrupt illegal phoenix activity.*

We rate this "9" (very high) insofar as the proposed restriction on voting rights of related party creditors is limited to resolutions for the proposed removal and replacement of an external administrator (and to the extent that a liquidator is aware of – or able to verify – a creditor's 'related' status).

35. *What are the benefits and risks of this approach?*

Recent reforms introduced by the ILRA enhance the rights of creditors to replace external administrators. We submit that these rights would be supported and complemented by a further measure which restricts the ability of related creditors to 'block' or obstruct the attempts by arms-length creditors to replace an external administrator if there is a perception that the practitioner chosen by the directors will not act in their interests. Indeed, as we submit below at [2.2], these new rights of replacement are one reason we submit that a cab rank system of appointment is unnecessary.

That said, we observe that any exclusion of related creditor votes will only be effective to the extent that a liquidator is aware of – or able to verify – a creditor's 'related' status.

36. *Is the current definition of "related creditor" too broad for this purpose? If so, how should "related creditor' be defined?*

The definition of 'related creditor', presumably that which is set out in s 75-41(4) of Schedule 2 to the Act, incorporates the definition of 'related entity' in s 5 of the *Bankruptcy Act*. That definition does not appear to be unduly broad and captures the range of related parties whose votes, we submit, should be excluded from any resolution dealing with the removal and replacement of an external administrator appointed by directors of a company.

37. *Should related creditors that were company employees be subjected to a different treatment than, say, if they were directors? Why or why not?*

No. We do not see why there should be any distinction within classes or categories of related creditors for the purposes of excluding voting rights on resolutions for the replacement of an external administrator.

38. *What level of evidence should be imposed on related creditors to substantiate their respective debts?*

We support a limited exclusion of related creditors' voting rights relating to resolutions for the removal and replacement of an external administrator. In all other contexts and for all other resolutions (or indeed for the purposes of distribution and dividends), related creditors need to substantiate their proofs and claims (whether formal proofs or for voting purposes) to the same extent as any other creditor. This should not and need not change.

The administrator is entitled to reject a related creditor's proof of debt for voting purposes if it cannot be substantiated because of a director's non-production of the company's books and records (which would otherwise enable such substantiation): *Re Waleri Nominees* [2003] VSC 42. An administrator is entitled to consider circumstances and matters beyond that which appear in the proof of debt itself.

Presently, s 75-100(2) of the *Insolvency Practice Rules (Corporations) 2016* ('IPRs') provides that the person presiding at a creditors' meeting, in deciding the entitlement of a person to vote 'must have regard to the merits of a person's claim'. Unnecessary complexity will be introduced to creditors' meetings if different evidentiary standards, burdens or tests are legislated and applied to creditors' proofs of debt for voting purposes, depending on whether a proof is lodged by a related or arms-length creditor. This complexity will just add time and cost to the process of creditors' meetings in external administrations.

39. *Should restrictions on related creditor voting be extended to all resolutions proposed in an external administration? Why or why not?*

We do not support a broad restriction on related creditor voting rights for all resolutions in external administrations. Subject to substantiation of their claims, related creditors are still creditors and legitimate stakeholders in an insolvency procedure. To the extent that the primary concern surrounds the ability of related creditors to block the attempts of arms-length creditors to override the directors' choice of external administrator, any restriction of related creditor voting rights should be targeted to this scenario and this issue.

Where related creditors in an external administration constitute a majority in number or value, broadly excluding their voting rights would hinder the efficient and cost-effective conduct of external administrations. For example, approval of remuneration could be more likely to necessitate an application to court if there are insufficient arms-length creditors to approve remuneration (whether due to a lack of quorum or because no arms-length creditor responds to a proposal without meeting).

40. *Will limiting related creditor voting participation in a creditors' meeting add additional complexities to proceedings? For example quorum requirements in order to validly hold a creditors' meeting.*

We repeat our submission in paragraph 39. If the restrictions on voting rights of related creditors are limited to removal/replacement resolutions, we do not envisage any additional complexities for the conduct of external administrations.

