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**Your reference:**

**Our reference:**

4010615

Dear Ms Nero

**Submission – Reforms to Combat Illegal Phoenix Activity**

We refer to your invitation to lodge a submission on the Exposure Draft of the *Treasury Laws Amendment (Combating Illegal Phoenixing) Bill 2018* (the **Exposure Draft**).

The Exposure Draft and Explanatory Memorandum (**EM**) seeks to reform the current phoenixing laws to effectively target and discourage illegal phoenixing as well as punish those who engage in and facilitate the illegal activity. We have considered the Exposure Draft in light of the Government's objective and make the below comments in relation to the provisions to be inserted into Part 5.7B of the *Corporations Act 2001* (Cth) (**CA**).

**Phoenixing offences and property transfers to defeat creditors**

The Government has proposed to address the need for phoenixing law reform by introducing new legislation rather than amending existing tools within the CA that may be used to combat illegal phoenix activity.

**1 Creditor-defeating dispositions**

*Creditor Defeating Disposition – proposed section 588FDB(1)(b) Exposure Draft*

- 1.1 The centre-piece of the proposed reform is to create a new concept of “creditor-defeating disposition”, and the related creation of a new voidable transaction provision and director's duty provision, all to be included in Part 5.7B of the CA.
- 1.2 Part 5.7B approaches liquidator's recoveries along two separate streams: voidable transactions and insolvent trading.
- 1.3 The voidable transactions provisions focus on the disposition of the company's assets in the lead up to external administration in a manner that would give preferential treatment to the recipient of any such property and undermine the *pari passu* principle. The voidable transactions regime seeks to reverse any such preferential treatment: if a transaction is voidable under section 588FE of the CA, section 588FF empowers the Court to make a wide array of possible remedies including making a transaction void, ordering compensation, and varying a person's right to prove a debt in the winding up. These various remedies enable a Court to, as appropriate, apply remedies that would have the

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effect of undoing the transaction or at least reducing the benefits of a transaction for a particular individual and enhancing the *pari passu* distribution of the company's assets among all creditors. This approach is intended to deter dissipation of the company's assets and to avoid the rush to enforcement by creditors of a financially distressed or insolvent company.

- 1.4 As explained by the Supreme Court of the United Kingdom in *Rubin v Eurofinance SA*<sup>1</sup> regarding avoidance provisions in insolvency:<sup>2</sup>

The underlying policy is to protect the general body of creditors against a diminution of the assets by a transaction which confers an unfair or improper advantage on the other party, and it is therefore an essential aspect of the process of liquidation that antecedent transactions whose consequences have been detrimental to the collective interest of the creditors should be amenable to adjustment or avoidance...

- 1.5 Further, in *Fortress Credit Corporation (Australia) II Pty Ltd v Fletcher*,<sup>3</sup> the Court commented that the voidable transaction provisions contained in Part 5.7B do not create any right of action in the company or allow the liquidator to recover, but instead enables the liquidator to seek the assistance of the Court in augmenting that estate for the benefit of creditors by countering the effects of certain pre-liquidation transactions.
- 1.6 The insolvent trading provisions focus on the incurring of debt in the lead up to external administration in a manner that would dilute the claims of already existing creditors. The focus of those provisions is on compensating the creditors, who are the ones who primarily suffer in the liquidation scenario.<sup>4</sup>
- 1.7 The central concept of the proposed changes to Part 5.7B in the Exposure Draft is the "creditor-defeating disposition." A transaction which has the characteristics of a "creditor-defeating disposition" will then be subject to a proposed voidable transaction provision (s588FE(6B)) and director's duty provisions akin to insolvent trading provisions (s588GAA & s588GAB).
- 1.8 A "creditor-defeating disposition" is defined in section 588FDB(1) of the Exposure Draft as:
- (1) a disposition of property;
  - (2) with the disposition having the effect of:
    - (a) preventing the property from becoming available; 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.
- 1.9 We generally support the intention of the proposed provision – to defeat asset stripping to diminish claims available to creditors in a liquidation. Plainly, such an intention is consistent with the rationale for voidable transactions provisions. However, we have some concerns that the current drafting is cast too widely and some of the ambiguity in the language used might result in unnecessary disputation.
- 1.10 The wording used in this proposed provision is similar to the wording of the proposed provisions of the *Corporations Amendment (Strengthening Protections for Employee Entitlements) Bill 2018* and it appears that there has been an attempt to adapt the concepts used in that bill in relation to employee claims and apply them broadly in respect of a disposition of a company's assets. We do not consider that this adaption is effective. To the contrary, we consider that a provision designed to prevent transactions intended to defeat a specific and narrow species of creditor claim – employee claims – cannot be readily applied in an indiscriminate fashion to all dispositions of pre-appointment property.

