Corporate insolvency

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PROFILING PHOENIX ACTIVITY: A NEW TAXONOMY

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INTRODUCTION

The concept of "phoenix activity" broadly centres on the idea of a company failing and a second company, often newly incorporated, arising from its ashes with essentially the same controllers and business. Phoenix activity can be legal as well as illegal. Legal phoenix activity covers situations where the previous controllers start another similar business, using a new company when their earlier company fails, in order to rescue its business. Illegal phoenix activity involves similar activities, but the intention is to exploit the corporate form to the detriment of unsecured creditors, including employees and tax authorities. Identifying and delineating the illegal from the legal types is problematic for regulators for several reasons.

The first is that there is no express "phoenix offence". Therefore, cases involving illegal phoenix activity typically describe the circumstances of "phoenixing", but do not employ the exact term. Regulators must indirectly regulate the behaviour through the identification of breaches of other laws that do not expressly proscribe phoenix activity, such as breaches of directors' duties. Drafting legislation to proscribe this behaviour is challenging because there remains no mutually agreed definition of illegal phoenix activity, despite various attempts to do so over the years by parliamentary committees, law reform bodies, and a Royal Commission. The second impediment is that where the offence requires proof of intention, it is difficult to establish this because the actions of the company's controllers are usually cloaked in the trappings of a legitimate business rescue. In this note the authors propose five ways of categorising phoenix activity, two of which are legal and three of which are illegal, to assist regulators in the detection and enforcement of the illegal variety of phoenixing. The authors' research report examines the issues in greater detail.[1]

BACKGROUND

In a typical phoenix activity scenario, a company in financial difficulties, "Oldco", is placed into liquidation or voluntary administration, or is simply left dormant and eventually deregistered. Prior to this occurring, Oldco's assets may be transferred either to a newly incorporated entity, "Newco", or to an existing entity, such as a related company in a corporate group.

Just as phoenix activity is difficult to define, it is equally difficult to quantify. Nonetheless, the figures produced in recent years by government and other agencies demonstrate the seriousness of the problem and the importance of this research. For example, in 2009 the Australian Taxation Office (ATO) estimated the cost of phoenix activity to be between $1 billion and $2.4 billion a year.[2] This was estimated to include approximately $600 million per year in lost tax revenue.[3] In 2012, a report

[1] Anderson H, O'Connell A, Ramsay I, Welsh M and Withers H, *Defining and Profiling Phoenix Activity* (December 2014), http://law.unimelb.edu.au/files/dmfile/DefiningandProfilingPhoenixActivity_MelbourneLawSchool2.pdf.

[2] ATO, *Targeting Tax Crime: A Whole-of-Government Approach* (July 2009) p 16, https://www.ato.gov.au/General/The-fight-against-tax-crime/In-detail/Targeting-Tax-Crime-magazine/Archive/Targeting-tax-crime--a-whole-of-government-approach---July-2009.

[3] Commonwealth Treasury, *Action Against Fraudulent Phoenix Activity*, Proposals Paper (November 2009) p 2

prepared for the Fair Work Ombudsman (FWO) estimated the cost to business generally from illegal phoenix activity to be between $1.8 billion and $3.2 billion annually.[4]

Phoenix activity can be entirely legal and even desirable, especially if the worth of the failed company's assets is maintained and the employees keep their jobs and entitlements. However, the repeated resurrection of a business can become problematic even in the absence of an improper intention where the returns to creditors and benefits to employees are minimal. The behaviour only becomes illegal where the intention of the company's controllers is to use the company's failure as a device to avoid paying Oldco's creditors, who may include the ATO and the company's employees.

Phoenix activity involving the use of successor companies – one after the other – was described as "basic" phoenix activity in Treasury's 2009 proposals paper entitled *Action Against Fraudulent Phoenix Activity*.[5] In addition, Treasury defined phoenix arrangements within corporate groups as "sophisticated" phoenix activity.[6] Typically, under Treasury's sophisticated form, one entity with few or no assets within a corporate group incurs substantial liabilities by way of wages, superannuation contributions, or tax liabilities, and then is deliberately liquidated to avoid paying these debts. Employees may be transferred to a sibling entity in the group to continue their employment, and may or may not be paid their entitlements.

Illegal phoenix activity is not susceptible to precise modelling, such that if certain specified conditions are present, a regulator can determine with certainty that it has taken place. It is virtually impossible to identify illegal phoenix activity from an incorporation of a successor company following a single failure in the absence of documentary evidence, such as written instructions from advisors. Rather, a suspicion of illegal phoenix activity is likely to come from the external observation of the conduct of specific individuals involved in multiple corporate failures over a period of time.

Information about companies contained in the databases of the Australian Securities and Investments Commission (ASIC) and the ATO render it relatively easy to identify cases that constitute the "basic" form of phoenix activity, remembering that this could be in its legal or illegal form. This may be because the name of a controller (or related parties) of a failed company can be seen in the incorporation documents of Newco, or perhaps because Newco has the same or similar name to Oldco. It may also be relatively easy to identify potential cases of "sophisticated" phoenix activity where businesses are conducted by complex corporate groups. However, determining whether the basic or sophisticated phoenix activity in question is legal, or is designed to avoid payment of debts and is therefore illegal, is more problematic.

