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27 September 2018

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

By Email: phoenixing@treasury.gov.au

Dear Ms Nero

Draft Legislation – Treasury Laws Amendment (Combating Illegal Phoenixing) Bill 2018

Thank you for the opportunity to lodge a submission on the range of law reform proposals (set out in the draft legislation 'Treasury Laws Amendment (Combating Illegal Phoenixing) 2018' and 'Insolvency Practice Rules (Corporations) Amendment (Restricting Related Creditor Voting Rights Rules 2018').

The submission is made by me in my capacity as the Chairman of the National Pitcher Partners Business Recovery and Insolvency practice, which is made up of practices in Melbourne, Sydney, Adelaide and Perth.

Preliminary Comments

We welcome reforms that detect, deter and disrupt illegal phoenixing and more harshly punish those who engage in and facilitate this illegal activity. However, we re-state the view we expressed in response to the Modernising Business Registers Program consultation paper of July 2018. In essence, we believe that open accessible corporate data is the first step to disrupt 'rogue' operators who exploit the corporate form to the detriment of unsecured creditors, including employees and tax authorities.

Overall, we welcome all the proposed reforms but highlight potential issues and areas for abuse. In particular:

- We support measures that strengthen the ability of liquidators and ASIC to investigate and attack illegal phoenix transactions. In this regard, we recommend that additional investigative powers are introduced in to the Corporations Act 2001 to mirror those set out in the Bankruptcy Act 1966.

- We recommend that ASIC is appropriately trained and resourced to ensure that it is capable of enforcing the proposed reforms, including the phoenix offence. A clear regulatory guide is required from ASIC as to how it intends to administer the proposed reforms.

- We highlight a numbers in which some of the proposed reforms may be abused by rogue operators.

- We recommend that the ATO give clear guidance on how intends to implement the proposed reforms and what steps it will take to limit the effect of the reforms on legitimate activities.

Yours sincerely

Paul Weston
Chairman
National Business Recovery and Insolvency

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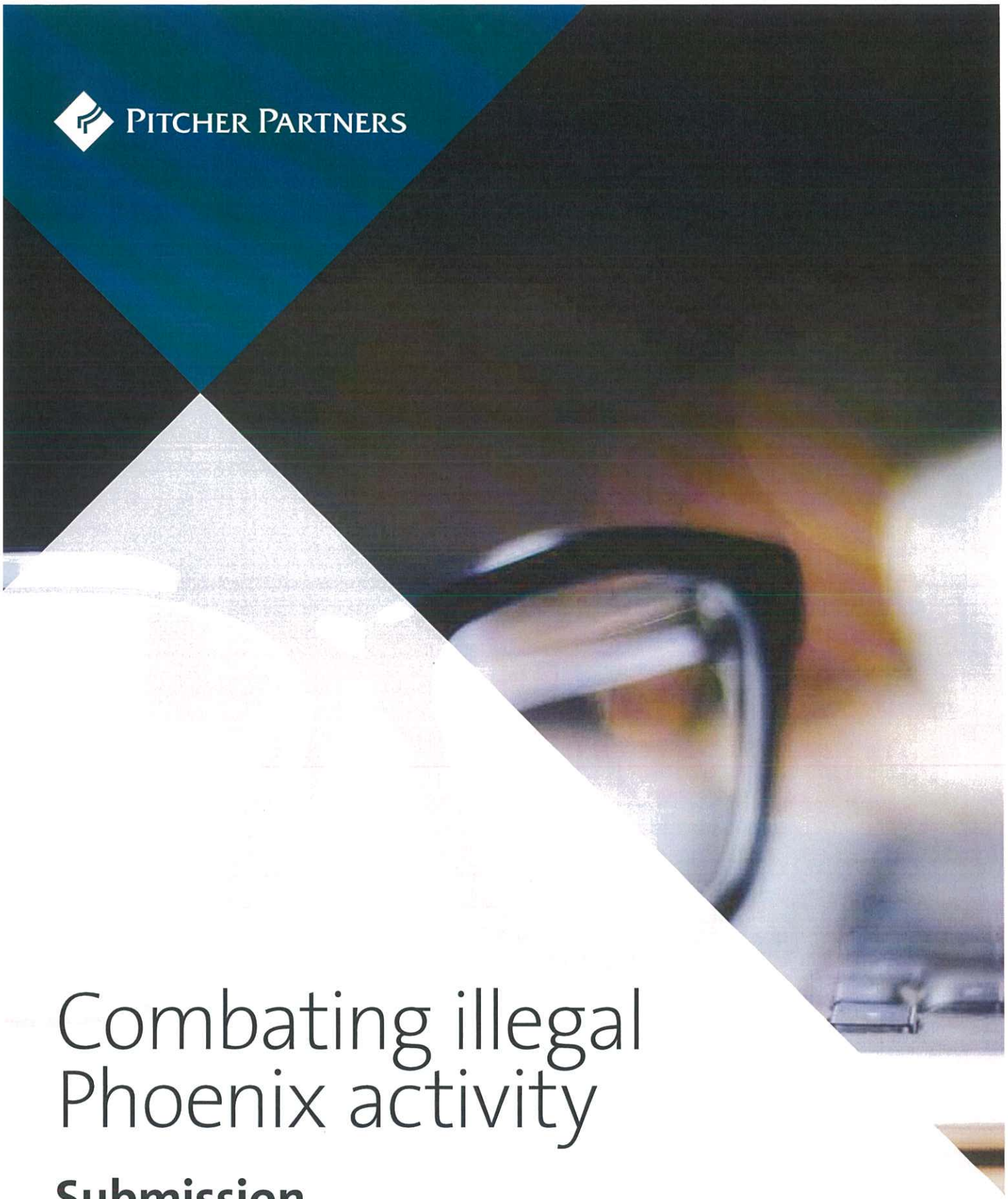

