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13 November 2017

James Mason
Senior Adviser
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The Treasury
Langton Crescent
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By email
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Dear Mr Mason

Combatting Illegal Phoenix Reform

The Australian Government recently released a Consultation Paper entitled "Combatting Illegal Phoenixing", seeking feedback on a number of proposed measures involved in the reform, which measures, in the words of the Consultation Paper, "*aimed at countering illegal phoenixing, and which are intended to form the Government's third tranche of insolvency law reforms*".

Baker McKenzie welcomes the opportunity to provide a submission in response to the Consultation Paper on combatting illegal phoenixing.

Baker McKenzie is a leading international law firm with over 77 offices in 47 countries. Our submission is based on our extensive experience having worked on some of the most high-profile restructuring and formal appointments in Australia, which engagements involve a wide array of stakeholders including financiers, directors and senior executives, insolvency practitioners and all types of creditors.

The purpose of this submission is to provide a series of observations to be considered by the Government. We do not intend to comment on each issue canvassed in the Consultation Paper. Rather, we limit our submission, in summary form, to issues on which we have a particular opinion.

1. General comments

Importance of implementing measures

As a general comment, we are supportive of the proposed reform that aims to combat illegal phoenix activity. There is no doubt that illegal phoenix activity is on the rise, yet the lack of resources available means that it is impossible for regulators to pursue every case of illegal phoenix activity. In many cases, perpetuators of illegal phoenixing suffer no consequences for their actions, despite the loss caused to stakeholders such as the Australian Taxation Office **(ATO)**, trade creditors and tax payers through the public funding of the Fair Entitlements Guarantee scheme.

A range of measures has been proposed with the intention to address loopholes, or inadequacies we say, in the existing legislative framework. Many of the measures appear to have a preventative focus and to serve as deterrents. Overall, the Consultation Paper is an excellent starting point to drive discussions although, we are concerned that some respects of the proposed reform, such as restrictions on related creditors' voting rights, may be deemed excessive and not necessarily achieve the desired effects.

To achieve a balance which measures would not unintendedly jeopardise honest business rescue, it is important that Government undertake a careful evaluation of the consequences likely to flow from each of the measures, and be wary that the measures are not inconsistent with the recent ipso facto and safe harbour reform, which aims to promote a true culture of corporate rescue and restructuring.

Involvement of other authorities - focus on advisors

Aside from the proposals canvassed in the Consultation Paper, there is a further, and important, proposal to consider. This proposal goes to regulation of the advisors who, according to anecdotal evidence, are central to much illegal phoenix activity.

We propose that careful consideration be given to better coordination of Commonwealth authorities with industry and State-based bodies, to regulate and, where appropriate, move aside advisors who promote or support illegal phoenix activity. There is anecdotal evidence that many of those advisors are holding themselves out to be providing either (a) accounting, (b) legal, or (c) financial services advice. Often, the advice provided in facilitating illegal phoenix activity is done without the requisite professional license, or in breach of the professional obligations that accompany such a license.

The State-based legal industry regulators, together with the accounting industry bodies and ASIC (as regulator of financial services licensees), have considerable powers, experience and resources to regulate individuals who misconduct themselves in providing (or purporting to provide) professional services. A focus for those bodies on individuals involved in facilitating illegal phoenix activity may be expected to substantially hamper that activity - without the need for any Commonwealth regulatory reform.

A key issue in better co-ordination between ASIC, State-based legal industry regulators and the accounting industry bodies will be facilitation of information sharing, particularly by ASIC (as the body who receives reporting from registered liquidators about insolvent companies who have conducted illegal phoenix activity). The privacy and confidentiality issues with such information sharing should be considered carefully, with a view to reform that better facilitates information sharing and co-ordination of regulatory activity.

We now turn to the Consultation Paper itself.

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2. A phoenix hotline (Questions 1 - 5)

A phoenix hotline is likely to be effective in achieving a more streamlined process of reporting and collation of information. It minimises resources being wasted on matching up information, which can be advantageous to effective regulatory investigation and enforcement.

We are concerned that information providers would not be informed about how or when such information was used. There appears to be few drawbacks associated with providing a channel for information providers to follow up on the regulator's investigation and be informed.

Undoubtedly, it would be imprudent to upload all reported suspected illegal phoenix activity on a website available for inspection by the public, for the obvious reason that such website can negatively impact on the suspects in circumstances where the reported cases have not been fully examined or proven.

