Australian Government, Productivity Commission

Business Set-up, Transfer and Closure

Productivity Commission Issues Paper December 2014

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Introduction

We thank the Productivity Commission for this opportunity to respond to the Issues Paper 'Business Set-up, Transfer and Closure'. We are a group of academics beginning the second year of a three year Australian Research Council-funded project examining the regulation of illegal phoenix activity. Our aim is to devise ways in which this damaging behaviour can be most efficiently and effectively prevented and deterred, without damaging legitimate business activities to the detriment of the economy. Our most recent output is a major report entitled Defining and Profiling Phoenix Activity, which is available from: http://law.unimelb.edu.au/cclsr/centre-activities/research/major-research-projects/regulating-fraudulent-phoenix-activity. Please note that the recommendations included in this submission are not the final or complete recommendations from the project.

The concept of phoenix activity broadly centres on the idea of a corporate failure and a second company, often newly incorporated, arising from the ashes of its failed predecessor where the second company's controllers and business are essentially the same. 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, usually 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. The illegality here is generally as a result of a breach of directors' duties in failing to act properly in respect of the failed company and its creditors. While our focus has been on disrupting illegal phoenix activity, the Productivity Commission in its current inquiry might also like to consider the danger posed by the hopeless entrepreneur, who incorporates multiple companies in succession, without learning from prior failures, and thus causes losses to successive groups of unsuspecting creditors.

Because phoenix activity spans the creation, transfer, and closure of businesses, our submission shall address all three of these areas together. This submission comprises the following parts. First, we address the economic justifications for the reduction of barriers to entry to, and exit from, business. Second, we address legitimate policy objectives that should be considered in this inquiry. Third, we propose some possible changes that the Productivity Commission might like to consider in the context of meeting legitimate policy objectives while reducing barriers to set-up and closure.

Economic justifications

The Issues Paper makes the valid points that 'firm entry and exit plays an important role in fostering innovation, competition, and thereby driving productivity and economic growth' and that 'certain barriers to entry and exit have the potential to hinder the efficient operation of markets, with negative consequences for economic growth'.

We do not dispute this. However, we urge the Productivity Commission to recognise that not all barriers to entry and exit necessarily involve negative economic consequences. Arguably, barriers that prove effective at disrupting illegal phoenix activity can have positive economic consequences if their implementation results in a reduction in the losses sustained by creditors, including the Australia Taxation Office (ATO). We will now explain the negative economic consequences that can arise when illegal phoenix activity is not disrupted.

Companies are legal entities which are separate from their controllers and shareholders. Shareholders enjoy limited liability, meaning that they are not personally liable for the debts of the company in which they have invested. Controllers only face personal liability for company debts where they have committed some breach of corporations law, taxation law, workplace law or the like. The insolvency of the company they control, of itself, breaches no law. On the other hand, sole traders whose businesses fail will be personally liable from their own resources in meeting the debts of their business. It is vital that the Productivity Commission have regard to this distinction. Any suggestions made to limit the detrimental effects of phoenix activity only operate in the company context. They have no effect on actually setting up or closing down the underlying business. Much of the compliance burden for business noted in the Issues Paper – licenses, planning approvals, Occupational Health and Safety (OHS) requirements, tax obligations, employment obligations – arise as a result of running a business, not doing so via a company.

The *Corporations Act* does very little to restrict people from setting up and managing multiple companies, either at the same time or in succession. The failure of one company does not automatically bar a person from trying again with another company, and indeed, trying again is implicitly encouraged. Provided a person satisfies the basic requirements for holding a directorship[1], their previous business failures are not considered when they seek to create a new company. While the Australian Securities and Investments Commission (ASIC)[2] or the court[3] may disqualify a person from being a director as a result of poor management of previous insolvent companies, these disqualifications are rare.[4]

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[1] *Corporations Act* s 201B: An individual who is over 18 and who has not been disqualified may be appointed as a director.

[2] *Corporations Act* s 206F: Section 206F allows ASIC to disqualify a person from managing companies for up to five years if, within the past seven years, the person has been an officer of two or more companies and the companies were wound up and the liquidator lodged a report under s 533(1) about the company's inability to pay its debts (ie, the companies were unable to pay their unsecured creditors more than 50 cents in the dollar).

[3] *Corporations Act* s 206D(1): (1) On application by ASIC, the Court may disqualify a person from managing corporations for up to 20 years if: (a) within the last 7 years, the person has been an officer of 2 or more corporations when they have failed; and (b) the Court is satisfied that: (i) the manner in which the corporation was managed was wholly or partly responsible for the corporation failing; and (ii) the disqualification is justified.

[4] A search of ASIC's media releases for the years January 2004 - August 2014 reveals that only 49 directors were disqualified by the regulator under s 206F during this period where the media release specifically mentions the term 'phoenix activity' (21 directors) or else implies illegal or problematic phoenix activity (28 directors). None of these ASIC media releases reveal any applications by ASIC to the court requesting it to disqualify a director pursuant to s 206D for engaging in behaviour that could be described as illegal phoenix activity. In fact, this enforcement mechanism appears to be rarely used. A search of the Austlii database disclosed only one case issued by ASIC pursuant to this section during this entire period and the events that gave rise to that application do not appear to involve illegal phoenix activity: See *ASIC v Elm Financial Services Pty Ltd* [2005] NSWSC 1065 (21 October 2005), [2005] NSWSC 1033 (13 October 2005), [2005] NSWSC 1020.

