Nathania Nero
Senior Adviser
Corporations Policy Unit
Consumer and Corporations Division
The Treasury
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SYDNEY 2000

Dear Nathania,

I wish to make a submission in respect of the proposed laws regarding illegal or fraudulent Phoenix Activity, being the draft "Treasury Laws Amendment (Combating Illegal Phoenixing) Bill 2018" and "Insolvency Practice Rules (Corporations) Amendment (Restricting Related Creditor Voting Rights) Rules 2018".

I am a registered liquidator and have been for over 30 years. Also I was previously a trustee in bankruptcy. I was the National Chairman of an Australia wide insolvency practice. I have been practising as a barrister since the late 1990s and "full time" since 2008. I appeared before the Senate Enquiry into the regulation, registration and remuneration of insolvency practitioners in Australia. I was a Board member of the NSW State Chamber of Commerce and secretary of the NSW Division of the Insolvency Practitioners Association of Australia (now known as ARITA).

I respectfully suggest that I have a great deal of knowledge and experience in this area of the law and practice and my opinions should be of some assistance to Treasury.

For over a decade, my comments have been published and discussed on the subject of phoenix companies.

In early 2010 I made a submission on the 2009 Proposals Paper titled "Action against fraudulent phoenix activity" issued by the Business Tax division of Treasury (as it existed back then).

In that submission I made reference to papers I had written and which had been published in professional magazines back in 2006/2007 on the same subject. I attach a copy of that submission. In reading it and the extracts from my earlier articles, now a decade later, I continue to hold the same beliefs and concerns.

I have also recently presented a number of seminars to members of the legal profession in which the subject of Phoenix companies was discussed. I attach a copy of the paper presented during the 2017 and 2018 seminars.

I appreciate that in combating illegal or fraudulent phoenix activity, there is a difficult line to be drawn between illegal activities and acceptable activities.

My submissions seek to find the right line and to balance the desire to save jobs and maximise the return to creditors, against the desire to combat unacceptable business activity.

There is also a need to recognise the existence of current laws, any deficiencies in those laws, any deficiencies in the monitoring and enforcement of compliance with those laws and the cost and inconvenience of introducing new laws (which may not improve the position). If it is not broken, then don't fix it, particularly if there may be unintended consequences from the changes and if the real problem is with monitoring/enforcement of what currently exists.

I am aware that, notwithstanding the best intentions behind these proposals, there can be unintended consequences of any change in the law. I seek to avoid those unintended consequences by expressing my opinion and in some cases warning of the possible or even likely outcomes. It may also be easier to explain my thoughts and opinions by reference to practical examples and for those examples to be at the extreme end of the spectrum.

I make these submissions by reference to the exposure draft of the foregoing Bills and in particular the sections therein, which for ease of reference, I have extracted and reproduced in this submission. I respectfully make the following submissions;

588FDB Creditor defeating disposition

(1) A disposition of property of a company is a creditor defeating disposition if the disposition has the effect of:

(a) preventing the property from becoming available for the benefit of the company's creditors in the winding up of the company; or

(b) hindering, or significantly delaying, the process of making the property available for the benefit of the company's creditors in the winding up of the company

The above proposed law contains the critical definition of a **creditor defeating disposition**.

In my opinion, the above definition would result in the proposed laws being applied to each and every sale of a company's business or assets, even to bona fide unrelated purchasers for fair value (assuming the vendor company was thereafter wound up).

Further, there is no recognition of transactions which occur every day in the ordinary course of business.

I expect that such transactions are not intended to be the target of the proposed laws.

If the above proposed law is analysed, I submit that it must be construed in this way.

A sale of a business must be a transaction which results in the disposition of property. The word "disposal" is defined in www.dictionary.com as "a disposing or allotting of, as by gift or sale".

Surely, any property or asset which is disposed cannot thereafter be available for the vendor, nor the creditors of the vendor.

The section pays no regard to the proceeds of sale or disposition.

I recommend that the section be amended such that the highlighted words are inserted;

588FDB Creditor defeating disposition

(1) A disposition of property of a company is a creditor defeating disposition if the disposition has the effect of:

(a) preventing the property ***or all proceeds or consideration for the disposition of that property,*** *from becoming available for the benefit of the company's creditors in the winding up of the company; or*

(b) hindering, or significantly delaying, the process of making the property ***or all proceeds or consideration for the disposition of that property,*** *available for the benefit of the company's creditors in the winding up of the company.*

This change would then provide protection and an exemption when property has been sold or disposed, but where all of the sale proceeds from any disposition have been made available for the company. This would accord with a normal transaction of selling any property of a company, whether that be in the ordinary course of business or otherwise.