Combating illegal Phoenix activity

Submission

September 2018

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$3.4bn
Worldwide revenue 2017 (USD)

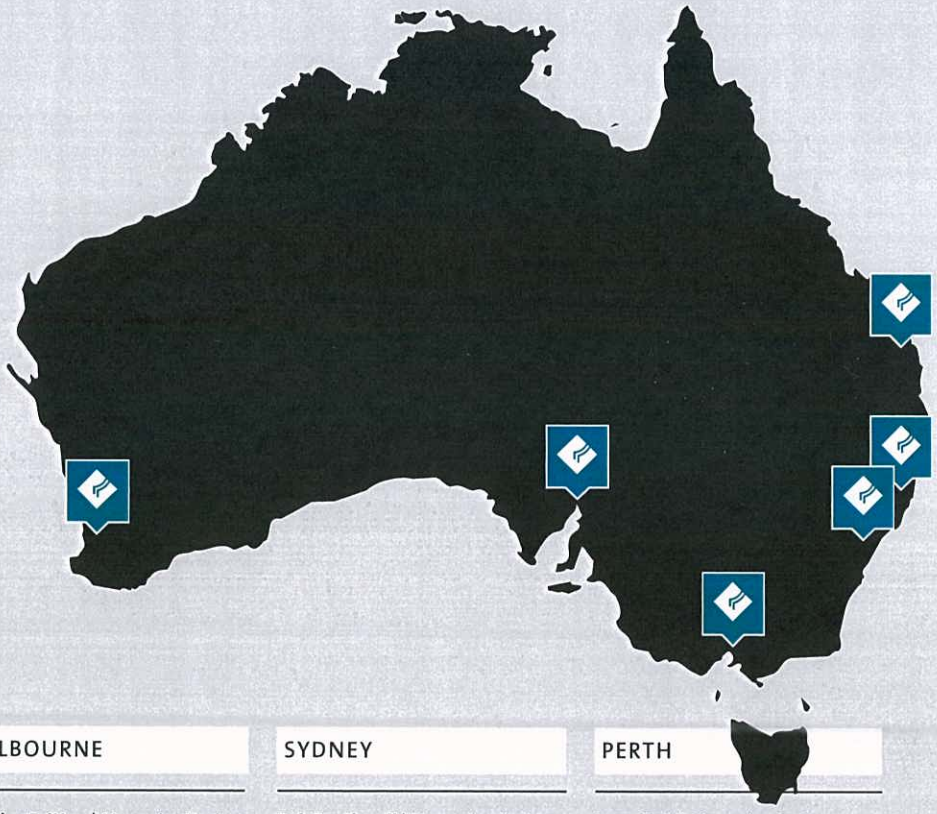
147
Territories

33,600+
Partners and staff globally

122
Partners nationwide

1,300+
People nationally

Firm locations



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Schedule 1: Phoenixing offences and other rules about property transfers to defeat creditors

1.1 Recovery of Creditor Defeating Disposition (CDD)

A new type of voidable transaction, a CDD, will apply in the following scenarios:

- Firstly, where a CDD occurs within 12 months prior to an external administration.
- Secondly, where a CDD occurs at a time the company was insolvent.
- Thirdly, where a company becomes insolvent as a result of a CDD.

The new provisions will obviate the need for the liquidator to prove insolvency for CDDs that occur within 12 months prior to the external administration.

In our experience, most phoenix activity is undertaken in the weeks prior to the liquidation of the company and the records often disposed of by or in the possession of the phoenix entity, which are difficult to access.

Consequently, we strongly support the introduction of this provision.

1.2 Market value

The proposed reforms introduce a concept of 'market value' consideration. Whilst there is no statutory guidance as to the interpretation of this term, there is an existing body of jurisprudence that will provide guidance on a case by case basis.

1.3 Recovery by ASIC (administrative order)

We support amendments that grant ASIC specific powers to make administrative orders to recover property the subject of voidable CDDs and welcome a recovery regime which avoids the need for Court processes and its associated costs and delays. We assume that the administrative order will be given effect by ASIC issuing a notice to the recipient.

If the administrative order is properly made, a notice properly issued, and if the order is set aside by the Court upon application within 60 days of the recipient becoming aware of it, the amount claimed is recoverable as a debt (new S588FGAD). Whether the statutory right of set-off set out in S553C is intended to be available to a respondent in these circumstances is unclear.

