THE LAW SOCIETY
OF NEW SOUTH WALES

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27 September 2018

Corporations Policy Unit
Consumer and Corporations Division
The Treasury
Level 5, 100 Market Street
SYDNEY NSW 2000

By email: Phoenixing@treasury.gov.au

Dear Sir/Madam,

Reforms to combat illegal phoenix activity – Draft Legislation

Thank you for the opportunity to comment on the suite of draft legislation comprising the Government's proposed reforms to combat illegal phoenix activity.

We note that the proposed reforms include a range of measures designed to both deter and disrupt illegal phoenixing and to strengthen penalties for those who engage in and facilitate this illegal activity.

The Law Society's Business Law Committee contributed to this submission.

Summary of the Law Society's position and general comments

The Law Society strongly supports the Government's commitment to combating illegal phoenix behaviour, which is a multi-million dollar scourge on the Australian economy generally and small business in particular.

However, the Law Society is concerned that some of the measures provided for in the draft legislation, particularly in relation to "creditor-defeating dispositions", duplicate existing provisions and remedies and are unnecessarily complex and confusing. They are also easily circumvented. These factors detract from the usefulness of these provisions to lawyers and insolvency practitioners, who are the persons primarily responsible for identifying and taking action in respect of specific instances of illegal phoenix activity.

The problem is not a lack of existing remedies under the current law. Phoenix activity will invariably entail a breach of various fiduciary and statutory duties, and transactions may be able to be defeated as uncommercial transactions and on other bases.

We suggest that a combination of factors provide major obstacles to holding phoenix operators to account, including lack of funding to engage the legal process and the onus being on the liquidator to establish all elements of the complaint, often without having been provided with all, or any, of the company's books and records. There are also many "grey areas" where those involved in phoenix behaviour are able to engage in disputation on a number of issues, including:

(a) whether or not the company was insolvent at a particular time;

(b) whether or not reasonable steps were taken to secure market value for property sold;

(c) whether or not a person not formally registered as a director is nevertheless a "director" within the expanded definition in section 9 of the *Corporations Act 2001*.

We suggest that creating yet another series of offences and voidable transactions may not be the most effective way to combat illegal phoenix activity. We note the problems caused by lack of adequate funding to engage the legal process, and suggest the introduction of adverse costs order protection for liquidators who are, in good faith, seeking to attack suspected phoenix behaviour. We also recommend a shifting of the onus of proof once certain criteria are met, for instance, where:

(a) there has been a disposition of the company's assets;

(b) the recipient of the assets was a related party; and

(c) the company went into liquidation or administration or ceased to carry on business within 12 months of the disposition.

The Law Society is concerned that introducing the legislation may lead to the misleading perception that anti-phoenix measures have now been put in place, when in reality many practical obstacles confronting liquidators remain.

Subject to these general comments, we comment on the provisions of the draft legislation below.

Schedule 1 – Treasury Laws Amendment (Combatting Illegal Phoenixing) Bill 2018

1. The failure to use the word "phoenix"

The type of behaviour the term "phoenix" describes is widely understood in the community, particularly in industries where such behaviour is highly prevalent, such as the construction industry. The Government has used the word "phoenix" to describe such conduct for several years, including for these reforms and for the joint government taskforce comprising Federal, State and Territory government agencies, which is called the "Phoenix Taskforce". There are many more examples of the widespread use of the term "phoenix". A strong stigma attaches to the term, and to the people who engage in such activity.

Despite this, the word "phoenix" does not appear anywhere in the draft legislation. There is no clear provision which a legal or accounting advisor will be able to point to, for example, in the context of attempting to warn a person of the potential consequences of a contemplated phoenix transaction, and say "What you are thinking of doing constitutes illegal phoenix behaviour. This conduct is illegal and punishable by imprisonment". There is no straightforward "anti-phoenix" provision which the Australian Securities and Investments Commission ("ASIC") or a liquidator is able to include in correspondence, such as a letter of demand for compensation, to a person who has been involved in such behaviour.

Liquidators and lawyers have long been recognised as the "gatekeepers" of the insolvency and restructuring regime, and are well placed to deter contemplated illegal phoenix activity and to hold those involved to account. This task would be easier, and the message would be more readily communicated, if the legislation were to use the term that everybody already understands.

We accept that this may not be a simple legislative fix, however we do think that tying the relevant provisions together could enhance education and awareness of these reforms and their policy intent. We would be happy to discuss this further if considered appropriate.