This change does not cater for the not uncommon circumstance of a company disposing of its assets and offsetting the sale consideration in some way (e.g. sale of business in which credit is given for taking over accrued employee entitlements).

This type of transaction could be protected if the following change was made to the proposed laws;

"preventing the property or all proceeds or consideration for the disposition of that property, from becoming available for the benefit of the company's creditors ***before or after*** ~~*in*~~ *the winding up of the company"*

If the company received the sale proceeds and then subsequently disposed of that property, then that subsequent transaction would be subjected to the proposed laws and the many laws which already exist, such as those laws which deal with void preferences.

In my opinion, the definition of a creditor defeating transaction still remains cumbersome and contains irrelevant terms.

If property is available for the company, at the time the company is wound up, then one must assume that such property is available for the creditors. This begs the question as to why the words "*creditors in the winding up of the company*" are needed and the definition does not simply end at *"available for the benefit of the company"*.

It is unclear why the term "*the process of making*" is used within the definition "*hindering, or significantly delaying, the process of making the property … available*".

The objective of the proposed law is that the property is made available. The words of "*the process of making*" only confuses the issue and does not assist in fulfilling the objectives of the proposed law.

In an extreme example, the transport company which fails to deliver items to a liquidator on time has delayed the process of making property available. That company is exposed to liabilities from that conduct; surely an unintended consequence of the proposed law.

In my opinion the objective of the proposed changes to the law is to discourage and prohibit transactions by which property is taken away from the company for no or inadequate consideration.

There is little more to it than that.

After subsection 588FE(6A), insert:

(6B) The transaction is voidable if:

(a) it is a creditor defeating disposition of property of the company; and

(b) at least one of the following applies:

(i) the transaction was entered into, or an act was done for the purposes of giving effect to it, when the company was insolvent;

(ii) the company became insolvent because of the transaction or an act done for the purposes of giving effect to the transaction;

(iii) less than 12 months after the transaction or an act done for the purposes of giving effect to the transaction, the start of an external administration (as defined in Schedule 2) of the company occurs as a direct or indirect result of the transaction or act; and

(c) the transaction, or the act done for the purpose of giving effect to it, was not entered into, or done:

(i) under a compromise or arrangement approved by a Court under section 411; or

(ii) under a deed of company arrangement executed by the company; or

(iii) by a liquidator of the company; or

(iv) by a provisional liquidator of the company.

The above proposed law defines a new type of voidable transaction, being the creditor defeating disposition of property (in certain circumstances).

There is an exemption, under subsection (c), for particular transactions and those transactions are described by reference to types of external administrations.

However, for some reason which is not apparent, the external administration known as voluntary administration has been excluded.

It appears that a sale or disposition of property by a voluntary administrator may be a voidable transaction.

In my opinion that is an error with the proposed laws.

I see no reason to differentiate between voluntary administrators and other types of external administrators. If there is some concern about the general conduct of voluntary administrators, then that should be addressed by amendment to the laws applicable to voluntary administration.

I agree that any disposition of property by any external administrators, or pursuant to terms of a Scheme or DOCA, should be exempt from any exposure under these proposed laws.

This comment recognises the fact that external administrators have a duty of care to the company and creditors when disposing of property of a company.

I note that administrator is empowered to dispose of all or part of the business of the company (see s. 437A(1)(c))

In my opinion, it is inconsistent for any such sale to be exposed to these proposed laws, particularly when sales by other external administrators, such as a liquidator or Deed Administrator and even company directors in accordance with the terms of a DOCA, are effectively exempted.

I note that another component of the definition of this new type of voidable transaction, is that the company starts an external administration as a direct or indirect result of the transaction.

In my opinion the words "direct or indirect result of" are so general that they will be meaningless.

In my experience, there are great difficulties in determining the reasons for an external administration starting or occurring. If there is any difficulty in ascertaining those reasons, then there will be difficulty determining whether an external administration started or occurred as a result, directly or otherwise, of a particular transaction.

Take as an example, a company that is hopelessly insolvent as a result of unprofitable trading for some years. The company has survived by failing to inform the ATO of its tax debts. Shortly before starting an external administration, the company disposes of its assets.

