



**Small Business
Development Corporation**

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Dear Ms Nero

Reforms to combat illegal phoenix activity

The Small Business Development Corporation (SBDC) welcomes the opportunity to provide feedback to the Federal Government's Reforms to combat illegal phoenix activity – draft legislation consultation (Consultation Paper).

Background

The SBDC is an independent statutory authority of the Government of Western Australia established to support and facilitate the growth and development of small businesses in the State. The agency's core role is to provide advisory services to new and existing businesses in Western Australia, including a focus on supporting the establishment of new enterprises and enhancing regulatory compliance.

Another key role of the agency is to influence the policy and regulatory environment affecting the small business sector in Western Australia. In this regard, the SBDC regularly contributes to policy and legislative reviews and inquiries undertaken across all tiers of government.

To this end, the SBDC¹ strongly supports the proposed reforms to better protect creditors, which often includes small businesses, from the loss suffered as a result of unscrupulous companies engaging in illegal phoenix activities.

¹ The views presented here are those of the SBDC and not necessarily those of the Western Australian Government.

Phoenixing activity and small businesses

As identified in the Consultation Paper, phoenix activity is not defined in legislation and at times it can be difficult to differentiate between legitimate business rescue activity and illegal phoenix activity. One common theme with illegal phoenix activity is the first company's directors, and in some circumstances which may also include pre-insolvency advisors, accountants, lawyers or other business advisers, deliberately stripping and transferring assets from the company to another with the intention of defeating the interests of the first company's creditors.

It is well documented that illegal phoenix activity has a significant impact on the Australian economy. A recent report from PricewaterhouseCoopers estimated that phoenix activity costs the Australian economy between \$2.85 billion to \$5.13 billion a year. This cost is spread across businesses, employees and government, with the cost to businesses specifically estimated at \$1,162 million to \$3,171 million a year.² While illegal phoenix activity has many victims, for small businesses the impact can have catastrophic impacts on their business as well as personal lives.

Illegal phoenix activity has been highlighted on a national level through the extensive reviews of the construction industry.³ However, this is not limited to construction and can extend into other industries such as manufacturers and installers of goods and service providers.

The SBDC has been observing the Federal Government's reforms in the insolvency space over the last couple of years. For instance, the SBDC commends the recent introduction of a phoenix hotline.⁴ Providing avenues for businesses to report illegal phoenixing activity is an important step in breaking this chain and providing an opportunity for small contractors to make a report anonymously should overcome their concerns of fear of commercial consequence should they report.

The SBDC is also supportive of the work of the Phoenix Taskforce in proactively dealing with illegal phoenix activity.

Feedback on proposed reforms

The SBDC was pleased to see the Federal Government's commitment in the 2018-19 Budget to a package of reforms to the corporations and tax laws to combat illegal phoenix activity. In particular, the SBDC agrees that reforms are urgently needed to both deter and disrupt illegal phoenix activity as well as punish those who

² PricewaterhouseCoopers, *The economic impacts of potential illegal phoenix activity report*, July 2018, available at: https://www.ato.gov.au/uploadedFiles/Content/ITX/downloads/The_economic_impacts_of_potential_illegal_Phoenix_activity.pdf (25 September 2018)

³ Both inquiries consider illegal phoenix activity in the construction industry context: *Independent Inquiry into Construction Industry Insolvency in New South Wales* (2012); and *Parliament of Australia, Insolvency in the Australian construction industry* (2015).

⁴ Small Business Development Corporation, 'New hotline to combat illegal phoenixing activity', *SBDC Blog*, 19 July 2018, available at <https://www.smallbusiness.wa.gov.au/blog/new-hotline-combat-illegal-phoenixing-activity> (25 September 2018)

engage in and facilitate this conduct. In line with the Consultation Paper, the following specific comments are provided.

Credit defeating property disposal

The SBDC supports the proposed reforms to address issues with insolvency advisors giving business advice to undertake credit defeating property disposals. When a company faces financial hardship and enters insolvency, company assets become critical for creditors in order to recoup some of the outstanding debt that is owed.

Unfortunately weakness in the law against illegal phoenix activity has created a market for unscrupulous insolvency advisors, other advisors and in some cases even liquidators, to provide advice and facilitate transactions to strip the assets of a company and transfer them to a new entity, ready for their client to continue operating a business without the burden of corporate debts. This then leaves creditors for the old company without a clear means to recover money owed.