<sup>1</sup> [2013] 1 AC 236

<sup>2</sup> *ibid* at [94]

<sup>3</sup> [2014] NSWCA 148 at [127]

<sup>4</sup> M Murray & J Harris, *Keay's Insolvency: Personal and Corporate Law and Practice*, 10<sup>th</sup> ed., 2018, at [16.85]

- 1.11 As it is drafted, the legislative provision does not clearly distinguish between a legitimate pre-insolvency disposition of property and a phoenixing disposition. A disposition preventing property from becoming available for the benefit of the company's creditors (s588FDB(1)(a)) could conceivably be any pre-appointment transaction, including ordinary trading transactions and transactions where the property was disposed of for its commercial value or was otherwise beneficial for the company (eg a sale of a non-core asset as part of a legitimate turnaround and restructuring program may be caught). While the proposed defences and safe harbour provisions potentially lessen the potential impact of the "broad brush" drafting approach, it unnecessarily poses a risk to all transactions conducted in times of a company's financial distress.
- 1.12 This approach is to be contrasted with the approach used in section 588FB of the CA which impugns all "uncommercial transactions" by reference to the test that "a reasonable person in the company's circumstances would not have entered into the transaction" having regard to the factors mentioned in section 588FB. The main problem with the uncommercial transaction provisions is the need to prove the company's insolvency at the time of the transaction in order for an uncommercial transaction to be voidable (see s588FE(3)). In our experience, proof of insolvency is often prohibitive in terms of costs and uncertainty of litigation and if this requirement can be made less onerous, much of the Government's intention to stop phoenixing activity in proposing this legislation would be achieved.
- 1.13 Consideration should be given to an alternative formulation. Possibilities might include:
- (1) rather than legislating section 588FDB, the effectiveness of the current voidable transactions provisions (Division 2 of Part 5.7B), in particular "uncommercial transactions";
  - (2) inserting the word "unreasonably", in section 588FDB(1)(a), before the word "preventing" and then defining "unreasonableness" in a manner similar to the formulation used in section 588FB in relation to "uncommercial transactions". It might also be appropriate to incorporate a suitable requirement that the liquidator establish that the transaction was for less than market value or not the best price obtainable in the circumstances (perhaps only to the level of a prima facie case with the burden then shifting to the defendant to prove market value or best price obtainable).<sup>5</sup>
- 1.14 In either case, we encourage the Government to take this opportunity to not only enhance the drafting of section 588FDB to address the issues identified above, but also to make changes to the overall voidable transaction regime (to enhance the existing provisions which in many cases are of limited utility, particularly when it comes to liquidators making recoveries for the benefit of creditors). We believe that some simple changes such as removing or lessening the requirement to prove insolvency and introducing the concept of "evidential burden" for liquidators' voidable transaction claims would increase their feasibility and lower their costs, and in turn make the provisions far more effective.