We suggest that information providers be provided with a case number regardless of whether they choose to report anonymously. The case number enables information providers to enquire as to the progress of an investigation and to provide further evidence if needed. Transparency is, in our view, essential in encouraging the public to report illegal phoenix activity and making sure that each report is taken with the seriousness it deserves. Provided the case number is only provided to the information provider and not to be shared with the public, there should be no issue arising from the reporting of assertions which could be detrimental to one's reputation.

It would be appropriate for ASIC to be the operator of the phoenix hotline. ASIC's expertise as a corporate regulator and access to the company registers, can be important for an efficient initial screening and preliminary investigation.

Effectiveness rating: 5 out of 10

3. A phoenix offence (Questions 6 - 16)

Broadly speaking, the proposed introduction of a notice system which seeks re-transfer of assets to the insolvent company can be a powerful tool in deterring illegal phoenix activity. The notice system attempts to form a simplified process of recovery, which acts as an alternative to the existing recovery action regime under the *Corporations Act 2001* (Cth) (the **Act**) or section 37A of the *Conveyancing Act 1919* (NSW) (the **Conveyancing Act**), where these recovery actions are often costly to pursue. There are however, some risks which must be drawn to the attention of the Government:

(a) The notice system is debatably contrary to the object of Part 5.3A of the Act. Part 5.3A exists to maximise the chance of survival of a company or its business. This is because a simple process of notice to reverse a transaction can discourage transactions involving distressed companies, and hence stifle the continued existence of struggling businesses.

(b) The notice system, as it is currently proposed, enables a notice to be issued so long as ASIC suspects an illegal phoenix activity has occurred and the sale of assets was effected for no or less than market value. The burden of proof then shifts to the recipient of the notice to prove otherwise. The threshold is seemingly too low and involves a considerable amount of subjectivity. Without any specific definitional boundaries or requirements, the notice could be misused by regulators, which creates a culture of unwillingness to engage in honest corporate rescue outside of formal insolvency. This is inconsistent with the policy behind the recent "safe harbour" reform.

(c) It may be more appropriate to have the burden of proof placed on the issuer of the notice, rather than on the recipient of the notice. That way it ensures that notice is not issued recklessly or purposelessly, which exerts pressure on purchasers of insolvent company's businesses.

If a notice system is introduced, it is suggested that:

(a) the power of issuing a notice be vested in ASIC only, to ensure consistency in relation to the issuing of notices. Liquidators and other non-ASIC regulators may report to ASIC if they are able to provide information sufficient for a notice to be issued;

(b) an administrative review process be created, which occurs prior to any judicial review. Not only would it reduce legal costs of both ASIC and the recipient of notice, it also lessen the burden of the court and reduce the use of ASIC's resources for defending any notices issued;

(c) the penalty for non-compliance of the notice be set on the high end, and it may be appropriate to criminalise deliberate dissipation of assets upon receipt of notice with the intent to frustrate ASIC's enforcement; and

(d) recipient should be given no more than 21 days to comply with the notice, unless otherwise extended with the leave of the court.

With respect to the proposed amendment to the Act to specifically prohibit the transfer of property from one company to another "*if the main purpose of the transfer was to prevent, hinder or delay the process of that property becoming available for division among the first company's creditors*", we cannot see any harm in amending the Act to that effect. Whilst the proposed amendment appears to overlap with section 37A of the *Conveyancing Act* (in New South Wales), the new amendment is explicitly targeted at an insolvency scenario and in particular, illegal phoenix activity. In determining the use of "*main purpose*" in the proposed provision, it may be worthwhile to consider the current judicial position in relation to a section 37A claim, where there is no requirement that the intent to defraud to be the sole and predominant purpose of the transferor, so long as there is an intent to defraud.[1]

[1] See *Marcolongo v Chan* (2001) 274 ALR 634 and *Patel v Lal* [2011] NSWSC 603.

In any event, it is expected that the amendment, if introduced to the Act, will be prone to challenges in court.

Effectiveness rating: 8 out of 10

4. Remedies (Questions 17 - 19)

It is entirely appropriate for liquidators and ASIC to be able to claw back assets or seek compensation through court process, from directors of the transferor, the transferee, and from others who are knowingly involved in the illegal phoenix activity. Creditors, on the other hand, should not be permitted to commence proceedings unless:

(a) consent of the liquidators or ASIC is obtained;[2] or

(b) the liquidators agree to assign those potential causes of action to the creditors.[3]

We appreciate that the difference between honest business rescue and illegal phoenix activity lies primarily on the question of intent to defeat creditors, which intent will require judicial determination. With that in mind, it would be sensible to include a non-exhaustive list of considerations to be taken into account by the court when determining whether a person has been involved in the facilitation of illegal phoenix activity, in the manner similar to section 90-15(4) of Schedule 2 to the Act.[4] By way of example, the proposed list may include:

(a) objective reasons of the transfer of assets;

(b) relationship between the insolvent company and the purchaser of the business;

(c) consideration of interests of the creditors prior to the transfer of assets;

(d) knowledge of the company's insolvency;

(e) steps that have been taken to repay debts owed to those creditors;

(f) historical record of the incurring of debt by the insolvent company.