41. *Should the above rule apply to a particular size or type of external administrations or liquidations?*

We submit that the policy justification for the *limited* exclusion of related creditor voting rights applies regardless of the size or type of external administration.

42. *Should the court have the power to overturn this restriction?*

In respect of resolutions for the removal and replacement of an external administrator, there is presently an ability of the 'outgoing administrator' to apply to Court for reappointment where he/she has been replaced by an 'improper use' of this power vested in creditors: s 90-35(4)-(6) of Sch 2 to the Act. This could possibly be

extended by providing for an excluded related creditor to also have standing to make such an application for relief against a resolution for the removal and replacement of an external administrator by arms-length creditors (if ss 90-10 and 90-15 of Sch 2 do not already provide such capacity for relief).

43. *Should this restriction only be applied to certain types of companies, for example small proprietary companies?*

No. We repeat our submission above in relation to Question No. 41.

44. *Are there circumstances where this restriction should not apply?*

No. We repeat our submission above in relation to Questions No. 41 and 42.

45. *What are some of the ways a related creditor might attempt to circumvent the above measure?*

It is conceivable that some related creditors may seek to circumvent any limits on their voting rights by debt trading.

46. *What other measures could be considered to avoid collusion between liquidators and related creditors?*

We reject the premise that this an issue or problem of a general or widespread nature. The Consultation Paper itself acknowledges that 'the overwhelming majority of registered liquidators … have done the right thing.' The few registered liquidators who allegedly are not 'doing the right thing' should be the focus of regulatory attention and action.

1.5 Promoter penalties

47. *On a scale of one to ten, where one is 'ineffective' and ten is 'highly effective', please rate how well you think this measure will operate to deter and disrupt illegal phoenix activity.*

We rate this measure "2" (ineffective).

48. *Should the promoter penalty laws be expanded to apply to promoters or facilitators of illegal phoenix activity?*

As a professional, there are already consequences of facilitating illegal phoenix activity

There are presently laws in place to deal with facilitators of illegal phoenix activity such as s 79 of the *Corporations Act* which was used by ASIC to prosecute a solicitor that advised directors on phoenix activity (*ASIC v Somerville & Ors* [2009] NSWSC 934).

There is also the *Crimes (Taxation Offences) Act 1980* which can be used to impose criminal sanctions where a person enters into an arrangement with the intention of securing that a company will be unable to pay a range of taxes, including SGC. Liability can also be imposed on advisors.

Rather than create new laws, existing laws should be better enforced. If necessary, penalties under existing laws could be increased to act as a greater deterrent.

49. *What are the benefits and risks of this approach?*

See above.

50. *If the promoter penalty laws are expanded to illegal phoenix activity, how would they best be structured? For example by adding a new limb to the existing provisions or creating a separate new provision?*

Existing law already addresses the issue. New law is not necessary.

51. *Are there additional safeguards that would be needed to ensure innocent advisers are not caught by the provisions? Should the adviser have to corroborate that they acted as mere adviser and not as a promoter?*

    New law is not necessary.

52. *If promoter penalties are expanded to apply to promoters of illegal phoenix activity, do the existing sanctions provide sufficient deterrent?*

    New law is not necessary.

53. *Are the offences of civil penalty and criminal prosecution available under section 202 the Superannuation Industry (Supervision) ACT 1993 preferred to the promoter penalty options above?*

    New law is not necessary.

54. *An alternative approach to stop the promotion or facilitation of illegal phoenix activity may be a Court order to require specific performance of some action, for example, submitting a company liquidation proposal for consideration by ASIC. Is there merit in this or alternate approaches to effectively deter those who promote or facilitate illegal phoenix activity?*

    New law is not necessary.