#### *Creditor-defeating disposition or transaction?*

- 1.15 The Oxford dictionary defines "*disposition*" to include "*the distribution or transfer of property...*" Disposition, in section 588FDB(1) of the Exposure Draft appears to indicate that property is being dealt with in a manner that sees ownership or possession move from the company to another person.
- 1.16 However, if the intention of proposed section 588FDB(1)(b) of the Exposure Draft is to capture transactions of a company that are not solely transfers of ownership of the company's property then we recommend that the use of the phrase "*disposition*" be replaced with "*transaction*." This term would then have the meaning given in section 9 of the CA and is used throughout Part 5.7B of the CA thereby ensuring that there is consistency with the interpretation of the new form of voidable transaction and those that are of longstanding use.
- 1.17 If the phrase "*transaction*" was to be used in place of "*disposition*", in proposed section 588FDB(1), it appears that proposed sub-section 588FDB(2) would no longer be necessary as the intention of

<sup>5</sup> See [2.11] to [2.13] below for further information on this topic.

section 588FDB(2) would be picked up in the definition of “*transaction*” in section 9 of the CA (in particular, (a) within that definition).

## 2 Voiding the Transaction

### *Where the company enters administration after disposition*

- 2.1 The proposed inclusion of sub-section 588FE(6B)(b)(iii), is a positive step in removing the requirement to prove a company’s insolvency in circumstances where the disposition occurred within 12 months prior to a company entering external administration (s588FDB(6B)(b)). As indicated above, the costs associated with proving insolvency can be quite high and therefore are a common factor in determining which actions to pursue. If costs can be reduced, this will encourage more actions involving illegal phoenixing to be brought before the Court and punished accordingly.
- 2.2 Consistent with our comments in part 1 above, in circumstances where the objective of the amending legislation is to improve the mechanisms available to combat illegal phoenix activity we suggest consideration be given to applying the proposed formulation in section 588FE(6B) to other existing voidable transactions in Part 5.7B of the CA.
- 2.3 Naturally, the period of 12 months in sub-section 588FE(6B) of the Exposure Draft is somewhat arbitrary but in the circumstances is reasonable. Nevertheless, it may be desirable to build in some flexibility in respect of this time frame by including drafting which provides for the period to be subject to variation by Regulation.

### *Where a disposition is not voidable – Deeds of Company Arrangement and Schemes of Arrangement*

- 2.4 In its current form section 588FE(6B)(c)(i) and (ii) of the Exposure Draft would exempt a disposition of property from being voidable under section 588FDB if such a transaction was effected under a DOCA or Court approved compromise or arrangement. The rationale for the exemption is to enable legitimate restructuring efforts of companies in financial distress (paragraph 2.36 & 2.37 of the EM) and on the assumption that there will be oversight of the transaction by creditors, ASIC and the Court (paragraph 2.38 of the EM).
- 2.5 A genuine restructure of a business facing financial distress is an effort to preserve enterprise value and maximise the potential return for the company’s creditors (and where possible, its shareholders) – “*return the company to a viable status, or at least to maximise the assets available for creditors.*”<sup>6</sup>
- 2.6 In that context, it is difficult to conceive of a genuine restructure that might justify a company entering into a phoenixing transaction because it occurs using a formal insolvency process.
- 2.7 The mechanism for effecting a restructuring, whether informal (consensual) or formal (involving a statutory process) would not, of itself, be a relevant reason for allowing a phoenixing transaction to stand in circumstances where it may otherwise be voidable.
- 2.8 Consequently, enabling formal or legislative mechanisms such as DOCAs to be used to effect a creditor-defeating disposition of property to prevent or hinder the property from being available to creditors in a winding up of a company may inadvertently establish a perverse incentive to use the restructuring mechanisms for the very purpose which the draft legislative provisions of the Exposure Draft seek to deter. A situation may arise where DOCAs are viewed by opportunistic directors or advisers, as the vehicle to engage in the very conduct for which the Government is aiming to legislate against while avoiding sanction.
- 2.9 In our view, any disposition of company property during a period in which the company was insolvent, or became insolvent because of the transaction, or was undertaken less than 12 months before the appointment of an administrator, should only be undertaken in circumstances where it can be established that the transaction was for the legitimate aim of realising value for the benefit of creditors.