2. Use of the term "creditor-defeating disposition"

We have serious concerns with the use of the term "creditor defeating disposition". In the draft legislation it captures any transaction where a company sells any of its property, even if it does so for full market value and otherwise appropriately and lawfully. By capturing innocent and lawful behaviour within the definition of "creditor-defeating disposition" in proposed section 588FDB (1), the provision inappropriately stigmatises people engaged in legitimate conduct. A term which encompasses a lawful disposition should not connote impropriety.

Another consequence of this negative connotation is that it may be used unfairly by the media, by an overbearing liquidator or litigation opponent, or by some other such person, to dissuade an innocent person from undertaking a legitimate and appropriate transfer of property.

The legislation should be amended so that a disposition is only a "creditor-defeating disposition" if it is voidable under section 588FE(6A). Transactions which potentially involve a "creditor-defeating disposition", but which may be lawful, should be given a less stigmatising descriptor, for instance "pre-appointment disposition" or "regulated disposition".

3. Defence where evidence "suggests a reasonable possibility"

Proposed section 588FG(9) will afford a defence to the recipient of property pursuant to a "creditor-defeating disposition" if that recipient produces evidence which "suggests a reasonable possibility" that market value was paid for the item concerned.

We suggest that this threshold is too low. It is not difficult to "establish" a reasonable possibility and even less so to "suggest" one. The ease with which this defence may be invoked will significantly undermine the efficacy of the "creditor-defeating disposition" regime.

We suggest the test should be whether there is an arguable case or that it is established on the balance of probabilities.

4. Time limit for a liquidator to request an ASIC order

The introduction of ASIC powers to make administrative orders in relation to "creditor-defeating dispositions" is a positive step which, to a large extent, mirrors the power the Official Trustee has long had in personal insolvency scenarios pursuant to section 139ZQ the *Bankruptcy Act 1966* (Cth).

However, proposed section 588FGAA(2) provides that a liquidator may only apply to ASIC to exercise this power within 12 months of his or her appointment. We consider that timeframe is too short, and should be extended.

It is not always possible for a liquidator to amass sufficient evidence within 12 months of his or her appointment to satisfy ASIC that a highly coercive and controversial power should be exercised. Even when a liquidator has been provided with sufficient records to disclose a creditor-defeating disposition, the process is often hindered by deliberate obfuscation by those from whom evidence of wrongdoing might be obtained. Often such persons are very ably represented by tenacious and determined advisors. More time may be required for public examinations or other coercive action may be necessary to overcome such obstacles.

The Law Society suggests that this timeframe should be extended to a minimum of three years, or at a bare minimum, there should be provision that liquidators have the ability to request that ASIC grant an extension before the time expires.

5. "Procuring, inciting, inducing or encouraging"

Proposed section 588GAB(1), which is directed at facilitators of illegal phoenix behaviour such as accountants, lawyers and pre-insolvency advisors, prohibits a person from engaging in conduct of "procuring, inciting, inducing or encouraging" a "creditor-defeating disposition".

This may not capture a pre-insolvency advisor who is aware of the wording of the prohibition and who "advises" a person how to engage in phoenix conduct, and "assists" him or her to do it, but does not "procure, incite, induce or encourage" it. "Procurement" connotes cause and effect and is interrupted by an independent decision on the part of the primary actor. We suggest that "incitement", "inducement" and "encouragement" are all something more than mere advice and assistance.

It would be preferable that, once it becomes objectively apparent that a proposed disposition is likely to be a "creditor-defeating disposition", a person must not "knowingly assist" another person to cause the company to proceed with the "creditor-defeating disposition", or be "knowingly concerned" in the making of it by the company. This construction would include the necessary "knowledge" element for criminal liability without raising the bar so high that the prohibition is too easily circumvented.

6. Requirement that winding up occur "as a result of" the "creditor-defeating disposition"

In proposed sections 588GAA and 588GAB, company officers and others are placed under a duty not to engage in conduct that results in a "creditor-defeating disposition" in circumstances of insolvency or where the company is placed into liquidation or administration "as a direct or indirect result of the disposition".

This causation requirement raises the bar too high for a liquidator. In our view, one of the best things about this legislation is that it removes the need for liquidators to affirmatively establish insolvency if the disposition occurs within the 12 months before a winding up. This has been lauded by the industry as a significant step forward. It is a good example of a practical measure which is likely to significantly aid liquidators by, in effect, reversing the onus once certain points are established.