This provision is based on the existing section 139ZQ of the Bankruptcy Act, whereby AFSA can issue a notice with respect to a voidable disposition of property by a person who later becomes bankrupt. We are concerned that ASIC may take a conservative approach when making an administrative order. If an administrative order were to be challenged, that challenge would occur in an AAT administrative review or judicial review in the Federal Court. The prospect of administrative and judicial review is likely to heighten ASIC's reluctance to issue recovery notices, except perhaps in the most clear-cut cases. A potential respondent to an administrative notice may be able to avoid ASIC issuing the notice by raising baseless defences which would otherwise have no prospects of success in a judicial contest. The resulting administrative burden on ASIC could frustrate the intent of the reform. We suggest the following adjunctive measures:

- ASIC should act on liquidators' applications in a timely and proactive manner (recommend placing a 3-month deadline for providing a response).
- ASIC should communicate with liquidators about the level of evidence required to ensure a successful application and provide details on why unsuccessful applications were not accepted.
- We considered whether liquidators could challenge ASIC's rejection of an application for an administrative order, say by way of an AAT application. We rejected this as a workable option, given that in practice, a liquidator who strongly believes a CDD has occurred ought to commence a Court proceeding for recovery were ASIC unwilling to issue a recovery notice.
- ASIC must be adequately funded and resourced to administer the administrative order regime. Further, ASIC staff responsible for reviewing a liquidators' application for an administrative order must be appropriately experienced and trained.

To reduce the reluctance of ASIC to issue an administrative order, we recommend that proposed legislation be expanded (our preferred option rather than a Practice Note) to incorporate 'reasonable efforts' to be undertaken by the liquidator prior to making an application to ASIC to ensure that only credible applications are submitted to ASIC. More specifically, we recommend legislation includes:

- criteria guiding the minimum steps the liquidator must have already taken prior to an application to ASIC (e.g. demands issued on the transferee, attempts to obtain financial records);
- criteria of what information and evidence the liquidator must provide to ensure a compliant application to ASIC;
- the formal process in which ASIC must respond to a liquidators' application (e.g. within 3 months); and

The success of this reform will require ASIC to implement the reform quickly and robustly. The entire basis of the phoenix reforms is to encourage changes in behaviour across the Australian corporate environment. This basis would be completely undermined were the reforms to be introduced, and for ASIC to thereafter either issue minimal or no recovery notices.