    We would however recommend that registration of advisors be required in the same way that to:

    - provide legal advice you must be a lawyer
    - undertake an insolvency administration you must be a registered liquidator
    - provide financial advice you must hold an Australian Financial Services Licence
    - provide tax advice you must be registered with the Tax Practitioners Board.

    If registration of the advisor is required, then facilitating phoenix behaviour could result in the registration being removed.

1.6 Extending the Director Penalty Notice regime to GST

55. *On a scale of one to ten, where one is 'ineffective' and ten is 'highly effective', please rate how well you think this measure will operate to deter and disrupt illegal phoenix activity.*

    We rate this "9" (very high).

56. *What are the benefits and risks of this approach?*

    We agree that the DPN regime should be extended to cover all Commonwealth tax debts. In our view this at least encourages reporting to avoid the lockdown provisions. As a result, the ATO is informed as to outstanding tax debts and can implement processes to recover debts in a timely fashion. Failure to report means the ATO may lack transparency of the outstanding tax position.

    However, the effectiveness of the DPN regime is limited to the assets held by the directors subject to the notices. It is likely that sophisticated directors will not hold any substantial assets in their own names and will have taken steps to minimise their personal risks prior to taking directorships. In this case, bankruptcy and the subsequent inability to act as a director may be the consequence of the DPN process.

As discussed earlier in this submission, we do hold concerns about the ATO's increasing priority position and the impact that has on ordinary unsecured creditors, particularly small business creditors.

57. *Should the DPN regime be expanded to cover GST for all directors, or be restricted to those identified as High Risk Phoenix Operators (see Part Two)?*

The DPN regime for GST should operate in the same way as the current process.

58. *Are there alternative approaches to securing outstanding payment of GST from companies and their directors?*

Yes, proactive monitoring and requirement for timely payment of GST liabilities – this should be the same approach for all taxes.

Consideration of the implementation of a single touch approach for GST – possibly implemented as single touch reporting for transactions over a certain size or in particular industries.

1.7 Security Deposits

59. *On a scale of one to ten, where one is 'ineffective' and ten is 'highly effective', please rate how well you think this measure will operate to deter and disrupt illegal phoenix activity.*

We rate this "6" (medium)

60. *What are the benefits and risks of this approach?*

The benefits are greater protection for the ATO, but this is at the potential detriment of other unsecured creditors.

61. *Would improvements to the garnishee provisions adequately address the proposal to strengthen the effectiveness of the security deposit power?*

We disagree with the use of garnishees as they unfairly advantage the ATO. If the ATO is going to have the power to garnishee, the garnishee proceeds should be subject to potential recovery as preferential payments in the event of a subsequent liquidation. All other creditors that receive payments from a company that may be insolvent run the risk of the payment being subsequently recovered and it is unfair that the ATO can avoid this risk.

62. *Should the proposal be limited to businesses that have been identified as High Risk Phoenix Operators (see Part Two)?*

We do not agree with the use of a HPRO designation.

63. *Are there concerns or practical issues that would need to be addressed with expanding the garnishee power generally for future tax liabilities?*

We do not agree that future tax liabilities should be able to be addressed by expanding the garnishee power. We do not agree with the unfair advantage provided to the ATO by the current use of garnishees. Extending garnishee powers to possible future tax liabilities would only increase this advantage to the detriment of the company's other unsecured creditors.

64. *Are there any further concerns if this were achieved through amending the definition of 'tax-related liability' to include the amount of an anticipated future tax liability which is the subject of a security deposit demand?*

We hold the same concerns as discussed at 63.

65. *Are there any issues with the existing garnishee processes that should be considered?*

Yes, as mentioned at paragraph 61, garnishees provide an unfair advantage to the ATO as the ATO is able to obtain payment without risk of subsequent recovery as a preference.

Furthermore, they are able to enforce garnishees after the appointment of a voluntary administrator against both pre-appointment and post-appointment debtors to the detriment of other creditors and against the objectives of Part 5.3A of the Act.

