Law Council
OF AUSTRALIA

Office of the President

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Nathania Nero
Senior Adviser
Corporations Policy Unit
Consumer and Corporations Division
The Treasury
Level 5, 100 Market St
SYDNEY NSW 2000

By email: phoenixing@treasury.gov.au

Dear Ms Nero

Reforms to combat illegal phoenix activity – Draft Legislation

1. The Law Council welcomes the opportunity to provide a submission to the Treasury's consultation on the Reforms to combat illegal phoenix activity – Draft Legislation (**the Consultation**).

2. The Law Council is grateful for the assistance of the Insolvency and Reconstruction Committee and the Corporations Committee of the Business Law Section of the Law Council of Australia and the National Criminal Law Committee in the preparation of this submission.

3. The proposed amendments are a significant step in advancing the Government's policy to address community and business concerns about the incidence of improper phoenix activity and will seek to reduce its harmful effects on the economy. The Law Council has long advocated a need to increase regulation of pre-insolvency advisors and these amendments are a step in the right direction to tackle the complex problems posed by phoenix activity.

4. Although the Law Council broadly supports the move to increase regulation of improper phoenix activity, several concerns remain about the wording of the proposed provisions. If the current wording is not amended, the Law Council is concerned that the introduction of the proposed provisions may be counter-productive to the Government's initiatives to encourage good faith restructuring and turnaround through the introduction of the safe harbour for directors.

<u>New voidable transaction</u>

5. The Law Council supports the introduction of a new voidable transaction to address improper phoenix activity. The proposed provision offers benefits over the existing voidable transaction provisions that could cover improper phoenix activity, such as *Corporations Act 2001* (Cth) (**Corporations Act**) section 588FB and subsection 588FE(5), because there is no need to prove that an insolvent transaction has occurred. However, it is recommended that consideration be given to explaining how the proposed new provision may interact with existing state fraudulent conveyancing laws (such as *Conveyancing Act* 1919 (NSW) section 37A).

Telephone +61 2 6246 3788 • *Fax* +61 2 6248 0639 • *Email* mail@lawcouncil.asn.au
GPO Box 1989, Canberra ACT 2601, DX 5719 Canberra • 19 Torrens St Braddon ACT 2612
Law Council of Australia Limited ABN 85 005 260 622
www.lawcouncil.asn.au

6. The Law Council supports the general approach of a new voidable transaction based on phoenix activity, however is concerned that the current drafting may cause significant problems with good faith restructuring activity. The proposed new subsection 588FDB(1) involves no requirement to establish an intention to improperly remove assets from being available from creditors, but rather uses an effects test. If the effect of the transaction is to prevent the company's property from being available for creditors in a winding up, or to delay or hinder the process for making the property available for creditors in a winding up, then the transaction is a 'creditor defeating disposition' and may be voidable where the company is insolvent at the time, becomes insolvent or enters external administration within 12 months (proposed paragraph 588FE(6B)(b)). Furthermore, entering into a transaction that is found to involve a creditor defeating disposition can lead to civil and criminal sanctions liability for officers involved (proposed section 588GAA) as well as for those advising them (proposed section 588GAB).

7. The wording of subsection 588FG(8) may cause confusion and uncertainty because the proposed carve-out for conduct that would satisfy the safe harbour in section 588GAA (see proposed subsection 588FG(8)) only apply where the order under section 588FF is based solely on the proposed new subsection 588FE(6B) alone. It may be clearer to state that orders under section 588FF cannot be made in respect of subsection 588FE(6B) where the safe harbour applies.