These factors coalesce to produce the following situation: a small business person may set up a company without hindrance. That company may trade successfully and incur substantial liabilities to suppliers, employees and the ATO. The business may genuinely struggle under the weight of these debts. The director perhaps consults their accountant or a turnaround specialist who advises that the business should be placed into liquidation and a new company created, to which the assets of the failed company are transferred for a modest or nominal cost. The creditors of the failed company suffer: unpaid suppliers face their own financial pressures, employees are forced to rely on the Fair Entitlements Guarantee ('FEG'), and the ATO and state revenue authorities do not receive remittances of Pay-As-You-Go withholding ('PAYG'), payroll and other taxes.

This costs the Australian taxpayer in three ways – the suppliers' bad debts are tax-deductible; the FEG is taxpayer-funded; and the ATO receives less revenue. In 2009, illegal phoenix activity was estimated to cost the ATO $600 million per annum in unrecovered taxes alone.[5]

In the context of the Productivity Commission's inquiry, let us stress that our aim is not to prevent business failure or the creation of new companies. Losses to creditors as a result of company failure are unavoidable in an efficient market economy. Our objective is to ensure that the corporate form is not utilised *deliberately* in order to separate a business from its debts.

Market forces, left unchecked, can produce an incentive *towards* illegal phoenix activity. Competitors who routinely 'phoenix' their companies and shed large volumes of debt can undercut honest companies, which are then driven out of business. This was recognised by the Cole Royal Commission[6] in 2003, Treasury in 2009[7] and the Fair Work Ombudsman (FWO) in 2012.[8] It is also highly detrimental to the economy to allow those with poor business skills to open company after company unchallenged, each of which end up leaving a trail of unpaid creditors. The rhetoric of free markets, economic growth and job creation must not be allowed to overshadow the very real damage that inept serial entrepreneurs and deliberate phoenix operators cause.

Thus, there is a very real possibility that less 'red tape' and fewer barriers to entry, business transfer and exit, might cause genuine harm to the economy.

One of the challenges in regulating to prevent and deter illegal phoenix activity is that it is very difficult to determine the controllers' intentions. Was that person simply unlucky on this and possibly other occasions? Are they 'unlucky' so often that they should not be allowed to establish another incorporated business? Or is this person deliberately using the corporate form to leave unpaid creditors behind? Because intention is so difficult to discern, we suggest that entry, business transfer and exit regulation should take into account both inept serial entrepreneurs and deliberately illegal phoenix operators.

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[5] Commonwealth of Australia, 'Action Against Fraudulent Phoenix Activity Proposals Paper' (2009 Phoenix Proposals Paper), [2]. Available at http://archive.treasury.gov.au/documents/1647/PDF/Phoenix_Proposal_Paper.pdf.

[6] Commonwealth, Royal Commission into the Building and Construction Industry, Final Report (2003) vol 8, ch 12, 106. For example, the Report notes that serial phoenix operators Emerson Industries were able to obtain large contracts by quoting the most competitive price, at 175.

[7] 2009 Phoenix Proposals Paper, above n 5 [1.1.1].

[8] Fair Work Ombudsman, 'Phoenix Activity: Sizing the Problem and Matching Solutions' June 2012, [4.5]. Report prepared by PriceWaterhouseCoopers.

Legitimate policy objectives

The Issues Paper recognises that ‘many government policies and/or regulations that create these barriers have legitimate policy objectives (for example, to provide health and safety standards and protect consumers).’ One of those legitimate policy objectives is the prevention and deterrence of illegal phoenix activity.

The ATO is the host of the Interagency Phoenix Forum (IAPF) – see https://www.ato.gov.au/General/Gen/Inter-Agency-Phoenix-Forum/. Its membership comprises the Australian Crime Commission (ACC); Australian Federal Police (AFP); ASIC; ATO; Clean Energy Regulator (CER); Department of Employment (DE); Department of Sustainability, Environment, Water, Population and Communities (DSEWPaC); Fair Work Building & Construction (FWBC); FWO; and state and territory revenue offices.

Each of these agencies has an interest in preventing and deterring illegal phoenix activity. Both the ACC and the AFP are involved because illegal phoenix activity is sometimes associated with tax fraud, false GST invoices, money laundering, fictitious transactions and identities, visa breaches and misuse of migrant labour, and other criminal behaviour. These can constitute serious organised crime.[9] The FWO and FWBC are concerned with the non-payment of employees, which often occurs as a consequence of business failure and is particularly prevalent in the building industry. Recently, the IAPF has been declared a prescribed taskforce by the Federal Government. This allows much freer transfers of information between the members of the IAPF. The declaration was made in recognition of the importance of preventing and deterring illegal phoenix activity.