<sup>6</sup> M Murray & J Harris, *Keay’s Insolvency: Personal and Corporate Law and Practice*, 10<sup>th</sup> ed., 2018

- 2.10 In order to address the matters raised above we recommend consideration be given to deleting subsection 588FE(6B)(c) in the Exposure Draft.

*Where a disposition is not voidable – Market value consideration*

- 2.11 Section 588FG(9) of the Exposure Draft requires a court not to make an order under section 588FF of the CA, in relation to a creditor-defeating disposition, in circumstances where there is evidence that:
- (1) consideration was given for the disposition; and
  - (2) 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 was made for the disposition.
- 2.12 Therefore, a person relying on proposed section 588FG(9)(a)(ii) must be able to provide evidence to the court in relation to the 'market value' of the property the subject of the disposition. Given the importance of this concept it is crucial that the guidance provided in the Explanatory Memorandum<sup>7</sup> is provided as a "Note:" in the amending legislation to ensure that there is clarity in relation to how 'market value' is to be assessed by the court.
- 2.13 Further, it may often be difficult to ascertain a precise market value and the market value of an asset can often be a matter of significant disputation. A potential alternative approach would be to provide a defence if the value of the consideration was market value or the best price reasonably obtainable at the appropriate time. This concept is well known in the context of section 420A of the CA<sup>8</sup> and we are of the view that case law with respect to section 420A can be utilised to establish a standard for companies and officers engaging in creditor-defeating dispositions. In our view consideration could also be given to including an additional sub-paragraph in section 588FG(9)(a) which picks up the alternative section 420A CA standard for sale of property of a company by a controller being a sale for the best price obtainable in the circumstances.
- 2.14 We also agree that the evidentiary burden in sub-section 588FG(9)(a), on establishing that the price for the property was the best price reasonably obtainable having regard to the circumstances or was for market value, should principally remain with the person seeking to rely on the defence. This should also be the case for officers and third parties seeking to rely on the exceptions in subsections 588GAA(3) and 588GAB(3) respectively (which are dealt with below). However, as suggested above<sup>9</sup>, it seems reasonable that the liquidator (or other person bringing the claim, such as ASIC) be required to have an "evidential burden" in showing that the transaction was not for market value or the best price obtainable.

### 3 Recovery by ASIC

*Making the administrative order*

- 3.1 The proposed inclusion of section 588FGAA enabling ASIC to make administrative orders in specific circumstances, where a company has made a creditor-defeating disposition of property, has underlying benefit in instances where liquidators are without funds to take the necessary steps to enforce rights under section 588FF of the CA. However, the proposed administrative power for ASIC is narrow, particularly in contrast to the *Bankruptcy Act 1966* (Cth) provisions which empower the Official Receiver to issue a notice to a person who has received money or property as a result of a transaction that is void against the trustee, with the notice requiring that person to pay to the trustee an amount equal to the money or the value of the property received. In light of our earlier comments in paragraph 1.6, we consider that a preferred approach may be that the administrative powers contemplated for ASIC, with respect to voidable creditor-defeating dispositions, should also be available to the regulator in relation to other voidable transactions in Division 2 of Part 5.7B of the CA.

<sup>7</sup> Page 20 at [2.28]

<sup>8</sup> See, for example McCoy, N, *Receiver's Duties in disposing of assets: s420A of the Corporations Act*, Insolvency Law Bulletin, Volume 7, Issues 1 & 2 (August & September), 2006

<sup>9</sup> See [1.13(2)]