66. *Should the Government consider additional measures to prevent circumvention of the provisions by transferring, disposing or encumbering assets where a request is issued?*

The Act already provides a range of recovery provisions in the event of liquidation, including for recovery of uncommercial transactions, unreasonable director-related transactions and unfair preferences (which can include taking security for no value).

The ATO needs to proactively pursue recovery of debts to liquidation if necessary.

Reforms need to be made to encourage director compliance with their obligations to provide RATAs and books and records to liquidators, ASIC needs to be more proactive in prosecuting directors for breaches of their duties and funding needs to be provided to liquidators so that they can undertake recovery actions for the benefit of creditors.

There is no point creating new laws – it is better to proactively pursue enforcement and recovery under the laws that are already available.

67. *Should the penalties for not complying with a security deposit request be increased to improve compliance?*

Note our concerns expressed above with regards to the ATO's increasing priority position and the impact that has on ordinary unsecured creditors, particularly small business creditors.

2 Dealing with Higher Risk Entities
2.1 Targeting higher risk entities

68. *On a scale of one to ten, where one is 'ineffective' and ten is 'highly effective', please rate how well you think this measure will operate to deter and disrupt illegal phoenix activity*.

We rate this "3" (low).

69. *What are the benefits and risks of this approach?*

It appears that many of the features of the proposed 'objective test' for designation as a 'Higher Risk Entity' ('HRE') already are either breaches of existing laws (eg, failure to provide books and records to a liquidator) or factors which are existing elements of the provisions in Part 2D.6 of the Act which provides for the disqualification of persons from managing corporations.

Indeed, it could be said that Part 2D.6 of the Act already serves as a regime for designating and dealing with 'high risk' persons. Instead of constructing another similar regime, these existing laws could and should be enforced with greater resolve.

Putting aside the provisions for automatic or court-ordered disqualification on the grounds of convictions, bankruptcy or the contravention of a civil penalty provision (ss 206B and 206C of the Act), a person may be disqualified by the Court or by ASIC for involvement in the failure of two or more corporations (ss 206D and 206F of the Act). ASIC's power of disqualification is based on the lodgement of a s 533 report by a liquidator for each of the corporations concerned. A s 533 report may be lodged due to either apprehended misconduct/breach of duty or the inability of the company to pay unsecured creditors more than 50 cents in the dollar.

ARITA receives regular feedback from its member registered liquidators that s 533 reports are rarely acted upon by ASIC. This appears to be borne out by ASIC's recent reports on enforcement measures and outcomes: ASIC's Annual Report 2015/16.

If the stated intention is indeed to 'target the most egregious illegal phoenix operators who have adopted phoenixing into their business model' then the existing disqualification regime in Part 2D.6 of the Act is sufficient and appropriately calibrated to enable regulator action to prevent these individuals from continuing to enjoy the privilege of trading through a corporation. This is the very reason these provisions exist: to guard against abuse of the corporate form.

In terms of risks of the proposed approach, it appears reasonable to assume that notification of a decision to declare an individual a High Risk Phoenix Operator ('HRPO'), followed by a review process, would simply increase the operator's apprehension of forthcoming regulator action. This may simply serve as a 'tip-off', prompting earlier sharp practices before the regulator moves to apply any 'preventative measures'.

70. *Are the safeguards for designating HRPO sufficient? Can you suggest any alternative safeguards that would still allow for swift preventative action to be taken to prevent phoenix activity from occurring?*

71. *What safeguards would be required to ensure that the measure is appropriately targeted?*

72. *Should the Commissioner of Taxation have a discretion to declare a company of which a HRPO is, or has recently been, an officer to also be a HRPO? Should this be extended to other individuals or entities which are associates of the HRPO?*

73. *Should "associate" be defined or determined administratively?*

Addressing these four questions (70-73) together, we repeat our submission above in respect of paragraph 69.