In the instance of a 'friendly liquidator', creditors may be the only source of information to alert ASIC to the existence of a CDD. The proposed reforms do not appear to allow creditors to initiate an application to ASIC for recovery of a CDD. In the absence of creditor initiated requests, there must be a procedure whereby the external administrator is obliged to notify creditors of the criteria for recovery of a CDD, ASIC's powers to make administrative orders, and the avenues for creditors to notify ASIC of offending behaviour.

1.4 Phoenix Offence

Pursuant to the existing s588FE(5), a liquidator is entitled to apply to set aside transactions that would be considered CDD under the proposed reforms. These provisions are rarely, if ever used.

The proposed reforms introduce a stand-alone concept of a CDD together with a number of statutory presumptions intended to assist a liquidator (and ASIC) to set aside CDDs.

We support this reforms.

We repeat our earlier concerns that these reforms must be concurrently backed by a better resourced ASIC and a more robust approach by the regulator to the prosecution of CDDs and offenders. Relying on an offence for deterrence without proper enforcement is futile.

1.5 Defences

Paragraph 2.91 of the Explanatory Memorandum refers to the reasonable steps defence available for a person that takes all reasonable steps to prevent the company making the creditor-defeating disposition. The paragraph makes specific reference to a non-executive director.

The reference to 'non-executive director' is confusing. In our experience, the distinction between executive and non-executive director has no application in practice in insolvency matters. For example, it is no defence to an insolvent trading claim to assert that one was a non-executive director. If you are director, you have obligations. How you chose to practically participate in the management of a company is immaterial to the imposition and application of those obligations.

We have concern that the reasonable steps defence may be manipulated by the use of dummy directors. The following example highlights our concerns:

- Company A has 3 directors.
- Director 1 is a legitimate director and the actual company controller in reality.
- Directors 2 & 3 are dummy directors.
- A resolution is put at a purported meeting of directors to authorise Company A to enter into a CDD.
- Directors 2 & 3 vote in favour of the resolution. Director 1 votes against.
- The resolution is passed and Company A enters into the transaction.
- Director 1 could rely on the 'reasonable steps defence' to avoid liability.

Our second area of concern is the defence that the defendant had reasonable grounds to expect the company was solvent at the time of the disposition. In particular, paragraph 2.89 of the Explanatory Memorandum says a defendant may rely on a competent and reliable person providing information about the company's solvency, and the defendant must have reasonable grounds to believe that the person is competent and reliable.

In our experience, the pre-insolvency market is where most illegal phoenixing occurs. It is not unusual that a company in financial difficulty will seek advice from advisors – often pre-insolvency advisors that hold themselves out as professional solvency experts, but who in reality are not members of any professional association nor who carry any professional indemnity insurance (including disqualified liquidators, accountants).

The concern here is to ensure that the person on whom the director relies to provide information about the company's solvency meets an appropriate threshold of 'competence and reliability'. How to achieve this?

In our view, it would be appropriate to require a director to enquire into the qualifications of the person providing solvency advice. This should include current membership of a recognised industry association (such as ARITA, CA, CPA).

We recommend, as we did with the safe harbour legislation, that the new legislation define a 'competent and reliable' advisor as one with accreditation or registration with a professional body and carry PI insurance. For example, an accountant with at least a CA or CPA qualification. The costs of pre-insolvency advisors are comparable to professional advisors with obligatory PI insurance. Accordingly, we believe the cost of seeking advice from a registered professional is not a valid excuse to preclude the definition of a competent advisor from the legislation. Communication is key that seeking advice from a qualified professional during a critical time in the company's business is the best option for all concerned.