In seeking to identify illegal forms of phoenix activity, regulators may look to evidence that the same controllers have operated multiple failed companies over a short time period. They may also look to whether Newco is conducting business under substantially the same company name as Oldco in order to retain customer goodwill, or is operating under the same registered business name, even if the company's name has changed markedly. Detection of phoenixing is rendered more difficult where company names are significantly changed and/or where dummy individuals are placed in directorships.

Nevertheless, it must be remembered that even where there are multiple failures and new companies are created with the same controllers, name, and/or business premises, this is not in and of itself proof of illegal phoenix activity. Where a business person has expertise in a particular field, they are likely to want to commence another business in that same field and possibly the same location as the first. They are also likely to want to preserve whatever reputation and goodwill their business has generated amongst their customers by retaining a similar company name where possible. If Oldco has tax losses, they may need to satisfy the "same business test" for the carry-forward of those losses. The illegality of phoenix activity instead turns predominantly on the intention of Oldco's controllers to

[4] PWC and Fair Work Ombudsman, *Phoenix Activity: Sizing the Problem and Matching Solutions* (June 2012) p 15.

[5] Treasury, n 3.

[6] Treasury, n 3, p 2.

determine whether Oldco was phoenixed deliberately in order to avoid debts. The difficulty of proving this intent is the crux of the difficulty in differentiating legal phoenix activity from illegal phoenix activity.

CATEGORISING PHOENIX ACTIVITY

The following category profiles offer a qualitative view of phoenix activity across the spectrum, beginning with legal business rescues and ending with complex illegal phoenix activity linked to other illegal behaviour, including organised crime.

Legal phoenix or business rescue

Legal phoenix activity is often termed “business rescue”. Typically, Oldco is in financial trouble and is placed in liquidation or voluntary administration, or becomes dormant. In this scenario, Oldco’s controllers or their associates transfer its assets to Newco, which is either a newly incorporated company or an existing entity, and continue with Oldco’s business.

Oldco’s controllers in this scenario are assumed to have no intention to defraud creditors, although the winding up of the company inevitably involves some creditors not being paid in full. Oldco cannot be saved because of its insolvency but some value can be maintained by saving its business. This type of phoenix is categorised as legal because the outcome for the company’s creditors is better, or is intended to be better, than it would have been had the business not been resurrected. Legal phoenixing is beneficial to society at large because it encourages entrepreneurism and may save jobs.

Whether the decision to sell the business assets is taken by the controllers of Oldco or by a liquidator, there may be issues with finding arm’s length purchasers. Third parties may be unwilling to buy the business “lock, stock and barrel”, and may pay less for individual assets such as machinery. In some cases, Oldco’s controllers may be the only party willing to purchase its assets. There are positives though: Oldco’s former controllers may have the desire and incentive to try again with the business, may have existing relationships with clients or customers that can be exploited by Newco, and may have the required knowledge of products, equipment and markets to have the best chance of succeeding with the business the second time around.

Nonetheless, it should be noted that even in cases where there is no intention to wind Oldco up for the purpose of avoiding debts, certain remedies are still available to regulators. For example, the ATO can still issue a director penalty notice imposing personal liability on Oldco’s directors where there has been non-remittance of Pay As You Go (PAYG) taxes.[7]

Problematic phoenix

As in the legal phoenix scenario, a failing business in the problematic scenario may be liquidated, placed into voluntary administration, become dormant, or be deregistered after remaining dormant for a period of time. The problematic phoenix is technically legal and evidences no intention on the part of the company controllers to defraud creditors. Nevertheless, the authors categorise this type of behaviour as problematic because the resurrection of the business is not beneficial to creditors or wider society. A business person with poor business skills may fail to learn from their previous experience, and when each of their businesses inevitably collapses, the number of creditors impacted by the harmful behaviour increases.

This separate classification is made because it may be appropriate in this situation for ASIC to intervene to stop this person incorporating yet another company. One way to determine whether or not the resurrection of the business is beneficial is to look at the number of business failures associated with the same controllers, and within each failure, to determine how much creditors received of what they were owed.

[7] *Taxation Administration Act 1953* (Cth), Sch 1, s 269-15.

Illegal phoenix: Type 1

The first type of illegal phoenixing occurs where a company was set up with the intention to succeed but nonetheless finds itself in financial difficulties. This could be as a result of bad luck or bad business practice. The intention to engage in the phoenixing behaviour is formed at the time of, or immediately prior to, the failure of the business. The controllers in this scenario deliberately separate the business from its debts, possibly after receiving encouragement and instructions from an advisor. As in all other cases of phoenix activity, the business is then continued through a newly created entity or through an existing entity controlled by the same people or their associates.

The illegality of the behaviour turns on the improper intention of the company's controllers, which inevitably involves a contravention of one or more laws, such as the directors' duties provisions or the provisions governing the fraudulent removal of company property. Its external indicators include the transfer of Oldco's assets to Newco for minimal consideration. However, assessing the adequacy of the consideration is difficult, and as noted above, the fact that Oldco's controllers were the purchasers is not determinative. Obtaining an independent valuation of the assets is problematic where assets are specific to a particular business.

