Précis Paper

What is Phoenix activity and how does the law (attempt to) regulate it?

An in-depth discussion of Phoenix activity and how the law attempts to regulate it.

Discussion includes

- What is Phoenix activity?
- Why are we hearing more about Phoenix activity now than we have before?
- Is there a specific law against Phoenix activity?
- Why is there not a specific law against Phoenix activity?
- Who stands to incur the biggest loss from Phoenix activity?
- Are there any benefits of Phoenix activity?
- How much does Phoenix activity cost our economy?
- How to draw the line between legally rebirthing a company as opposed to Phoenix activity?
- What is a pre-pack arrangement?
- *Australian Securities and Investments Commission v Franklin (liquidator), in the matter of Walton Constructions Pty Ltd* [2014] FCAFC 85
- Importance to Phoenix activity of the commerciality of a transfer of a business
- Enforcement of laws dealing with Phoenix activity
- Who may be considered to be a Phoenix operator?
- The Plutus Payroll Scam
- *Australian Securities and Investments Commission v Somerville* [2009] NSWSC 934

- What is the level of consideration that is required in order for a transfer to be legitimate?
- Being a legitimate transfer of assets, does a pre-pack insolvency arrangement still provide money to go into the insolvent company, because the assets are being transferred for consideration?
- *Korda, in the matter of Ten Network Holdings Ltd (Administrators Appointed) (Receivers and Managers Appointed)* [2017] FCA 914
- Proposed Government reforms for targeting Phoenix activity
- How might these proposed reforms impact on Phoenix activity?

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What is Phoenix activity and how does the law (attempt to) regulate it?

1. In this edition of BenchTV, Ben Sewell (Principal, Sewell and Kettle Lawyers, Sydney) and Lauren Willgoose (Lawyer, Sewell and Kettle Lawyers, Sydney) engage in an in-depth discussion of Phoenix activity and how the law attempts to regulate it.

<u>What is Phoenix activity?</u>

2. There is no definition for Phoenix activity in the *Corporations Act 2001* (Cth), though there have been calls for it to be defined and much academic debate about what it is.

3. Nonetheless, there is a general understanding about the nature of Phoenix activity. Phoenix activity is about rebirthing an enterprise by taking the assets from a company that is insolvent and moving them into another entity. The key issue with Phoenix activity is that there has been inadequate consideration paid. This means that there is a fraudulent element to the transaction, or the creditors do not have any entitlement to the value in the assets that are being moved.

4. Assets of a business may include land, equipment, goodwill – generally, whatever a business needs to operate.

<u>Why are we hearing more about Phoenix activity now than we have before?</u>

5. There have been two significant developments in the area of Phoenix activity which have led to it being more heard of now than ever before. These two developments are:
    i. The Phoenix Research Team, an academic research team including eminent academics who have thoroughly researched the area of Phoenix activity and produced three reports based on their findings. As a result, there is, for the first time, comprehensive academic analysis and critique of Phoenix activity.
    ii. The Government's announcement that it will target Phoenix activity. It has identified the "Phoenix operators" (that is, the people who are promoting and setting up Phoenix schemes), and announced that it will target them and also, potentially, introduce very significant reforms to the way that the insolvency regime works, to take out some of the gaming element to it.

<u>Is there a specific law against Phoenix activity?</u>

6. There is no specific offence against Phoenix activity that refers to it as "Phoenix activity". However, there is a variety of different actions. In the 1970s, a raft of law came into effect to stop the "bottom of the harbour" schemes. One of these laws that was introduced into the tax law made it illegal for a person to deliberately put a company in a position where they are unable to pay their debts. Unfortunately, this law was not enforced comprehensively. In terms of insolvency laws, there are actions that can be taken by a liquidator to claw back uncommercial transactions and unreasonable director-related transfers.

7. Therefore, the laws are there in essence. However, the issue which has arisen is that relying purely on the liquidation regime or the insolvency processes to enforce these laws has not created an optimal outcome in the view of the policy-makers.

Why is there not a specific law against Phoenix activity?

8. In 2012 amendments to the *Corporations Act 2001* (Cth) were considered to stop companies from essentially rebirthing themselves and being able to use the same name. These reforms were not brought into effect.

9. There are several reasons why a specific law against Phoenix activity may not yet have been implemented. Two of these are:
    i. The likely reluctance of governments to be seen as targeting small enterprises; and
    ii. The most effective way to target Phoenix activity is to criminalise it, by looking not at the objective occurrence of a transfer of assets, but rather the intention of the person who has transferred the assets. To do this, however, a whole raft of new laws would need to be brought into effect, and someone, or some agency, would need to be tasked with the responsibility of regulating and controlling this area. All of this would involve a lot of work, and governments have not yet shown any enthusiasm for doing this.