2.2 Appointing liquidators on a cab rank basis

We acknowledge the need for a mechanism that enables early intervention to hinder or limit illegal phoenix activity. However, putting aside the recent ILRA reforms which deliver such a mechanism (discussed further below), we also note that the Consultation Paper refers to the 'incentive' or 'opportunities' for registered liquidators to facilitate illegal phoenix activity but cites no evidence or empirical research in support (or as evidence) of the prevalence of such activity.

We also observe that:

- Australian general law independence standards are rigorous and case law in recent years has demonstrated that the existing laws are able to address problematic referral relationships and their potentially adverse impact on investigations carried out by an external administrator;[1]
- Recent changes to the law implemented by the *Insolvency Law Reform Act 2016* (Cth) ('ILRA') have made it easier for creditors to replace an external administrator if they harbour discontent with the performance of an incumbent practitioner in the discharge of his/her role and responsibilities;
- 'High risk phoenix operators' could be identified and dealt with under existing laws (eg, director disqualification provisions) so that there are fewer 'phoenix operators' managing corporations in the first place. In this regard, see our submission above at [2.1];
- The Consultation Paper acknowledges the role played by 'pre-insolvency advisers' in facilitating phoenix activity. Our view is that there are grounds for characterising such pre-insolvency advisers as either:
    - unlawfully engaging in legal practice in breach of State and Territory legislation regulating the entitlement to provide legal advice (such entitlement being limited to admitted lawyers who hold a current practising certificate); or
    - unlawfully providing financial product advice without an Australian financial services licence ('AFSL').

Unlike legal practitioners and registered liquidators who are entitled to give advice to directors of insolvent companies in the course of lawful and regulated professional practice, pre-insolvency advisers who facilitate phoenix activity would appear to be doing so in flagrant breach of existing State/Territory or Commonwealth legislation.

There is a pressing need for regulatory action – either by the Legal Services Commissions in various States and Territories or by ASIC at the Federal level – to restrain pre-insolvency advisers from plying their trade and facilitating phoenix strategies.

2.2.1 Option 1: High risk phoenix operators

74. *On a scale of one to ten, where one is 'ineffective' and ten is 'highly effective', please rate how well you think this measure will operate to deter and disrupt illegal phoenix activity.*

We rate this "2" (very low).

[1] *Australian Securities and Investments Commission v Franklin (liquidator), in the matter of Walton Construction Pty Ltd* [2014] FCAFC 85.

The notion of a cab rank or 'roster' system for the appointment of external administrators to voluntary insolvency procedures has previously been considered – and rejected – in Australia.

We note that registries of various State and Territory Supreme Courts may still administer, if required, a rotational system for court appointments whereby applicants for a winding up order may approach the registry which may select a liquidator from a list maintained by the Court (whereupon the applicant must then proceed to seek a signed consent from that selected liquidator). However, the designation of 'Official Liquidator' was abolished in March 2017 and, as a practical matter, it has been the case for some time that usually the applicant (petitioning creditor) obtains and furnishes the Court with a consent signed by a registered liquidator and the Court will proceed to appoint the applicant's nominee.

Turning to voluntary appointments, the 1988 *Harmer Report* addressed the notion of a 'roster basis' for the appointment of an administrator. After acknowledging the importance of the independence of administrators and that 'the administrator not be the "puppet" of the directors', the Commission concluded that:[2]

> '*A roster system would detract from the voluntary nature of the procedure. The quality of administrators would inevitably vary from person to person. The directors may have proposals for dealing with the company's insolvency. In fact, the existence of those proposals may have encouraged the directors to have the company voluntarily submit its affairs to a particular insolvency administrator. Therefore, it is important that the company, at least in the initial stages, should have some freedom of choice in appointing the administrator*.'