This type of illegal phoenix activity appears to be exemplified by *Fair Work Ombudsman v Foure Mile Pty Ltd*.[8] Foure Mile Pty Ltd was a transport and road freight company. Before entering liquidation in 2011, its assets were stripped and sold for inadequate consideration to a newly incorporated company, Foure Mile Holdings Pty Ltd, allowing the business to continue operating under the same ownership, debt-free. This case was brought by the FWO on behalf of a former employee denied wages. The FWO claimed award contraventions under the *Workplace Relations Act 1996* (Cth) and the *Fair Work Act 2009* (Cth). While the judge noted that he was not persuaded that the directors' actions were deliberate in the sense of "setting out to exploit the employee", he *was* persuaded that they were "a product of recklessness".[9] In finding against the company and its sole director, Riethmuller J of the Federal Circuit Court stated the following:

> It does not appear to me that the Second Respondent has shown any real remorse or contrition, nor has corrective action been taken. Rather, the contrary has occurred in the operation of the business. Its re-structure has been such as to effectively deny the employee the capacity of suing the First Respondent with any real expectations of recovering the amount owing. There is clearly a need for deterrence, not only with respect to the specific conduct in the underpayments and with respect to the conditions but also with respect to the conduct in operating the business in such a fashion as to result in an employee being left without any practical remedies for the underpayment.[10]

Illegal phoenix: Type 2

In the second type of illegal behaviour, Oldco's controllers never intend the company to succeed. After accumulating tax debts, trading debts, judgment debts or other liabilities, the controllers transfer the assets out of the company and liquidate it or leave it dormant. These actions are taken deliberately with the intent of separating the business from its obligations, and similarly may come about as the result of advice from a third party, for example an accountant, insolvency practitioner or financial adviser.

Company controllers in the illegal type two scenario may facilitate the illegal behaviour through a corporate group structure by deliberately undercapitalising a subsidiary then liquidating it to avoid debts such as tax liabilities and employee entitlements. The subsidiary's assets and employees may be transferred to another entity in the group prior to the liquidation in an uncommercial transaction, or alternatively, the subsidiary may never have owned any assets, acting simply as the contracting or labour hire arm of the corporate group.

[8] *Fair Work Ombudsman v Foure Mile Pty Ltd* [2013] FCCA 682.

[9] *Fair Work Ombudsman v Foure Mile Pty Ltd* [2013] FCCA 682 at [33].

[10] *Fair Work Ombudsman v Foure Mile Pty Ltd* [2013] FCCA 682 at [34].

The case *Deputy Commissioner of Taxation v Casualife Furniture International Pty Ltd*[11] is an example of this type of phoenix activity. Joseph Guss, his wife and adult children controlled a succession of companies operating the same furniture business. The Deputy Commissioner of Taxation alleged a typical pattern of illegal phoenix activity over 20 years. A Guss controlled company would become indebted to the ATO, and just as winding up proceedings were commenced for the purpose of debt recovery, its stock in trade, plant and equipment, employees, and other assets were transferred to another Guss company, carrying on the same business, usually from the same premises and in the same manner.

Complex illegal phoenix activity

Complex illegal phoenix activity exhibits the same characteristics as illegal phoenixing type two, in that the company was deliberately set up to avoid payment of debts from the outset. However, complex illegal phoenix activity is also likely to coincide with other forms of illegality, such as false invoices, including Goods and Services Tax fraud, false identities, fictitious transactions, money laundering, or visa breaches and the misuse of migrant labour.

Conclusion

The authors' taxonomy is not intended merely as an observation on what is occurring. Rather, it serves a purpose in guiding regulators, such as ASIC, the ATO or the FWO, towards the circumstances that may indicate illegal behaviour. A wide variety of offences may be committed as part of illegal phoenix activity and these are detailed in the authors' research report. Regulators are encouraged to use the provided classification to design strategies to educate the regulated community, detect incidences of the activity, and enhance enforcement.

Likewise, the five categories presented above are useful for governments seeking legislative or administrative changes that may hinder illegal phoenix activity but nonetheless allow and encourage legitimate business rescue. For example, problematic phoenix activity could be tackled by placing additional hurdles, such as compulsory business education or the lodgement of bonds, for people with extensive track records of business failure. Illegal phoenix activity, whether type one or two, could be disrupted by targeting education campaigns towards advisors such as lawyers, accountants, insolvency practitioners and turnaround specialists. Complex illegal phoenix activity could be better detected through a wide network of information sharing between government agencies dealing with different areas. Fictitious directors could be eliminated by requiring business people to register and provide proof of identity, in the same way that those seeking to open bank accounts or apply for a passport are required to do. These and other suggestions for tackling the problem of phoenix activity will be dealt with in a later research report.

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[11] *Deputy Commissioner of Taxation v Casualife Furniture International Pty Ltd* (2004) 9 VR 549; [2004] VSC 157.