Who stands to incur the biggest loss from Phoenix activity?

10. There are two perspectives on who stands to lose the most from Phoenix activity. The first is that the ATO is the party that will lose the most, as it loses income tax, PAYG, GST, and other taxes, particularly because one of the drivers behind Phoenix activity is to evade tax. The second perspective is that, economically, it is actually competitors who lose the most. For example, if a building and construction business has a competitor

that is not paying any tax and is continually rebirthing its enterprise, if the first-mentioned building and construction business is paying its taxes, there is no way that it will be able to compete with its competitor.

<u>Are there any benefits of Phoenix activity?</u>

11. There is an academic debate about whether, on the one hand, it is worth allowing a business to legally rebirth itself, because it saves jobs, or the goodwill in the enterprise, and, on the other, whether, if a company is not able to sustain itself, it should be promptly put into liquidation, and its assets moved on to businesses that are able to be sustainable.

12. Unfortunately, there is not a great deal of empirical research by academics on whether Phoenix activity has the potential to save jobs or goodwill, or has positive effects for the economy.

<u>How much does Phoenix activity cost our economy?</u>

13. The second report of the Phoenix Research Team, mentioned above, examined the empirical evidence to try to work out how widespread Phoenix activity was in Australia, but found that there was no set of information or statistics that could be relied on to draw conclusions on this. As a result, no answer is able to be arrived at about how much Phoenix activity costs our economy annually. However, it is hypothesised that it is costing in the billions.

14. There are two types of cost involved:
    i. the cost to the creditors and the ATO of unpaid debts; and
    ii. The economic cost to competitors. So, for example, if a business in the building and construction industry has a competitor who is continually not paying their taxes, while the first-mentioned business is paying its taxes, as well as its employee entitlements and its debts, it may find it impossible to compete with the competitor.

It is very difficult to assess how much of an effect the second type of economic cost has on the community.

<u>How to draw the line between legally rebirthing a company as opposed to Phoenix activity?</u>

15. This is in interesting area of current debate. If it is argued that a Phoenix transfer takes place where there is inadequate or uncommercial consideration paid for the transfer of assets, if there is commercial consideration, does that make the transfer legitimate? Where there is commercial consideration, this is called a pre-pack insolvency arrangement, a pre-position sale, or a business rescue. This is a fine line, and there is no specific case law on this point that can provide guidance on where this line should be drawn.

16. Ultimately, if a company goes into liquidation, the person who needs to take legal action to determine whether there has been a legitimate or an illegitimate transfer is the liquidator themselves. However, unfortunately, if the liquidator does not have sufficient assets to run a claim, it is unlikely that any legal action will occur.

<u>What is a pre-pack arrangement?</u>

17. A pre-pack arrangement exists where a new company pays consideration or enters into a transaction to take over some or all of the assets of an insolvent company. As this transaction does not come within any of the claw-back arrangements or sham transfer laws, by default, it is seen as a legitimate transfer.

18. There has been a degree of silence from policy-makers in this area. In 2015, there was a Productivity Commission report that recommended that a regulation be implemented to put some shape on these types of transfers, however, in 2017, the Treasury released a report that rejected this recommendation. Therefore, as things currently stand, this is still an open area.

<u>*Australian Securities and Investments Commission v Franklin (liquidator), in the matter of Walton Constructions Pty Ltd* [2014] FCAFC 85</u>

19. In this case, ASIC commenced an action to remove a liquidator on the basis of apprehended bias. A particular insolvency firm had, over the course of years, accepted referrals from one particular pre-insolvency advisory firm (insolvency practitioners tend to run their practices based on referrals). ASIC decided to take action against the insolvency firm on the basis that the stream of referrals it had gave rise to a perception of apprehended bias, particularly as the fees relating to these referrals were significant. ASIC argued that if the insolvency firm was accepting work that was so important to its practice in terms of its value, a court should remove the firm from its appointment as a liquidator, not on the basis of any actual bias or illegality, but on the basis that a

reasonable person would have cause for concern that the firm may be biased. The court accepted this argument and removed the firm from its appointment as liquidator.

20. The case also touches on the area of pre-insolvency advice. In the case, a construction company had millions of dollars' worth of contracts that were transferred that forgave a $30,000 debt, where employees of the pre-insolvency advisory firm were appointed directors of the company which took over the assets of the insolvent company. It is important to note that the case did not deal with the commerciality of the transaction itself, but only with removing the liquidator on the basis of apprehended bias.