Section 588FG(9) provides that a court is not to make an order concerning a CDD if there is evidence before the court that suggests a ***reasonable possibility*** that consideration of at least the market value was given. This threshold is too low. The legislation should specifically state that person relying on the validity of this defence bears the burden of proving that consideration of at least market value was paid. This test would be applied on the balance of probabilities.

2.1 Prevent directors from backdating their resignations to avoid personal liability

We agree with this sensible and relatively straightforward reform.

We are concerned that the 12 month lock out period may cause an injustice in instances where a director has taken reasonable steps to lodge their resignation but it was not lodged for some other reason. For example:

- The director signed a resignation form and provided it to their accountant to lodge. Due to accountant's oversight, the form was not lodged with ASIC.
- The director signed the form and gave it to the company (another director or secretary). The company represented that the form would be lodged, but failed to do so.

In each of these instances, the director would be locked out of an application to Court for an order reflecting the actual resignation date, if the failure to lodge is not detected and a Court application was not filed within 12 months. This would be manifestly unjust in some instances, such as where a Director Penalty Notice was issued by the ATO.

An appropriate solution would be to allow any director to seek the leave of the Court to bring an application outside 12 months. To ensure that this reform appropriately obliges directors to take personal responsibility for ensuring that their resignation is lodged with ASIC, the reforms should include a set of prescribed matters the Court can take into account when considering whether leave should be granted. These could include an obligation to consider the reasonableness of the steps the director took to lodge their resignation with ASIC.

Other options:

In our experience, illegal phoenix operators will appoint 'dummy' directors from the date of a company's incorporation, particularly asset holding entities. The proposed Director Identification Number (DIN) regime will aide in detecting the appointment of dummy directors.

Importantly, in our experience, rogue operators will never appoint themselves as a company officer. No reform can possibly stop this occurring.

However, the introduction (and enforcement) of a criminal offence relating to the facilitation (aiding and abetting) of the appointment of a dummy director would deter this type of fraud.

2.2 Prevent a sole director from resigning and leaving a company as an empty corporate shell with no director

The proposed legislation proposes that a director may not resign if the resignation would leave the company without a director. We agree with this reform which will require directors to be proactive with the fate of a company.

Paragraph 3.29 in the Explanatory Memorandum says that the amendments do not prevent a sole director being removed because they are disqualified from being a director. We agree with this approach; however we cannot see how the exposure draft has appropriately considered the practical consequences of this event. In our view, it seems that in this circumstance a company will be left without a director.

It would be appropriate in this instance for ASIC to automatically initiate the liquidation of the company, if appropriate remedial measures for the appointment of a replacement director do not occur within a statutory time-frame (say 3 months).

3.1 Extending the estimates and director penalty regimes to GST liabilities, including LCT and WET.

We understand that failing to pay GST is a recognised problem with phoenix activity. In our experience, illegal phoenixing involves substantial GST debt where most other supplier trade creditors have been paid. We agree that this reform is a necessary deterrent to stop this unfair commercial advantage of participants who have no intention of paying their GST liabilities.

Historically the DPN regime has been linked with non-payment of employee related tax withholding and superannuation obligations. The expansion to include GST, LCT and WET liabilities is a step away from employee related obligations. We caution against any further broadening of the DPN regime beyond GST, LCT and WET without community consultation. We are concerned about the risk that the DPN regime might be incrementally expanded to include new categories of tax, such as income tax liabilities.

As a leader in the middle market, we have concerns with any measure that negatively impacts the lawful operation of small to medium enterprises. A concern we have identified is that this reform could be a barrier to people going into business. GST is a significant exposure in operating a business, far more so than PAYG withholding and SGC liabilities. We see plenty of non-employing entities that still have significant GST debts. Currently, whilst government is looking at reducing the bankruptcy period to one year to encourage entrepreneurism, this reform could be a step in the opposite direction. Many people that go into business fail after the first couple of years. Under the expanded DPN regime, all directors of such entities face potential bankruptcy.