The disposition of assets is not, in any way, the cause or reason for the company starting the external administration (or being insolvent or any other such criteria). The administration starts as a result of the unprofitable trading and arguably because the ATO finally catches up with the company (not that it is the fault of the ATO). The disposition of the assets is irrelevant to the need for any external administration. The need for an external administration existed before any disposition (and arguably for a long period of time).

As a result of my experience, I have heard many a company director and their liquidator state that the reasons for a company entering into external administration

was as a result of poor cash flow. They then suggest that the reason for the poor cash flow was because the business had been sold.

But, as a matter of logic and business principles, those matters do not follow and the comments are misguided.

As an example, if the explanation for a company failure is given as being "inadequate cash flow", then this ignores the fact that, for example, the reason why the company has inadequate cash flow was because of poor debt collection procedures or because of poor production techniques resulting in faulty stock for which customers refuse to pay. Those are the real reasons for the failure of a company.

The inadequate cash flow is the symptom of the reason cause. This difference is rarely recognised and poorly understood.

In my opinion the words "direct or indirect result of" do not add anything to the proposed laws.

I agree that there needs to be some time limit on the retrospectivity of the proposed laws. In other words, a disposition which took place a long time before any external administration should be exempt.

It is unclear why the period of 12 months has been chosen, as compared to say the period of six months that is used for void preferences or longer periods when the transaction involves related entities.

In my opinion, the period of time should be the same as that period set under the current void disposition provisions, such as s. 588FE(2) [6 months] and s. 588FE(4) [4 years for related entities].

At the end of section 588FG, add:
(8) A court is not to make under section 588FF an order solely on the grounds of subsection 588FE(6B) (as applying wholly or partly because of subparagraph 588FE(6B)(b)(i) or (ii)) if it is proved that paragraphs 588GA(1)(a) and (b) apply in relation to an officer of the company and the disposition. For the purposes of determining whether it is proved that those paragraphs apply in that way:
(a) subsections 588GA(2) to (7) apply; and
(b) section 588GB applies as if the proceeding under section 588FF were a relevant proceeding.

The wording of subsection (8) is so long and complicated that such drafting will, with respect, lead to problems.

I presume that the subsection means that, if a court finds that a director is liable under section 588GA, then the transaction is not liable to be set aside and the

recipient of the disposition is not liable to have an order made against it under section 588FF.

There is a further exemption under subsection (9) in favour of, for example, the purchaser of property from a company.

At the end of section 588FG, add:
(9) A court is not to make, solely on the grounds of subsection 588FE(6B) (about a creditor defeating disposition of property), an order under section 588FF materially prejudicing a right or interest of a person to whom the disposition of property was made if:
(a) there is evidence before the court that suggests a reasonable possibility that:
(i) consideration was given for the disposition; and
(ii) the value of the consideration was at least the market value of the property at the time of the disposition or at the time the relevant agreement (as defined in section 9) was made for the disposition; and
(b) the court is not satisfied that subparagraph (a)(ii) does not apply.

The above proposed law effectively provides another exemption to this new type of voidable transaction, being the creditor defeating disposition of property. The exemption is expressed by way of prohibiting the court from making orders in certain circumstances relating to the disposition of the property.

In effect, there will not be a creditor defeating transaction if **there is a suggestion that there is a reasonable possibility that the disposition was for the market value of the property.**

In my opinion, this exemption applies in exceptionally generous circumstances. In my opinion, the threshold for the exemption to be available is extremely low.

In my opinion, as a result of using the words "suggests" and "possibility", the threshold is low. Other insolvency laws use the threshold of "reason to suspect", which has been defined as being more than "mere idle wondering" whether a state of affairs exists and requires a positive feeling of apprehension or distrust.

This proposed laws use a lower threshold.

In my opinion, the generosity of this proposed law will (subject to my later comment about the criminal provisions) counter balance what I have identified as being an extremely onerous proposed law in defining a "creditor defeating transaction". I express this opinion, even though there is the need for "market value", which itself has its own shortcomings as a definition.

In my opinion, the bar is set too low because of the use of the word "suggests" and "possibility" in subsection (a);

(a) *there is evidence before the court that* ***suggests*** *a reasonable* ***possibility*** *that:*

If you had to apply a mathematical formula or percentage to those words, each would both be less than 5 out of 10. When you then multiply such fractions (to use the mathematical equation from school; multiply for "and", rather than add for "or"), the probabilities or percentages are reduced significantly, down to a very low figure.