Importance to Phoenix activity of the commerciality of a transfer of a business

21. The commerciality of a transfer of a business is central to Phoenix activity. This is because the principal basis on which a liquidator can claw back a transaction on the basis of it being uncommercial is contained in the *Corporations Act 2001* (Cth), where the test applied is a reasonable objective one – that is, what would a reasonable person in the position of a director do in relation to whether or not to give effect to the transaction? If the objective test fails, and the court finds that a reasonable director would not have undertaken the transaction, then there is a basis for it to be clawed back. As such, this is an area where, if directors are transferring assets from one company to another whilst the first company is insolvent, they need to give very careful consideration to the valuation they apply to those assets.

Enforcement of laws dealing with Phoenix activity

22. Although there is plenty of law that can be used in the area of Phoenix activity, one of the critical issues is: who is going to enforce it? In one particular case, for example, a solicitor was accused of facilitating Phoenix activity, and under s 79 of the *Corporations Act 2001* (Cth), was found to be an accessory to Phoenix activity. ASIC took action against the solicitor, and a banning order was issued against the solicitor. However, given the amount of work involved in such a matter, for ASIC to take such a comprehensive action against a single legal practitioner would be an exceptional case.

23. This raises the question of enforcement of the relevant laws, that is, who is going to go out there and actually gather the evidence and run claims to claw back assets and prosecute directors who have breached their duties? If the liquidator lacks the funds and ASIC lacks the resources, then who is left to enforce the laws relevant to Phoenix

activity? This is an area which has not been thoroughly looked at from a regulatory point of view.

Who may be considered to be a Phoenix operator?

24. Phoenix operators are those who may be classed as 'promoters' – that is, those who seek out companies in distress, and assist them in putting together sham arrangements or tax evasion arrangements, with an objective of not paying debts, not remitting PAYG tax, etc. There is no hard-and-fast rules on the position a Phoenix operator may hold – they may be solicitors, they may be former liquidators, etc. The one constant, however, seems to be that Phoenix operators have the same objective – making a lot of money in a short period of time from these types of arrangements.

The Plutus Payroll Scam

25. One particular strand of Phoenix activity is the payroll scam. This is where a business is approached by a Phoenix operator who suggests to the business that it outsource all its payroll and staffing to the operator, who will take care of it and give the business a kickback.

26. An example is the $165 million Plutus Payroll Scam, a very troubling issue for the ATO, and something which it and the Government have created taskforces to directly challenge.

27. The scam moved from being a liquidation issue (that is, something a liquidator would deal with in terms of claw back) to a fraud and crime issue. The Australian Federal Police conducted a thorough investigation into the scam, and have since arrested the operators and are looking to arrest the participants.

28. In terms of its mode of operation, the scam used dummy directors and rebirthed companies over and over again. Its clients were various businesses around Australia that had outsourced their payroll and received a kickback, which was a proportion of the unpaid income tax and PAYG tax.

Australian Securities and Investments Commission v Somerville [2009] NSWSC 934

29. This was a case where the facts were agreed. ASIC brought an action against a lawyer who had written letters of advice to the directors of companies, which the court found

advised them to breach their duties as directors. The court found that these arrangements were “asset-stripping” and a direct breach of the directors’ duties under the *Corporations Act 2001* (Cth) and the common law.

30. Essentially, the lawyer had advised the directors that the companies were insolvent, and in order to protect the companies’ assets, the directors had to transfer the assets from Entity A to Entity B. The lawyer did everything that was required to give effect to the transfer, namely, registering the new companies, setting up the transfer agreements, and setting up the consideration.

31. The court said that the consideration created was illusory and a complete sham. The consideration in question was X class shares in the new company, having a discretionary element to them, expressed in the lawyer’s letters of advice as being in the discretion of the directors as to whether the transfer of assets from the old company was actually paid. Further, the valuation of the shares was equivalent to the valuation of the assets being transferred.

32. Therefore, the court held that, under s 79 of the *Corporations Act 2001* (Cth), the lawyer had aided and abetted the directors of the companies in breaching their duties.

<u>What is the level of consideration that is required in order for a transfer to be legitimate?</u>

33. This is an issue that is under debate. A prudent lawyer advising a client would advise the client to go to a valuer to provide a valuation of the assets. The valuation of business is based on the market at the time and a variety of factors that lawyers will not be in touch with, therefore, a valuer is best placed to provide this assessment.

34. When an asset transfer occurs, only the assets (that is, anything of value, or anything that is needed to operate the undertaking of the enterprise) are taken out of the company, and the debts are left behind. Debts include: tax obligations, supply debts, entitlements, etc. This is a delicate area, because if a pre-pack insolvency arrangement takes place where there is some sort of legitimacy to the transfer, there will still be a lot of potentially unhappy people who will be left in the lurch, and investigation by a liquidator taking place afterwards. Therefore, solicitors should be very careful about how they tread in these matters, so as not to be accused of being a pre-insolvency advisor who has helped a client undertake a Phoenix transaction.