Affirmatively establishing insolvency is often very difficult due to lack of books and records and lack of management cooperation, and in many cases deliberate obfuscation. The introduction of proposed sections 588GAA(1)(c) and 588GAB(2)(a)(iii) is a practical and welcome step to address this concern.

However, the requirement that the external administration commence "as a direct or indirect result of the disposition" undermines much of the good work done by this provision. It will invariably be contended that the relevant external administration commenced not as a result of the disposition of property, but as a result of the company's overwhelming debt burden.

In most cases of phoenix behaviour, the company's unpaid debts will far exceed the market value of its property. In those circumstances it will always be able to be contended that the failure of the company would have happened anyway, and was not a "direct or indirect result" of the disposition of the company's property.

Schedule 2

7. Backdating director resignations

The Law Society welcomes the proposed measures to prevent backdating of director resignations.

However, we are concerned that directors only have a period of up to 12 months to appeal to the court, and only 56 days to appeal to ASIC, in cases where a person has genuinely ceased being a director, but that cessation was not promptly communicated to ASIC (proposed section 203AA(5)).

In some cases, a person may reasonably rely on third parties, such as an accountant or co-director, to "look after the paperwork". Where a person has genuinely resigned, and played no further role in the company, but ASIC was not notified, and the resigning director did not know that ASIC had not been notified, then the 56-day and 12-month periods should be able to be extended, subject to prescribed conditions.

8. Director resignation prohibition – anti-circumvention

The Law Society welcomes the proposed measures to prohibit the abandonment of a company by its last remaining director. As they are currently drafted, these measures prohibit voluntary resignations (proposed section 203AB(1)) and member-initiated removals (proposed section 203CA(1)).

However, these provisions do not prevent a third method of removing a director, that is, by amending the Constitution of a company so that the final remaining director becomes ineligible to act as director of the company, for instance by reason of the imposition of a new residence, age or other requirement in the Constitution.

This should be remedied by the inclusion of a provision providing that any amendment to a company's Constitution which has the consequence of vacating the office of a director or directors, where such vacation will result in the company having no remaining directors, is of no force or effect.

Schedule 3

9. Director penalties for GST

The Law Society welcomes the introduction of director penalties for the non-remission of GST.

Director penalties are already a part of the corporate landscape for PAYG withholdings and superannuation contributions. In many ways the case for GST director penalties is stronger than the case for the existing varieties of director penalty. With GST, the money has been collected, and if it is not remitted, in essence it is being misappropriated for other purposes. This is in contrast to PAYG and superannuation, where sometimes the money was never available in the first place.

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

10. Improperly influencing the outcome of creditors' meetings

The Law Society welcomes the introduction of measures, partially reflecting measures which have long existed in personal insolvency, to limit the votes of related party assignee creditors, subject to our comments below.

The term "value of the consideration" in proposed paragraph (7) in section 75-110 is too broad. It should be changed to "the amount actually paid, prior to the meeting, in consideration of the assignment", or words to that effect. Failing this, a related party may contract with a genuine creditor to pay, for example, twice the face value of the debt, at some future point, never actually pay that amount – but insist on being admitted to vote for the greater amount on the basis that a promise of future payment is "consideration", a proposition that is supported by judicial authority.

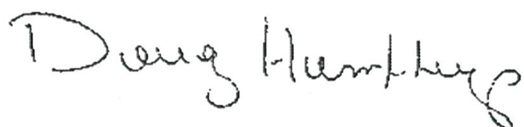
In a similar vein, the Rule should be amended by providing that the voting value is limited to the lesser of the face value of the debt and the amount actually paid. This will prevent related parties paying over the odds for assigned debts, possibly subject to some secret rebate or offset arrangement, in order to increase their voting power.

One issue that the proposed amendments do not address is the approach of paying a creditor a fee or inducement to vote in a particular way, rather than purchasing that creditor's claim outright. This has been described as "a species of equitable fraud" resulting in "a corrupt voting process" (*Canadian Solar v ACN 138 535 832 Pty Ltd, In the Matter of ACN 138 535 832 Pty Ltd* [2014] FCA 783).

The draft amendment ought to provide for such arrangements to be void, and/or unlawful, and a liquidator or administrator to refuse to admit a claim for voting purposes in circumstances where there is evidence that this has occurred.

Please contact Liza Booth, Principal Policy Lawyer, at liza.booth@lawsociety.com.au or on (02) 9926 0202 if you would like to discuss this submission.

Yours faithfully,



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