Whilst this terminology is to the benefit of the recipient of the disposition, the onus of proving the facts still falls upon that purchaser, who could be put to the task of defending litigation which has no real prospects of success.

In my opinion, this is not the way to write the proposed laws.

In my opinion, even the well-used term "market value" has its limitations. In my experience that term is not without its difficulties.

I refer to a case in which I was involved, which is a leading case on the issue of improper disposition of assets. It has direct relevance to these proposed changes to the law as the case involved circumstances which would be squarely described as illegal phoenix activity. In this case, a company director sold the assets to his son shortly before a liquidation. In this case, *McDonald and Anor v Hanselmann,* Matter No 3480/97 [1998] NSWSC 171 (28 April 1998), Justice Young of the NSW Supreme Court identified the difficulties in valuing the assets and ascertaining their market and therefore their market value. His Honour commented;

"I have to deal with the questions of value. Value is not a matter which is to be decided in a vacuum. Value usually is associated with a person. The pure concept of value is, of course, what a reasonable objective person would pay for the property rather than lose it, but very often property will have a special value to a person because of factors unique to that person."

"Again, when one is looking at a company on the verge of liquidation, one bears in mind the words Shakespeare attributed to Richard the Third "A horse! A horse! My kingdom for a horse!". Because of the company's need for current liquid funds, the value of its assets to it may be affected."

"Both sides have provided evidence from a valuer and it is quite obvious that both valuers respect each other as competent professional experts in their field. Both valuers gave two sets of figures, one on a "going concern" basis, and the other on an "auction" basis."

"First, the court may consider that because of the imprecision in the valuation, it might discount the apparent benefit, and secondly, the court may consider that the value to the purchaser was in fact greater than the market value and increase the benefit figure. This is because just as one may adjust the market value to find the value to the company under s 588FB, so one may adjust the market value to what is the value and benefit to the purchaser under s 588FF"

I again note the proposed law above;

*(a) there is evidence before the court that **suggests** a reasonable **possibility** that:*

It is unclear why the Corporations Act needs to be changed so as to include the requirement for a court to have evidence, before making a decision. The common law and rules of court have, possibly for a millennium, required evidence to be presented to the courts.

The next point I cover is the most critical.

In my opinion, the above exemption (under the proposed s. 588FG(9)) is being introduced to protect the very parties which I have identified, earlier in these submissions, as being exposed; the buyer bona fide unrelated purchasers for fair value and the buyer in the ordinary course of business.

Importantly, the above exemption does not apply when the new laws deal with criminal activity.

In my opinion, the onerous definition of creditor-defeating disposition is still applied to criminal activity, noted below, but the generous exemption under s. 588FG(9) noted above, only applies to the civil proceedings commenced to recover a void transaction.

<u>588GAA Officer's duty to prevent creditor defeating disposition</u>

(1) An officer of a company must not engage in conduct that results in the company making a creditor defeating disposition of property of the company, if:

(a) the company is insolvent; or

(b) the company becomes insolvent because of the disposition or a number of dispositions made at the time of the disposition; or

(c) less than 12 months after the disposition, the start of an external administration (as defined in Schedule 2) of the company occurs as a direct or indirect result of the disposition.

Note 1: Failure to comply with this subsection is an offence: see subsection 1311(1).

There will be a positive obligation upon an officer of a company not to engage in conduct that results in creditor defeating dispositions. I note that a breach of that section will be an offence under section 1311.

There is no defence on similar terms to the proposed s. 588FG(9) noted above.

I might have missed something, but it seems that there will be an offence for the director, even the Administrator to dispose of a company's property and this offence will be subject to punishment of 10 years imprisonment.

Schedule 3 (after table item 138) insert:
138A Subsection 588GAA(1)

Imprisonment for 10 years or a fine of the greater of the following:
(a) 4,500 penalty units;
(b) if the court can determine the total value of the benefits that have been obtained by one or more persons and are reasonably attributable to the commission of the offence—3 times that total value;
or both.

I hope that I have missed something. I am happy to stand corrected.

I am sorry, but in my opinion, the exemption under s. 588FG(9), being the exemption expressed as a probation upon the court making orders if "there is a suggestion that there is a reasonable possibility that the disposition was for the market value of the property", is not available as a defence to these criminal charges.

This means that the unacceptable definition of creditor defeating disposition has direct application to this proposed new law, which is a criminal offence.