Given how broadly the legislation has been drafted and because of the subjective nature of deemed estimates, the ATO needs clear and robust policies and guidelines on how they will apply the reform to ensure their application to targeted phoenix entities. For example, when can the ATO issue a DPN beyond the ordinary 4-year limit?
We would encourage the ATO to develop appropriate policies and guidelines to ensure alternatives are provided to directors that are lawfully operating a business prior to issuing a DPN. For example, the option that the ATO take security over assets as an incentive to approve and enter into payment arrangements.

4.1 Expand the Australian Taxation Office's existing power to retain refunds where there are tax lodgements outstanding

Currently, the Commissioner can retain refunds and apply them against other outstanding debts of the taxpayer. This reform extends this process to instances where a taxpayer has outstanding returns or information required by the Commissioner, allowing the ATO to retain the taxpayer's refunds.

In principal, we support this reform, but only if the Commissioner selectively applies his discretion to high risk taxpayers and if refunds retained across different entities are part of the same tax consolidated group. The ATO is well placed to identify those involved in phoenixing – with its visibility over the conduct of taxpayers. Significant powers to compel the production of documents and information exist, and we welcome the introduction of a power to stop refunds to high-risk taxpayers who fail to lodge returns on time.

In our experience, the expansion of these regimes occurs incrementally. We are concerned that these reforms will be oppressively expanded in the future to all taxpayers. Measures should be put in place today, to ensure that future generations understand that the intention of these reforms was to cover high risk operators only.

This reform should encourage taxpayers to attend to their tax affairs in a timely manner.

INSOLVENCY PRACTICE RULES (CORPORATIONS) AMENDMENT (RESTRICTING RELATED PARTY CREDITOR VOTING RIGHTS) RULES 2018

Schedule 1: Amendments

Proposed reform: Restrict the voting rights of related creditors of the phoenix operator at meetings of creditors to vote on the appointment or removal and replacement of an external administrator.

This reform will mean that related parties are only allowed to vote on assigned debts for the amount that they paid for the assignment, where a vote relates to the appointment or removal of an incumbent external administrator. This approach exists in bankruptcy, but applies to all creditors. We support this reform on the basis that it applies to all creditors, both related and un-related and applies to every vote on any resolution.

Additional commentary regarding options to combat illegal phoenix activity from the liquidators' perspective:

To further assist liquidators in their investigations to detect and report illegal phoenix activity to ASIC, and for ASIC to enforce and prosecute, we invite Treasury and ASIC to consider and adopt the following measures:

- Empowering ASIC to conduct examinations equivalent to AFSA's power under s.77C of the Bankruptcy Act 1966. Currently, when faced with a non-compliant director, advisor or third party, the power of the liquidator to obtain necessary information is often through public examinations; a very costly process.
- Empowering ASIC to issue the equivalent of AFSA's Notices under s.77AA of the Bankruptcy Act 1966. Much time and cost is expended by external administrators trying to obtain the company records from those phoenix facilitators. We are spending more time reporting accountants and lawyers to ASIC and the Victorian Legal Services Commission in recent years with the proliferation of phoenix facilitators in the industry and the difficulty we experience in obtaining documents from third parties.
- Offshore Information Notices are issued by the ATO under Section 264A of the Income Taxation Assessment Act 1936. They are generally issued to Australian taxpayers to produce documents held outside of Australia e.g. offshore bank statements. A similar power exists for AFSA under the Bankruptcy Act. Liquidators should have similar powers to assist them properly investigate the affairs of the insolvent, or realising or recovering assets for the benefit of creditors.

Conclusion

The introduction of the reforms is welcomed and will support existing measures and inter government task-forces to deter and disrupt illegal phoenix activity. The proposed reforms will not eradicate illegal phoenix activity, but if ASIC staff are trained, funded and are willing to enforce the amended corporation laws, the reforms should assist in combating illegal phoenix.

The ATO will need to provide further guidance on how it will selectively apply the proposed new tax laws to high-risk taxpayers and give comfort that the DPN regime will not extend any further than GST, LCT and WET in the future. We have foreshadowed our concerns regarding the increased power to the ATO to withhold payments having a detrimental impact on genuine businesses, particularly those in the middle market.

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