5. Addressing issues with directorship (Questions 22 - 27)

When a director resigns from a company, he or she owes no further duties to the company. For this reason, the existing system which places the burden on the company to report to ASIC, is completely justified.

The rebuttable presumption imposed under the proposed reform renders a director liable for misconduct that had occurred up to the point of lodgement of the resignation, even if such resignation was lodged late. We consider that the

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[2] Similar to the operation of section 588R of the Act.

[3] Similar to where liquidators assign causes of action for possible breaches of directors' duties to creditors.

[4] Section 90-15(4) provides a list of matters which may be considered by the court when making orders in relation to the external administration of a company.

liability is disproportionate if the responsibility to lodge resignation notices is not borne by the director.

It would be helpful for the legislation to specifically provide that the lodgement responsibility is borne by the resigning director. This can then resolve the practical and theoretical absurdity that resigning directors, who have no authority to lodge such forms, are liable for misconduct for the company's failure to comply with the requirements. Provided that a convenient online lodgement system is set up, we do not envisage there to be significant compliance burden for a former director to lodge a form within 28 days of his or her resignation.

From an enforcement perspective, it may be suitable to prescribe a specific time frame for a former director to rebut the presumption by producing relevant evidence to ASIC. Once that time frame has expired and no reasonable effort has been made to rebut that presumption, the director will have to apply to court and any cost incurred cannot be sought against ASIC or other parties.

Effectiveness rating: 5 out of 10

6. Abandoning a company (Questions 28 - 33)

Question 29 contains an error – a liquidator can only be appointed by creditors or members, not directors. Directors can only appoint voluntary administrators.

We are of the firm view that there is no justification for sole directors to resign leaving the company without a director. A restriction on a sole director's ability to resign from office without finding a replacement director or appointing a voluntary administrator can prevent the company from trading without a director. This ensures the presence of a director who is accountable to any liability incurred by the company or arising from his or her breaches of directors' duties.

In the normal course a director would cause the relevant company to lodge a deregistration application with ASIC, if the company has ceased trading - this is a straightforward and cheap administrative process. Unless the Government could identify any legitimate circumstances where a company (particularly the one that is insolvent) can be abandoned, it is not unreasonable to make the abandonment of a company an offence. If, upon further review and consultation, the Government can identify these "legitimate circumstances" which would justify an abandonment of company, the circumstances can be included in the relevant offence as a defence.

Effectiveness rating: 5 out of 10

7. Restrictions on voting rights (Questions 34 - 46)

Whilst the Consultation Paper has identified some flaws in the current regime which can be exploited by phoenix operators by "vote stacking", the proposed measure seemingly proceeds on the premise that <u>all</u> related creditors would vote against the interests of other unrelated creditors.

The current definition of "related creditor" is unfortunately too broad for the purpose of the proposed measure. Indeed, it is nearly impossible to draft a "related creditor" definition that is sufficiently flexible to adjust to the different circumstances. Exclusion of a particular category of related creditor for the same purpose is unlikely to work either.

It would similarly not be feasible to have a particular person determine whether a related creditor should be excluded, due to the difficulty in formulating an appropriate definition or set of criteria. It would also be inappropriate to have administrators or liquidators determine the exclusion of a related creditor due to potential conflict of interest for that decision-maker.

In light of the above, we consider that the restrictions on related creditors' rights are likely to prejudice the rights of related creditors. The existing power pursuant to section 90-35 of Schedule 2 to the Act for creditors to replace an external administrator is, in our view, sufficient for now. Besides, in our experience it is difficult to see how, practically, greater restrictions on voting rights can be effective in combatting illegal phoenix activity.

If this measure is to be implemented, it will be necessary to provide an option for related creditors to apply to an independent body such as ASIC or the Court to have the restrictions released.

Effectiveness rating: 1 out of 10

8. Promoter penalties (Questions 47 - 54)

As touched on in the introduction to this submission, greater attention to advisors (or promoters) in the field of illegal phoenix activity is warranted and will, in our view, be highly effective.