588GAB Procuring creditor defeating disposition

(1) A person must not engage in conduct of procuring, inciting, inducing or encouraging the making by a company of a disposition of property that results in the company making the disposition of the property, if:

(a) one or more of the following applies:

(i) the company is insolvent;

(ii) the company becomes insolvent because of the disposition or a number of dispositions made at the time of the disposition;

(iii) less than 12 months after the disposition, the start of an external administration (as defined in Schedule 2) of the company occurs as a direct or indirect result of the disposition; and

(b) the disposition is a creditor defeating disposition.

Note 1: Failure to comply with this subsection is an offence: see subsection 1311(1).

The prohibition on engaging in conduct which defeats creditors is expanded to include any other person who procures, incites, induces or encourages a company to enter into the disposition.

I understand that this proposed law is aimed at discouraging the activities of the unregulated pre-insolvency sector.

However, in my opinion, as the proposed law is drafted, it will have unintended and unacceptable consequences.

In my opinion, the proposed law would apply, for example, to every solicitor and accountant who, in the most honest and responsible circumstances, advises and encourages their client to purchase assets of a company of an insolvent company at the lowest possible price.

The fact that the purchaser obtains a bargain, in such circumstances, should not expose their lawyer or accountant to a criminal charge.

I again express the opinion that the definition of creditor defeating disposition is unacceptable.

I also note there is not the protection which is customarily provided to a professional advisor under the s 9 definition of director;

"the directors of the company or body are accustomed to act in accordance with ***the person's*** *instructions or wishes, (unless) the directors act on advice given by* ***the person*** *in the proper performance of functions attaching to the* ***person's professional capacity, or the person's business relationship*** *with the directors or the company or body*

588FGAA ASIC may order undoing of effect of creditor defeating dispositions by company being wound up
588FGAB Content and copies of orders
588FGAC Compliance with orders generally
588FGAD Compliance with orders for payment
588FGAE Court may set aside order by ASIC

The proposed laws will provide the ASIC with the power to make orders undoing the effect of a creditor defeating disposition.

In my opinion, with the greatest respect to the ASIC, this is a recipe for disaster.

This is a power which most organisations would struggle to properly administer.

There must be significant checks and balances, which are currently inadequate under the proposed laws.

As a result, I oppose these new proposed laws.

There is no guidance on how the ASIC is to conduct the process by which the decision will be made.

There is an absence of the many checks and balances that are absolutely ordinary for bodies such as the Courts and Tribunals.

I am also concerned that the right of appeal against any decision of the ASIC is only to a Court, rather than the present system applicable, for example, to the decision by ASIC to disqualify a person from managing a company (under s 206F), which can be the subject of appeal to the AAT.

In my opinion, there is much to be said for the opinion that there are already adequate laws to combat illegal phoenix activities, but it is the compliance with those laws that is not being monitored or enforced. In any event there can always be improvements, such as the following proposed changes to the laws;

203AA Resignation of directors—when resignation takes effect
When resignation takes effect

(1) A person's resignation as a director of a company takes effect on:

(a) if, within 28 days after the day the person stopped being a director of the company, ASIC is notified of that fact under subsection 205A(1) or 205B(5)—the day the person stopped being a director of the company; or

(b) in any other case—the day written notice is lodged with ASIC stating that the person has stopped being a director of the company.

203AB Resignation of directors—resignation has no effect if company has no other directors

(1) The resignation of a director of a company does not take effect if, at the end of the day that the resignation is to take effect, the company does not have at least one director

I agree with the principles behind the above changes, even though I warn that there will be many innocent people affected by the changes. If the inconvenience to the many innocent can be minimised, then the imposition upon the mischievous ones will be worthwhile to the business community.

I am a strong supporter of the above proposed changes to deal with a company being left with no director.

In my opinion, if a sole director does not wish to continue being a director, they need to take responsibility for either finding another director or closing down the activities of the company. The latter could be achieved through the appointment of a liquidator voluntarily or the deregistration of the company. The sole director cannot abandon their own ship.

I trust that these submissions are of assistance to Treasury.

Regards

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Hyden, Clare

From:	Geoffrey McDonald [barrister@helpingclients.com.au]
Sent:	Friday, 15 January 2010 9:25 AM
To:	Phoenix
Subject:	ATO Phoenix Companies enquiry

The General Manager
Business Tax Division
The Treasury
Langton Crescent
PARKES ACT 2600

Email: phoenix@treasury.gov.au

Dear Sir

I wish to make a submission to your Department on your enquiry into Phoenix companies.