The *Harmer Report* also acknowledged that there were other 'sufficient safeguards towards ensuring … independence': Registered liquidators have appropriate experience and qualifications and owe general law duties of independence which can, in some circumstances, justify a court order for their removal. Certain close connections between a practitioner and a company will also disqualify a practitioner from taking an appointment.

With the addition of the ARITA Code of Professional Practice, the safeguards identified in the Harmer Report are still part of the legal landscape affecting the appointment of liquidators and administrators today. Liquidators and administrators are disqualified (under the *Corporations Act*) from taking appointments in the event of certain pre-appointment connections with the company. Further, there are general law duties of actual and perceived independence which apply to external administrators of collective insolvency procedures (ie, liquidations and voluntary administrations).

We envisage practical difficulties in the efficient administration of a cab rank or 'roster' system which incorporates (as it must) a right to refuse consent to an appointment on various grounds (eg, conflict or time, experience or resource constraints). It is possible that days (or even a week) could pass before an appointee accepts an appointment. This delay may result in significant prejudice to stakeholders (creditors).

It stands to reason that the few 'dishonest liquidators' said to exist – and whose existence is the very rationale for the notion of a cab rank system – will also be panel liquidators, capable of taking appointments to companies whose officers are HRPOs. There is no suggestion in the Consultation Paper that any registered liquidator will be ineligible as a panel liquidator for the mooted cab rank.

This highlights the logical flaw in the proposed cab rank system: unscrupulous registered liquidators need to be sanctioned or deregistered rather than be incorporated into a modified appointment system which is designed to rein in their conduct. Alternatively, any notion of excluding certain registered liquidators from the cab rank panel would beg the question as to why the individual is still registered at all.

Further, the very existence of a cab rank is anti-competitive. As the *Harmer Report* alluded to, the quality of the performance of various practitioners should be expected to affect directors' choice of practitioners for prospective appointments. If the decision to engage professionals with a track record of high quality work is taken out of the hands of the market and put under Government control, this diminishes competition. Indeed, it could be said that it reduces incentives for practitioners to aspire to excellence and efficiency in service

[2] General Insolvency Inquiry (ALRC Report 45), pp 37, 38.

delivery. Why seek to achieve distinction in the market for one's work when the ability to attract new engagements is determined by a roster rather than market forces and perceptions?

For the same reasons, a cab rank system will mean that the costs of some external administrations will be higher than they otherwise would have been. Some directors, faced with the choice between two practitioners of commensurate standing and quality, will not be able to choose the one with lower charge-out rates. This is how competition can work for the benefit of stakeholders in an external administration.

Ultimately, a cab rank is a step towards the 'de-professionalisation' of the highly specialised and expert work performed by registered liquidators. Similar considerations apply to the notion of a Government liquidator, addressed in more detail below.

75. *Are there alternate measures that would be more effective? If so, please provide an outline of what you think would work*.

Rather than establishing and administering a cab rank, we contend that a more effective use of ASIC's current expenditure on the regulation of registered liquidators ($10.2 million in annual costs) could adequately address any liquidators who have been identified as facilitating their appointors' interests to the detriment of creditors.

The recent changes to the rules for the conduct of external administrators introduced by the ILRA enhance the ability of creditors to replace external administrators 'as of right', rather than having to apply to a court and 'show cause' for the replacement of the practitioner. These mechanisms, which have only been in force for less than two months, will provide creditors with the means to take appropriate action where there is an apprehension that a liquidator either lacks independence, is not carrying out due investigations or is failing to fulfil any other aspect of his/her role and duties.

We accept that excluding related party creditor votes for the purposes of voting on a resolution to replace an incumbent practitioner would strengthen these new rules and make them work even more effectively.

Against the background of these recent improvements to creditors' rights to replace external administrators, the notion of a can rank appears premature.

76. *Currently, it is intended that the cab rank be restricted to circumstances where an HRPO is or has recently been an officer of the company*. *Should a cab rank apply to all external administration appointments?*

We do not think a cab rank system of appointments has merit for any type of appointment of an external administrator.