- 3.2 We also query whether the 12 month timeframe prescribed in s 588FGAA(2), for which the liquidator has to request ASIC to make an order, is consistent with the objective of the provision insofar as providing an avenue for redress for the liquidator (and creditors) in circumstances where the liquidator has insufficient funds to cover the cost of court action.
- 3.3 Given the effect of the administrative order, insofar as it may order a person to transfer property the subject of the disposition to the company in liquidation or require payment of an amount fairly representing the benefits that a person has received because of the disposition, it is assumed that the considerations of ASIC in proposed section 588FGAA(5) will be critically evaluated. Therefore, we assume that where a request is made by a liquidator for an administrative order the threshold for satisfying ASIC that such an order should be made will not be insignificant.
- 3.4 In these circumstances, a period of 12 months from the date a liquidator of a company is first appointed may not be sufficient to enable a liquidator to make a request if the liquidator is unable to definitively establish the voidable creditor-defeating disposition of property on the face of books and records of the company. A liquidator may be awaiting funding to examine directors or third parties with knowledge of the affairs of the company's examinable affairs and/or may have gathered the funding for such examinations but been unable to secure an examination date within the prescribed 12 month period. In such circumstances, we consider that there should be a mechanism for ASIC to extend the period in which a liquidator may request the making of an administrative order. This could operate similarly to the extension provision in section 588FF(3) of the CA in circumstances where an application is made to the Court for a longer period in which a liquidator can bring an application for orders in relation to a voidable transaction by seeking such an extension within the initial 12 month period.
- 3.5 If such an extension provision was to be included ASIC should be required to undertake the same considerations that the Court undertakes when granting such extensions under section 588FF(3) of the CA including:
- (1) balancing the interests of the creditors in the winding up against those of the parties to the dispositions that may be impugned; and
  - (2) the genuine reasons for the liquidator needing the extension<sup>10</sup>.
- 3.6 The utility of the phrase "*ASIC must decide whether to grant the request*" at the end of sub-section 588FGAA(2) is also unclear in circumstances where sub-section 588FGAA(3) provides ASIC with a discretion to make an order following the making of a request. Therefore, it appears that ASIC's decision whether to grant the request is in fact included in its decision to actually make an order in sub-section 588FGAA(3).

*Applications to set aside administrative orders - Review of ASIC order by the Administrative Appeals Tribunal*

- 3.7 Paragraph 2.53 of the EM contemplates that a person may apply to the Administrative Appeals Tribunal (**AAT**) in relation to ASIC's decision to issue an administrative order in accordance with section 1317B of the CA.
- 3.8 Section 1317B of the CA does not prescribe a mandatory review procedure but rather enables an application to be made to the AAT for a review of a decision under the CA, made by ASIC, that is not an excluded decision pursuant to section 1317C of the CA.
- 3.9 In our view, consideration should be given to amending section 1317C of the CA so that section 1317B does not apply to a decision of ASIC with respect to an order made under sub-section 588FGAA(3). This would then limit the avenues of redress, to set aside an administrative order, to the Court,<sup>11</sup> rather than also the Administrative Appeals Tribunal. The entitlement afforded to persons, against whom an administrative order has been made, to apply to the AAT for a review of that decision pursuant to section 1317B of the CA may be a deterrent to liquidators making a request to ASIC under proposed section 588FGAA(2).

<sup>10</sup> *BP Australia Ltd v Brown* (2003) 58 NSWLR 322 at [138] to [139]

<sup>11</sup> Proposed section 588FGAE(1)

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*Court may set aside order by ASIC*

- 3.10 Section 588FGAE of the Exposure Draft contemplates that a person subject to an order under subsection 588FGAA(3) or any other interested person may apply to the Court to have the order set aside. However, the mechanism for making such application requires that it be made within 60 days after the “applicant” was given the order or otherwise became aware of it. In circumstances where there are multiple potential applicants contemplated in sub-paragraph 588FGAE(1) there should be some certainty as to when such an application is made.
- 3.11 In our view, the preferable course is for any application to be made 60 days after the person subject to an order, under subsection 588FGAA(3), is given the order. As orders by ASIC are given to the person, the subject of the order (sub-section 588FGAA(3)), we see no prejudice in this approach.
- 3.12 Further, the phrase “...or otherwise became aware of it” in subsection 588FGAE(2) should be deleted as the phrase creates some uncertainty as to when the 60 day period in which the person has to apply to have the order set aside may make such application.

Should you have any queries in relation to the above please do not hesitate to contact Noel McCoy or Lee Pascoe.

Yours faithfully



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