Being a legitimate transfer of assets, does a pre-pack insolvency arrangement still provide money to go into the insolvent company, because the assets are being transferred for consideration?

35. The answer to this question is yes. The current approach is to look at any pre-pack insolvency arrangement or legitimate transfer of assets as working together with, or corresponding to, a safe harbour advice arrangement. Under the safe harbour regime which was implemented in September 2018, a director has some protection at law if they are able to implement a plan which is likely to improve the results to creditors in a liquidation scenario. Essentially, the policy-makers are encouraging directors to see a good lawyer and a good accountant, and do things the right way, rather than see someone who is encouraging them to get involved in fraud and an illegitimate transfer.

Korda, in the matter of Ten Network Holdings Ltd (Administrators Appointed) (Receivers and Managers Appointed) [2017] FCA 914

36. In this case, a large insolvency firm got involved in working on the restructure of Channel Ten before subsequently taking on an appointment as a voluntary administrator. This caused a great deal of fallout because of the assumption that an insolvency practitioner should be completely independent.

37. In this case, there was a fair bit of comment on what a pre-pack arrangement was, but the court made clear that although it had an opportunity to do so, it would not be drawn into an argument on whether a pre-pack arrangement was valid, or something to be recommended. This is largely because courts generally try to refrain from getting involved in judging commercial decisions.

38. Of course, this does not prevent a liquidator from subsequently examining any transaction the company has undertaken, coming to a decision as to whether the transaction is uncommercial or an unreasonable director-related transfer, and taking legal action to obtain compensation, or to claw back the assets.

Proposed Government reforms for targeting Phoenix activity

39. The Government has announced that it would undertake very significant reforms relating to this area. One of these reforms is the Director Identification Number (DIN), targeted at addressing the lack of checking of the names, dates of birth, etc, of people who become directors. Currently a big problem in Australia, this means that, theoretically,

anyone could be listed as a director. This is a very significant concern in the area of Phoenix activity, where dummy directors are used.

40. Inter-governmental task forces are also being created. This means that the ATO is in conversation with the Australian Federal Police and other departments to work out how to take action against Phoenix operators.

41. In terms of specific laws, there is no specific proposal to bring any laws into effect to criminalise Phoenix activity, because essentially, the relevant law is already there, albeit not being enforced.

42. Further, the Government has announced that it will look into a "cab rank" liquidation model. Currently, directors generally choose their own voluntary administrators and liquidators unless it is a court-based appointment, so if implemented, the cab rank liquidation model would be a significant change. Though this reform has been mentioned in a press release, it is not clear as yet whether it will be implemented. One of the criticisms of the insolvency regime is that directors are able to choose their own appointee, who may have a positive apprehended bias to not thoroughly look into the transactions, as this might "bite the hand that feeds them", so to speak. The proposed "cab rank" liquidation model would therefore be a way of addressing this issue, as it would deny directors the right to choose which voluntary administrator or liquidator to appoint.

43. A number of other reforms have been proposed, such as: security deposits from the ATO; an extension of the director penalty regime; and a stricter process for the issuing of ABNs.

<u>How might these proposed reforms impact on Phoenix activity?</u>

44. Where the Phoenix activity in question is a payroll scam with dummy directors, the introduction of the DIN and a more restrictive ABN issuing process will likely have a very disruptive effect on Phoenix activity. However, where the Phoenix activity is a basic transfer of assets from one entity to another for no consideration, then these reforms are not likely to have much of an effect.

45. The proposed cab rank model, if implemented, is likely to have some very interesting side effects in relation to the insolvency industry, which are difficult to predict at this point in time.

BIOGRAPHY

Ben Sewell

Principal, Sewell and Kettle Lawyers, Sydney

Ben is an expert in commercial litigation and insolvency law, having developed this expertise from 15 years of experience as a specialist solicitor. Ben is also a leading expert in personal property securities law. He has advised hirers, lenders, creditors, and insolvency practitioners about this evolving area. Ben also drafts security documentation and advises lenders about how to take security over personal property, including debt factoring and discounting. Over the past two years, Ben has acted for the principal defendant in shadow directorship proceedings run out of the Cayman Islands by the liquidators of the Centaur Litigation Fund.

Lauren Willgoose

Lawyer, Sewell and Kettle Lawyers, Sydney

Lauren joined Swell and Kettle Lawyers in 2016. She is the first point of contact in a number of commercial litigation and insolvency matters. Before becoming a lawyer, Lauren completed an internship at a human rights clinic in South Africa. She has also worked in a general practice firm in South Australia and gained experience in commercial property law, succession law, and debt recovery.

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Legislation

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