However, the potential problems and impracticalities of a cab rank rule would be even more acute for voluntary administrations, where there may be a very real need to make an urgent or timely appointment of a practitioner with appropriate industry experience and requisite resources. The administration of a roster system of appointment could mean several days to complete an appointment and obtain the Part 5.3A statutory moratorium. Such a delay could prejudice the preservation of business value or compromise potential outcomes and returns to creditors.

77. *Should it be applied more widely, but be limited to specified types of external administration appointments where certain criteria are met? For example:*

- *whether it was a director initiated creditors' voluntary liquidation and/or the appointment of a liquidator following a voluntary administration*
- *industry sector*
- *whether pre-insolvency advice was received*
- *prescribed criteria on the company's financial affairs*
- *when there has been a recent transfer identified for some or all the companies assets*

- *where there has been a change of directors within a prescribed period.*

If the cab rank applies only to those companies where specified criteria are met what should those criteria be? Please specify your reasons.

As a general point, we are sceptical of the capacity for a cab rank system to be applied accurately and efficiently against the above criteria.

To the extent that circumstances of pre-insolvency advice, financial affairs and asset transfers were relevant criteria, presumably this would necessitate a declaration or provision of information by directors, which would then be used for the purposes of administering the cab rank. Again, this administrative process would take a good deal of time and, in any event, the outcome would be only as reliable as the declarations or information provided by directors.

Another important consideration in applying a cab rank to, say, creditors' voluntary liquidations ('CVLs') but not to voluntary administrations is that this may create the unintended consequence of directors favouring one type of procedure over another solely due to the ability to invoke a voluntary appointment procedure. Insolvent companies which are suited to a CVL may become the subject of voluntary administration appointments when in fact liquidation is the only feasible fate for those companies.

We also note that under the current law creditors can influence the choice of insolvency practitioner who acts as either administrator of a deed of company arrangement or liquidator following a voluntary administration.[3]

78. *Who should administer the cab rank and how should it be administered? Please explain your reasoning*.

The practical issues, cost and unintended consequences of a cab rank appointment system will exist regardless of what Government agency might be responsible for administering it.

79. *How do you think such a system should be funded?*

The notion of a cab rank appointment mechanism is an excessive measure, the cost of which will be disproportionate to the 'opportunities' stated to exist for a 'dishonest liquidator' to facilitate misconduct.

The Consultation Paper itself acknowledges the 'overwhelming majority of registered liquidators who have done the right thing'. Accordingly, any cab rank system should not constitute a cost of regulating registered liquidators and therefore should not be recovered from registered liquidators under the new ASIC Industry Funding Model.

On the matter of funding liquidators to conduct basic investigations and reporting, we acknowledge and agree with the statement in the Consultation Paper that the activities of liquidators need to be funded in instances of low or no-asset companies.

2.2.2 A Government liquidator

80. *On a scale of one to ten, where one is 'ineffective' and ten is 'highly effective', please rate how well you think this measure will operate to deter and disrupt illegal phoenix activity.*

We rate this "2" (very low).

81. *Should consideration be given to establishing a government liquidator to conduct small-to-medium external administrations? Please provide your reasons.*

[3] Sections 444A(2) and 499(2A) of the *Corporations Act 2001* (Cth).

We do not support of the notion of a government liquidator to conduct external administrations (regardless of their size, however that might be defined or determined). Broadly, we identify two drawbacks of a government liquidator:

- The existing profession of private, registered liquidators are better placed – in terms of efficiency, competence, expertise and costs – to conduct external administrations. What is needed is more funding of registered liquidators to enable them to carry out investigations and take the necessary action to pursue perpetrators or beneficiaries of illegal phoenix activity. Registered liquidators are part of the solution, not part of the problem.
- The Commonwealth Government is often a major creditor in external administrations, either through the ATO or the Department of Employment which administers the FEG Scheme. The ATO is not uncommonly met with claims to disgorge unfair preference payments. For this reason, we think issues and questions arise as to the independence or potential conflict of interest where a major creditor is responsible for conducting an external administration and deciding whether to appoint a private registered liquidator (and who to appoint).