I have significant experience in dealing with insolvent companies. I have been an accountant practicing in the area of insolvency for over 25 years. I am still a Registered Liquidator and Trustee in Bankruptcy. I have also concurrently been practicing as a barrister for nearly 10 years.

Since June 2008 I have decided to move away from practicing as an Insolvency accountant and focus on my work as a Barrister "specialising" in insolvency law..

I have practiced in the area of insolvency law known within the profession as "voluntary" or "debtor based". This area involves clients, who are predominantly the debtors who owe money to the creditors, such as the Australian Taxation Office seeking my advice and assistance. This area differs significantly in practice from the area in which you act for the creditors, such as Banks or other large organisations such as the Australian Taxation Office.

In my area of practise, I have consulted to thousands of companies and individuals. Over the 25 years, I would have been directly appointed to administer or been responsible to control over 5,000 different companies or individuals. These range from the smallest of businesses to larger well known companies such as Firepower or Traveland.

I have already publicly expressed an opinion on the subject of Phoenix companies. My comments remain valid.

My principal concern is that there is no legal recognition of this term or concept known as "phoenix companies".

I support the concept that makes "phoenix activity" effectively illegal, but I have been and remain very critical of the ASIC in failing to use its position to implement laws which make such conduct illegal.

I readily point to the relatively new laws in New Zealand which have directly addressed this position. That country has laws which define "phoenix" activity, clarifies the illegality and sets out the penalties from engaging in such activity.

As stated above, I have made by opinion known publicly.

I have co-written an article on the subject which appeared in the magazine of the National Institute of Accountants in late 2007/early 2008. The article sets out my thoughts as follows;

The Flight of the Phoenix

The new corporate law amendments have established the assetless administration fund.

That is the Australian Securities and Investments Commission "(ASIC)" will fund a liquidator to complete an investigation into an insolvent company which is otherwise without assets and accordingly lacks the resources to fund a detailed investigation into the causes of collapse etc.

This is statutory recognition of the scheme ASIC has been operating administratively for the last 18 months or so.

The initial stage of the assetless funding scheme has been primarily utilized by ASIC to assist in its director banning programme under Section 206F of the Corporations Act i.e. where directors have been involved in two or more liquidations which result in a return of less than 50 cents in the dollar within a twelve month period.

It would probably be fair to say director banning is probably the main weapon in ASIC's armoury with respect to the so called "phoenix company" phenomena.

Accordingly it is timely to revisit this vexed and emotive area of insolvency regulation.

What is a phoenix company?

Despite the rhetoric that abounds about phoenix company activity it may come as a surprise that there is no specific prohibition on "phoenix companies" in the Corporations Act.

Further the regulators themselves have struggled to develop a workable definition of the behaviour they are seeking to discourage. Accordingly regulatory initiatives in this area have traditionally engendered a degree of cynicism in the credit industry and the wider business community.

In its 1995 research paper on the topic, the then ASC provided the following definition for phoenix activities:

i.e. those where an incorporated entity either:

1. *fails and is unable to pay its debts; and/or*
2. *acts in a manner which intentionally denies unsecured creditors equal access to the entity's assets in order to meet unpaid debts; and*
3. *within 12 months another business commences which may use some or all of the assets of the former business and is controlled by parties related to either the management or directors of the previous entity.*

There are a number of difficulties with this definition:

- *One often hears feedback from disgruntled creditors that a director of a failed company is back in business as if that in and of itself is a bad thing.*
  It is the very nature of limited liability that one can deny liability for the debts of another.

It is where this privilege is abused that should be prohibited.

- *Unsecured creditors are invariably going to be denied equal access to a company's assets as directors are obliged to ensure their secured creditors and priority creditors get "first bite of the cherry" and get paid first. Failure to do so would leave a company in default of its relevant facility agreements.*

- *There really should not be an objection to directors/associates acquiring assets of a previous failed company for their market value.*

  Directors/their associates are often the only realistic market for the assets of a failed business as a going concern as they have some familiarity/attachment to the business and it often represents their only means of support.

  The alternative of simply abandoning/liquidating the business and its assets only has the effect of exacerbating the loss incurred by creditors as a result of company failure.