8. A more significant problem arises from the wording of the carve out in subsection 588FG(8) and the failure to include paragraph 588FE(6B)(iii) within the scope of the carve out for safe harbour conduct. Under the proposed wording of subsection 588FG(8), conduct within the safe harbour would be protected from orders under section 588FF if the sole basis of the order is subsection 588FE(6B) where the company was insolvent (subparagraph 588FE(6B)(b)(i)) or became insolvent as a result of the transaction (subparagraph 588FE(6B)(b)(ii)). However, there is no similar protection where conduct fits within the safe harbour but the company is not insolvent (or becomes insolvent) as a result of the transaction (subparagraphs 588FE(6B)(b)(i) and (ii), but where the company then enters external administration within 12 months of the conduct (subparagraph 588FE(6B)(b)(iii)). This could significantly stifle good faith restructuring activity where a company in financial difficulties (but not insolvent) grants security over its property to a creditor as part of a restructuring plan. The granting of security over previously unencumbered property would mean that the property would be unavailable to creditors in a subsequent winding up of the company, as the secured creditor could enforce their security against the assets. This would satisfy the effects test in subsection 588FDB(1) and the transaction would be voidable under subparagraph 588FE(6B)(b)(iii) if the company entered external administration within 12 months. However, a period of voluntary administration (which is a form of external administration for the purposes of the *Insolvency Practice Schedule (Corporations)*: see sections 5-15) may be a necessary element of the restructuring plan due a debt for equity swap using Corporations Act section 444GA under a deed of company arrangement.

9. The Law Council strongly recommends that the proposed amendments to subsection 588FG(8) be extended to cover subparagraph 588FE(6B)(b)(iii), which will offer greater certainty for good faith restructuring efforts.

10. The proposed subsection 588FG(9) does not sufficiently protect good faith restructuring involving the granting of security as part of a restructuring plan that could fall within subparagraph 588FE(6B)(b)(iii). This is because subsection 588FG(9)

requires evidence that consideration was given for the disposition and that the consideration was at least the market value of the property at the time of the disposition or at the time the disposition was agreed to. This may be difficult for a creditor supporting a good faith commercial restructuring plan who takes security (which could amount to a creditor defeating disposition as explained above) in exchange for entering into a restructuring plan to turn around a struggling (but not yet insolvent) company. How is a creditor to show evidence that the value it provided in the terms of the restructuring (such as forbearance and/or a variation of repayment terms) under a restructuring plan is at least the market value of the assets (which are likely to cover all present and after acquired assets)? If the granting of security is unreasonable it may already be caught by existing section 588FB (or section 588FDA if it involves a director-related transaction), but the new proposed paragraph 588FE(6B)(iii) will catch even commercially reasonable transactions and will not protect conduct within the safe harbour due to the limitations in the wording of subsection 588FG(8) (explained above).

11. The Law Council also recommends that the drafting in paragraph 588FG(9)(b) be amended to remove the double negative. Furthermore, the evidentiary burden in paragraph 588FG(9)(a) may be so vague as to cause uncertainty. It may be better to require that a valuation of the assets be obtained at the time of the relevant transaction in order to satisfy this provision.

<u>Australian Securities and Investments Commission (**ASIC**) administrative recovery power (proposed section 588FGAA)</u>

12. The Law Council supports the Government's proposal to make liquidator recoveries for creditors easier but does not support this proposed power on the basis that it raises multiple rule of law concerns by being too broad and arguably seeks to confer judicial power of the Commonwealth on ASIC.

13. The Law Council notes that concerns about the similar *Bankruptcy Act* 1966 (Cth) provision (**Bankruptcy Act**) (section 139ZQ) have also been raised in prior cases. In *Re McLernon; Ex parte SWF Hoists & Industrial Equipment Pty Ltd v Prebble,*[1] the court held that the section 139ZQ notice power given to the Official Receiver (**OR**) in Bankruptcy did not confer judicial power because the issue of the notice did not provide a final and determination of existing rights but rather conferred new rights that were subject to a de novo appeal by the court.

14. The proposed new section 588FGAA confers a broad discretion on ASIC as to whether to issue a notice (subsection 588FGAA(5)), and specifically limits ASIC's discretion if it believes that the court would not make an order (subsection 588FGAA(4)). Furthermore, ASIC may determine what it believes represents the benefits received by the person or fairly represents the application of proceeds of the transferred property. These are powers that are far beyond the powers conferred on the OR under the equivalent Bankruptcy Act provision. Furthermore, the Court may only overturn the notice if it determines that section 588FGAA does not apply (subsection 588FGAE(3)). In the Law Council's view, these elements not only make the proposed new power inappropriate as being too broad, but render it open to a constitutional challenge for improperly conferring judicial power on ASIC.

15. Should the proposed power be retained, the Law Council strongly suggests that the timeframe for ASIC to issue the notice should be extended to 3 years from the

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[1] (1995) 58 FCR 391.

proposed 12 months limit. This would align the provision with the liquidator's power to seek court orders in relation to voidable transactions under section 588FF.