Given that illegal phoenix activity tend to have a tax element and is in some cases driven by an intention to avoid payment of the company's tax obligations, the expansion of the promoter penalty laws to include promoter of illegal phoenix activity is likely to be impactful in terms of deterrence. Nonetheless, we strongly recommend that defences be made available, regardless of whether Option One, Option Two or Option Three is adopted.

One defence that may be considered is where the advisers were misled by the directors, resulting in them giving an advice that has the effect of defeating creditors. Provided that the advisers have taken reasonable steps to enquire and validate information provided to them, they should not be held liable for promoter penalty liability.

Further, as noted above, there is good reason to implement a program where professional bodies such as the Law Society of the relevant State and Chartered Accountants can collaboratively detect these wrongdoers and report them to the regulatory bodies.

Whilst we are not in favour of the imposition of criminal liability on a promoter, a substantial maximum penalty should be introduced such that it acts as a disincentive to engage in or promote illegal phoenix.

Effectiveness rating: 7 out of 10

9. Targeting Higher Risk Entities (Questions 68 - 73)

The two-tier approach set out in the Consultation Paper, which includes an automatic designation as a HRE based on a fixed set of criteria, and a discretionary designation as a HRPO (presumably taking into consideration surrounding circumstances), is in our view an innovative measure to undertake a more targeted approach to individuals who are more likely than not illegal phoenix operators.

In contrast to the conferral of the HRE status, which is purely objective, the identification process of HRPO is almost entirely subjective based on criteria that are not identified in the Consultation Paper. Bearing in mind the ramifications that would typically flow from designation as an HRPO, the Government should consider devising a list of objective considerations that must be taken into account prior to declaring an individual or entity as a HRPO.

Considering the inevitable human error and subjectivity involved in the decision-making process of declaring a HRPO, an internal review process should also be established to enable a HRPO to request for a review of the decision.

To increase the effectiveness of this measure, it is recommended that a public register be set up which discloses information of all HRPOs and is available to the public for free. The public register can be a valuable due diligence tool for the public, and acts as a effective deterrent to those who have engaged (or intend to engage) in illegal phoenix activity.

Effectiveness rating: 9 out of 10

10. Appointing liquidators on a cab rank basis (Questions 74 - 80)

It is proposed that the cab rank system should, if implemented, be limited to HRPO. We acknowledge, however, that such a limitation will reduce the effectiveness of the measure in face of first-time illegal phoenix offenders.

In the event that a cab rank system applies to all external administration appointments, it will pose serious risks to the business model of many insolvency practitioners who rely heavily on their own referral networks, which in the vast majority of cases is not concerned with facilitating illegal phoenix activity. The system has an effect of punishing insolvency practitioners financially even if they adhere to the highest ethical standards and had never involved in illegal phoenix activity.

It may be pointless to devise a set of criteria in respect of company for the application of the cab rank. The ever-changing nature of modern businesses may render any criteria redundant and prone to exploitation by phoenix operators.

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In short, we are concerned at the effectiveness of the cab rank - it penalises the vast majority of the insolvency practitioner profession, with little obvious benefit.

Effectiveness rating: 2 out of 10

11. Appointing a government liquidator (Questions 81 - 85)

Whilst the notion of appointing a government liquidator ostensibly ensures a "*streamlined external administration of small-to-medium size enterprises*", it begs the questions of whether the government liquidator can be funded to the same level as that of private liquidators and if so, what funding model should be adopted. If the government liquidator is not sufficiently funded, it will lead to a situation where the company's affairs are not fully investigated and illegal phoenix operators will be unidentified. It would not only fail to eliminate illegal phoenix activity but also damage the interests of creditors.

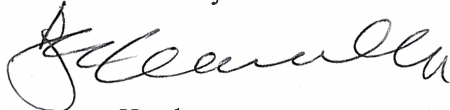
Further, it is unclear when and who can determine the appointment of a private registered liquidator if a government liquidator model is implemented. If the power of determination is vested in a government liquidator, we are concerned that a government liquidator may act merely as a "screener" who refers most of the engagements to a private liquidator, which extra work is redundant and could have been eliminated to achieve greater efficiency.

In any event, the type of engagement a government liquidator can conduct should be limited to small-to-medium external administrations. Due to the complexity inherently associated with large-scale external administrations, it is best to leave such engagements with private liquidators who have the requisite resources and experience to manage those situations.

Effectiveness rating: 2 out of 10

Please do not hesitate to contact us if you wish to discuss any aspect of this submission.

Yours sincerely



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