  The fact there may still be a deficiency to creditors after a sale at market value is more a function of the market economy than any moral turpitude on the part of directors worthy of sanction.

  The whole idea of competition in a free market economy is that there will be winners and losers.

Candidates for a Phoenix

One suspects the idea of phoenix behaviour is almost as old as the concept of limited liability itself.

However structural changes to the economy and the development of the "subcontractor culture" over time would appear to indicate the phenomena has become more prevalent recently.

There is a whole raft of people today, particularly in the construction and related industries whose career path effectively demands they be in business for themselves, whereas a generation ago they would have been in paid employment.

It is a truism that not everyone has the financial skills/discipline to be in business for themselves.

The then ASC in its 1995 research paper identified the following candidates for potential phoenix behaviour:

Innocent offender
Involves a business which gets into financial distress because its principals do not realize the business is performing poorly due to inadequate managerial control and monitoring systems.

Once the iceberg of imminent collapse is spotted assets are transferred which speeds up the collapse.

Occupational Hazard
This segment are at risk of engaging in potential phoenix behaviour simply by dint of their occupation.

Following the collapse of the first business tradesmen/service providers have little option but to continue to trade in that occupational group because it is essentially their only means of deriving income.

Careerist
involves those who are aware of the law and make a conscious decision to behave in a way that will defeat their creditors.

It is this type of phoenix behaviour that should be regulated and discouraged as it is damaging to the economy and anti-competitive i.e. the serial offender acquires a competitive advantage over other participants in the industry by not paying certain creditors e.g. ATO and other taxes.

Phoenixism – what to do

The following provisions are likely to come into play to deal with the careerist phoenix offender.

***Section 180, 181 and Section 182** – Directors statutory fiduciary duty not to misuse position and company property for own benefit;*

***Section 588G** – Directors duty to prevent insolvent trading;*

***Section 206F** - Director banning provisions*

However these provisions are largely remedial – not preventative. The damage has been done by alleged phoenix behaviour and the horse has often bolted by the time these provisions come into play.

The New Zealand Approach

New Zealand has recently introduced a new offence relating to phoenix companies to its corporate legislation.

Section 386A of the Companies Act 1993 (NZ) provides as follows:

Except with the permission of the court a director of a failed company must not for a period of five years after the date of commencement of the liquidation of the failed company:

(a) be a director of a phoenix company; or
(b) directly or indirectly be concerned in or take part in the promotion, formation, or management of a phoenix company; or
(c) directly or indirectly be concerned in or take part in the carrying on of a business that has the same name as the failed company's pre-liquidation name or a similar name.

***phoenix company** means, in relation to a failed company, a company that, at any time before, or within 5 years after, the commencement of the liquidation of the failed company, is known by a name that is also—*
(a) a pre-liquidation name of the failed company; or
(b) a similar name

A contravention of the section may also result in a director being personally liable for certain debts of the phoenix company.

The legislation has the relatively modest aim of curbing the practice of directors of failed companies utilizing the same or similar name in their new venture, as was utilized in the earlier failed venture to take advantage of any residual goodwill remaining in the failed business.

The provision does not place any restrictions on phoenix companies as such, but rather it is the director of the failed company who is subject to the restraint.

The explanatory material indicates the legislation implicitly recognizes that the use of phoenix arrangements is counter to stakeholder interests in only a subset of cases as many phoenix situations are legitimate and operate to promote the interests of creditors of the insolvent entity through lower transactions costs and higher sale price as the business is sold as a going concern.

Implications

The New Zealand authorities have taken a common sense and pragmatic approach to the problem of phoenixism and appear to have been informed by the following considerations.

- *It is still not illegal to fail in business – in fact it is a fundamental, (if unpleasant) characteristic of a free market economy;*
- *The problem of phoenixism and its associated economic costs are perhaps sometimes overstated due to an inability by corporate regulators to adequately define exactly what constitutes a phoenix company;*
- *Structural characteristics of certain sectors of the economy compel some people to be in business for themselves whether we like it or not;*

There is certainly scope for a similar provision to be introduced into the Australian corporate legislation.

Nonetheless one still has the suspicion that the market is still the most efficient "regulator" of the habitual phoenix offender.

If a director continually fails to cause his/her companies to pay their debts the markets response is simply to cut off the supply of credit and not deal with him/her.

Further often by the time ASIC's director banning activities have run their course, the credit market has already acted decisively and enforced directors guarantees and bankrupted the recalcitrant director. Bankrupts are unable to hold office as directors for the duration of the bankruptcy.