Officer duty to prevent creditor defeating transaction

16. The Law Council is supportive of the Government's policy to target those involved in improper phoenix activity, including promoters and the unregulated pre-insolvency advisor market, however does not support the proposed amendments. In the Law Council's view, the proposed amendments could constrain the market for good faith restructuring efforts and could be inconsistent with the existing policy that underpins the recently introduced safe harbour for directors in the Corporations Act section 588GA.

17. The proposed amendments would limit good faith restructuring to situations where a company continues to trade and does not enter external administration (or at least not for 12 months after the restructuring plan is implemented). This is because of the combined effect of the proposed new 'creditor defeating disposition' provision in subsection 588FDB(1) (made voidable under subsection 588FE(6B)) and the new offence and civil penalty provisions that will apply to officers and those who procure transactions that are creditor defeating dispositions.

18. The Law Council does not support the imposition of strict criminal liability for officers or for those who procure creditor defeating dispositions in subsections 588GAA(1), 588GAB(1). The Law Council also notes that the section 588GAB offences appear to be drafted in an overly complex manner which may make enforcement difficult. Further, there does not appear to be a great deal of difference between the conduct in subsection 588GAB(1) and 588GAB(2), although the former carries a term of imprisonment of 10 years while the latter is a civil penalty provision.

19. Individual company officers would be required to assess transactions to determine if they would contravene proposed section 588GAA. The Law Council believes that this could create difficulties where company officers such as company secretaries are not taking part in management decisions but are merely actioning decisions to deal with assets made at a board or more senior executive level.

20. Furthermore, it may be difficult for officers to make clear decisions about whether subsection 588FDB(1) would be satisfied without obtaining a detailed legal opinion on each transaction.

Director resignations

21. The Law Council is generally supportive of the proposed limitations on director resignations, which should deal with community concerns relating to directors backdating resignations to avoid liability. While this will not deal with current problems of directors appointing straw directors with little or no assets to replace them, it is better than the current system.

22. The Law Council believes that directors have an obligation under their statutory duties to deal with the company's problems rather than simply resigning. The proposed changes will force directors to face up to the company's problems by appointing an external administrator rather than abandoning the company.

23. However, the Law Council is of the view that nothing should restrict a director from resigning in circumstances where that director has proposed entry into administration

(acting reasonably) but is in the minority and there are continuing directors. In those circumstances, it is proper that the director be permitted to resign.

24. The Law Council also wishes to point out the difficulties that individual directors can have in resigning where they do not possess the company's Corporate Key needed to lodge forms electronically with ASIC. Consideration should be given to simplifying and streamlining this process.

Changes to Goods and Services Tax (**GST**) liability

25. The proposed amendments would allow the Commissioner to impose director penalty notices on company directors to collect outstanding GST liabilities.

26. The recently enacted 'Safe Harbour' provisions require that in order to qualify a company must keep Business Activity Statement returns up to date, though payment is not necessarily required in order for the company to remain in the 'safe harbour'.

27. The introduction of Director Penalty Notices for GST liability will likely lead to directors receiving cautious advice which may contribute to the under-utilisation of the 'safe harbour'.

Insolvency Practice Rules (Corporations) Amendment (Restricting Related Creditor Voting Rights) Rules 2018

28. The Law Council opposes the proposed changes to limit related party assignees who vote in on a resolution relating to the appointment or removal of an external administrator to the value that the creditor gave for the assignment.

29. The rules relating to voting for creditors in corporate insolvency have never previously limited the votes of assignees of debts, which has allowed a healthy market for trading in corporate debt to develop. This provides an important mechanism for creditors to manage the risk of external administration by trading their claims in the secondary market. This is a beneficial feature of the Australian market and these proposed reforms may curtail that market which could result in a detrimental effect on credit markets as risk may need to be repriced.

30. The proposed amendments would also detrimentally affect a parent company who seeks to support a restructuring through administration by purchasing debt to bolster its chances of approving a restructuring deed of company arrangement.

31. Please contact Dr Natasha Molt, Director of Policy, Policy Division (02 6246 3754 or Natasha.molt@lawcouncil.asn.au), in the first instance should you require further information or clarification.

Yours sincerely

Morry Bailes
President