The SBDC welcomes the creation of new civil and criminal offences that extend beyond company directors to insolvency advisers and other persons whom facilitate a company making creditor-defeating dispositions. In order to bring about meaningful and lasting cultural change, it is important that all parties that are involved in facilitating illegal phoenixing behaviour being captured by the proposed reforms to the *Corporations Act 2001*.

Increasing the powers of the Australian Securities and Investments Commission (when a company is in liquidation)

The SBDC also welcomes the proposed reforms to extend the powers of the Australian Securities and Investments Commission (ASIC) to recover assets in cases where liquidators or other creditors do not have the funds to pursue legal action. Liquidators can only act to the capacity that it can be paid resulting in difficulties when a company has insufficient funds to cover the cost of court actions.

Also it has become apparent that in some cases the liquidator may be complicit in the illegal phoenixing activity of a company director, so this extension of ASIC's power to take action to recover assets will enable it to intervene if it suspects this sort of behaviour by a liquidator.

Liquidators must be careful in spending any money on legal action against company directors or their advisors given a company that has fallen into insolvent liquidation generally has inadequate assets to cover creditor claims. By extending the role of ASIC, which has resources available that are outside of the fallen company's assets, it ensures that any money that remains with the insolvent company may be used towards creditor claims. As small businesses typically fall into the creditor category, the SBDC supports this proposal.

However, any new legislative protections and regulator enforcement powers are only as good as the regulators funding allows. The SBDC strongly supports active enforcement of the proposed new reforms subject to ASIC being appropriately resourced.

Director accountability

The SBDC supports the Federal Government's commitment to holding directors accountable for misconduct. As the Consultation Paper identified, company directors when engaging in illegal phoenix activity can exploit deficiencies in the current *Corporations Act 2001* to enable them to obscure their role in company decisions and even shift accountability to other directors.

The proposed reforms to prevent the significant backdating of resignations of directors as well as preventing directors from resigning their position and leaving the company with no director at all are therefore supported. These reforms will serve as a means to stop directors from being able to remove themselves to escape liability which in turn will reduce the incidence of illegal phoenix activity and its effect on employees, creditors and government revenue.

The SBDC also sees enormous benefit to introducing director identification numbers (DIN), which is currently under consideration as part of the Federal Government's reform of the business registration process. DINs would allow governments (and ASIC in this case) to map the relationship between individuals and entities and individuals and other people. This would offer a greater level of protection for small business creditors, in the knowledge that company director "movements" are being tracked.

Further to this, the SBDC believes that more should be done to hold company directors accountable when they chose to repeatedly engage in conduct that amounts to illegal phoenix activity. Directors serve a very important role and their conduct can have grave effects on employees and creditors when they engage in illegal phoenix activity. While the SBDC acknowledges that ASIC has processes in place to reprimand directors if they are caught doing the wrong thing, it is felt that further consideration should be given to targeting serial offenders.

Specifically, the SBDC proposes company directors:

- who have been involved in X number of insolvent companies, and
- their creditors have received less than X cents in the dollar,

should be made to prove to ASIC they are "fit and proper" before they can be appointed as a director again.⁵

The fit and proper test is a concept that applies to many professions where parties are put in a position of trust and confidence, including real estate agents, tax agents

⁵ In suggesting this model the SBDC has chosen not to provide specific figures. We are not an expert in this area but believe this could form the basis for an appropriate method in making directors accountable for their actions.

and lawyers. Directors are not dissimilar to these professions and when dealing with the livelihoods of employees and creditors it is important that they are held to a high standard.⁶

The direct result of this measure is that:

- the onus is shifted from ASIC to prove that a director is no longer fit and proper to the director having to prove this, and
- it also captures directors that are incompetent as opposed to criminal.

The SBDC believes that such a measure is a much needed addition to stop directors from repeatedly choosing to engage in activity that puts employees and creditors at risk. The SBDC welcomes the opportunity to work with The Treasury to further develop this proposal.

Concluding comments

The SBDC is particularly interested in reducing the impacts on small businesses of illegal phoenix activity in Australia and eagerly awaits the final recommendations following the conclusion of the consultation period. If you would like to discuss this submission in more detail, please contact Nikki Forrest, Policy and Advocacy on (08) 6552 3373 or email nikki.forrest@smallbusiness.wa.gov.au.

Yours sincerely



David Eaton
SMALL BUSINESS COMMISSIONER

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⁶ This concept is similar to the restricted directorship concept discussed at page 50 onwards in a paper prepared by Professor Helen Anderson (and others) for the University of Melbourne called *Phoenix Activity, Recommendations on Detection, Disruption and Enforcement*, 27 February 2017, Available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2924277 (25 September 2018).