We also reject the presumption that the occurrence of phoenix activity is limited to 'small-to-medium' external administrations.

82. *What are the benefits and risks of this approach?*

Refer paragraph 82.

83. *If a government liquidator is created, what external administrations should they conduct? Please provide your reasons.*
84. Refer paragraph 82.
85. *How do you believe a government liquidator should be funded?*

Refer paragraph 82. We believe that serious consideration should be given to increasing Government funding of registered liquidators to investigate and pursue remedies for illegal phoenix activity. This is far preferable to appropriating scarce Government resources and funding to the conduct of external administrations.

2.3 Removing the 21-day waiting period for a DPN

86. *On a scale of one to ten, where one is 'ineffective' and ten is 'highly effective', please rate how well you think this measure will operate to deter and disrupt illegal phoenix activity.*

We rate this "2" (very low).

87. *Should the 21 day notice period be removed where a director has been designated as a HRPO?*

No, directors are entitled to a period in which to attempt to deal with the DPN (noting that we do not agree with the HRPO designation).

The fact that DPNs are served at the time they are put in the post also means that if this change were made, enforcement could occur with no notice.

88. *What are the benefits and risks of this approach?*

As noted earlier in this submission, it is likely that sophisticated directors will not hold any substantial assets in their own names and will have taken steps to minimise their personal risks prior to taking directorships (for example through the transfer of assets into trusts). This will have occurred well before the issuance of any DPN.

If the director is unable to pay and ends up bankrupt, the bankruptcy trustee has powers to recover assets for the benefit of the estate where applicable. The laws already exist to overcome the behaviour set out in the consultation paper, trustees just need to be funded to take the needed action.

89. *Should further safeguards attach to DPNs issued to HRPOs in addition to the existing legal rights and safeguards that currently apply to DPNs?*

See above paragraph 88.

90. *Are there alternative approaches to stop a designated HRPO from disposing of their personal assets once they are aware they are required to pay a director penalty?*

Existing legislation already exists to recover any such transfers in the event of bankruptcy. It is important that a trustee in bankruptcy is funded to undertake such actions.

2.4 Providing the ATO with the power to retain refunds

91. *On a scale of one to ten, where one is 'ineffective' and ten is 'highly effective', please rate how well you think this measure will operate to deter and disrupt illegal phoenix activity.*

We rate this "3" (low).

92. *Should the ATO's power to retain refunds be broadened in respect of HRPOs who have failed to provide other notifications/lodgements capable of affecting their tax liability?*

Yes, but this should be extended to all taxpayers, not just HPROs (noting that we are not supportive of the HPRO designation). If a taxpayer has not complied with their reporting obligations, they should not be entitled to a refund until their tax affairs are bought up to date.

93. *What are the benefits and risks of this approach?*

The benefits are to ensure that the taxpayer is up to date with their reporting obligations prior to making refund to reduce the risk of refunding when there is a pending obligation. The risk is that the unexpected loss of cashflow will detrimentally affect the business and other creditors.

94. *Should this proposed power be broadened further where notifications are not yet due but will become due in the next reporting cycle? For example where lodgement of an income tax return by the HRPO is not due for some months but is expected to result in a significant liability, should the ATO be able to retain a refund presently owed?*

The ATO should have to follow a process to determine likely liability (such as an estimated assessment) in order to be able to retain the refund. The outcome of the process should be able to be administratively challenged. It should not be a unilateral power to retain.

Unilateral power for early retention of a refund would likely force businesses suffering some level of financial difficulty to fail (possible prematurely) due to cash flow disruption and may cause other creditors to suffer a more significant loss.