By vacating the field to an extent and leaving it to the "law of the jungle" the regulatory authorities would be able to free up scarce regulatory resources to other more pressing priorities.

I also co-wrote an article for publication in Lawyers Weekly Magazine back in late 2007. I don't have a record of the article being published, but I have a copy of the article. Again, I cover the topic of phoenix companies. An extract is set out below;

Corporate Law Reform

The Corporations Amendment (Insolvency) Act 2007 became law on 8 August 2007.
The legislation will take effect from 31 December 2007.

...

Implications

One can't help but be slightly under whelmed by these amendments, particularly given the number of reviews they supposedly draw from.

The Act has been dubbed the most comprehensive package for insolvency law since the "Harmer" review in 1988 which led to the introduction of voluntary administration in 1993, some fourteen years ago.

This of itself reflects the glacial speed of the law reform process, which is a subject for an article some other time.

The visionary Harmer reforms reflected a paradigm shift in insolvency practice in this country. For the first time directors of failing companies could call in independent administrators rather than waiting for creditors to come and get them.

The philosophy underpinning the Harmer review was to maximise the chances of a company or its business remaining in existence thereby improving the likely return to creditors rather than the scorched earth policy of liquidation, which had previously been the dominant philosophy in insolvency practice. As the man himself stated at the World insolvency conference in Sydney, it is all about the "horse trading" between debtors and creditors to negotiate a deal.

In this light, the new "reforms" really do not warrant mention in the same breath as Harmer and reflect little more than tinkering at the edges.

The reforms by and large focus on the process of external administration, rather than the final outcome.

It is generally acknowledged that the voluntary administration procedures are effective and a quantum improvement on the alternatives previously available to creditors of financially stressed companies.

However, they could always be improved.

Some ideas complimenting the reconstruction philosophy which underpinned the original Harmer review, include the following:

- *Moratorium on ipso facto clauses during the voluntary administration process. Agreements such as franchise agreements, supply contracts and leases contain clauses which deem voluntary administration as a terminable event. The triggering of these clauses has the effect destroying value for often little apparent reason and a moratorium on their enforcement would complement the existing VA moratorium;*

- *Strategies to encourage directors to seek independent help sooner, rather than later.*

  Perhaps, the greatest barrier to success of voluntary administration, (and indeed any turnaround strategy) is that directors leave it too late, before calling in independent assistance. The legislation should include further incentives for

directors to take early corrective action when they encounter solvency difficulties.

Indeed recent amendments to New Zealand laws make the Australian amendments look inadequate by comparison. Under NZ law, the Directors can not place their company into Administration if it has been served with a winding up application and 10 days has lapsed. The Directors are prohibited from making that last minute appointment of Administrator the day before the court hearing. This law forces Directors to act quicker.

Further, in New Zealand the new laws define and then criminalise "phoenix company" activity. In Australia, there are no laws specifically on the subject and there has been a complete failing by the authorities to do what the New Zealanders have done so easily. The New Zealand law now adds a strong incentive for directors to rescue their company rather than liquidating and starting again as a "phoenix rising from the ashes."

...

In many respects the Corporate Law Reform Bill represents a lost opportunity.

The insolvency regime in Australia does not operate in a vacuum, but is a necessary part of the wider economic and social fabric of the country.

Hopefully, the next time corporate insolvency law reform is on the agenda, it will take a more balanced approach reflecting economic concerns rather than simply a prescriptive / compliance focus.

My comments are supportive of the introduction of a law in this area. They are critical of the lack of a law in this area.

Separately, I am also supportive of there being greater ability for the Australian Taxation Office to restrict the amount of credit which it must give to a company which is properly determined to be a phoenix company.

I recognise the fact that any new business will be able to obtain some months credit in respect of PAYG deductions. Up until 1993, these funds were treated in some respects as being trust funds. They represent funds which are supposedly deducted from the gross wages of employees on each occasion that employees are paid.

In some cases, it would not be unreasonable for those funds to be payable to the ATO at the same time they are "deducted" from the wages. In other words, the employer would be obliged to make payment as it goes, just like it does with the net wages, rather than being given time to make payment later.

I understand that currently there is limited scope for the ATO to restrict the credit which an employer will be given in respect of PAYG deductions.

I trust that these comments are of some assistance and I would welcome the opportunity to elaborate further if possible.

Yours Sincerely

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