To assist these regulators in their work, we urge the Productivity Commission to recognise the legitimate policy objective of preventing and deterring illegal phoenix activity and to adopt a balanced approach when considering whether to recommend a reduction to barriers to business entry, transfer and exit.

Meeting legitimate policy objectives while reducing barriers to set-up and closure

The Issues Paper states that:

> A key task of this inquiry will be to identify alternative mechanisms, where the case can be made for change, that both meet the legitimate policy and regulatory objectives of government and reduce or remove unnecessary barriers to business set-up and closure.

In general, we do not believe that additional hurdles should be placed in the way of business people in creating or dismantling companies. However, to address the obvious problems created by phoenix activity for government and for legitimate business operators, we do consider that the following measures should be considered:

1. A director identification number (DIN).

We believe that would-be directors should be required to establish their identity via 100 points of identity proof. This is well-accepted and uncontroversial in the context of opening bank accounts and obtaining passports. The Productivity Commission Issues paper identifies examples of current regulatory arrangements and requirements that are faced by some persons setting up a business.[10] They include ‘obtaining licences, registrations or approvals to

[9] Criminal Code Act 1995 Schedule 1, [390.3].

[10] Australian Government, *Productivity Commission, Business Set-up, Transfer and Closure Productivity Commission Issues Paper* December 2014.

operate the business, acquiring relevant re-zoning and development approvals, establishing the required reporting systems and having the appropriately qualified staff employed in or operating and managing the business.'[11] Arguably imposing the requirement of a DIN would constitute a lesser burden on honest business operators than most, if not all, of these other existing requirements.

With relatively little inconvenience to honest business operators, a DIN should eliminate the problem of fictitious identities being used for company directorships when new companies are registered. Requiring people to cite their DIN would also assist ASIC in 'joining the dots' between multiple failed companies so that they might seek to have a person with a consistent history of insolvent companies banned from managing any further companies. It would also alert ASIC if disqualified persons attempted to register as directors.

Moreover, it would also assist the ATO in data gathering. The regulator's suspicions might be raised when a single person's name is used for the directorships of dozens of companies that the person could not possibly be managing or supervising in compliance with their legal obligations. Anecdotally, we hear that pensioners are sometimes paid a fee to be nominated as a company director, in order to shield a disqualified person. By utilising the DIN, the ATO's extensive database could prompt its phoenix risk team to investigate instances where an elderly person with no assessable income appears to be running one or more companies. The advantages of a DIN are obvious for agencies such as the ACC and the AFP.

2. Company registration with drop-down menus

Company registration is completed online and is simple for anyone with the ability to conduct a business. Another way to assist regulatory agencies without inhibiting legitimate business activity is to ask additional questions via drop-down menus when companies are incorporated. Having cited the director's DIN, the form could ask whether the person has managed any other company. If the answer is no, then the rest of the form is simple and quick to complete. If yes, then a drop-down menu could require more information. Where directorships change, including where a shelf company has been acquired by business operators, these questions could be asked on the 'change of company details' form.[12]

Further questions could include whether the other companies are still in existence and if not, whether they paid their creditors in full or less than 50 cents in the dollar. Again, answers indicating a poor track record could prompt more questions. It is not unreasonable to ask a person who wants another opportunity to run a company to provide this level of detail. The aim here is to equip ASIC with information about this person, allowing the regulator to take appropriate action which may include placing them on a watch list. A secondary but equally important aim is to alert the would-be director to the fact that *ASIC knows this information*, thereby discouraging them from engaging in illegal phoenix activity. If the director provides false information, ASIC may prosecute them.[13]

3. Reporting

The Issues Paper asks whether, '… specific regulatory requirements — for example, licensing, approvals, reporting requirements — act as the stronger disincentive to set-up or acquire an existing business?' In the context of preventing and deterring illegal phoenix

[11] Ibid, 7.
[12] ASIC Form 484.
[13] *Corporations Act s* 1308(2).

activity, we strongly urge the Productivity Commission to resist any suggestions to reduce the amount of reporting done by small business.

We accept that pointless red tape and other compliance hurdles are detrimental to business. However, reporting requirements for small business only reflect the work that a properly diligent company director ought to be doing to satisfy their statutory and general law duties. Reporting is a valuable mechanism that allows ASIC to determine whether companies are dormant and should be deregistered. Understandably, the reporting demands on larger businesses are considerably greater, and this distinction should be maintained.

4. Closing businesses

We accept the positive effects of business closures and do not seek to impose any restrictions on these. We are not of the belief that 'difficulties associated with closing a business may create a disincentive to set-up a business in the first place' as the Issues Paper inquires.

In order to deter illegal phoenix activity, the Productivity Commission might like to consider that greater transparency at the time of business insolvency may assist. For example, where the assets are to be transferred to another entity controlled by the directors of the failed company, an independent valuation could be required. The present 'Report as to Affairs',[14] prepared and submitted by the directors to the external administrator, lacks any qualitative information as to the circumstances of the closure or previous insolvencies of companies controlled by the same people. Greater detail here would assist ASIC in detecting those closures where breaches of directors' duties may have occurred.

Similarly, greater disclosure about the circumstances of the company's failure could be required of external administrators. These investigations are already part of the external administrators' duties. At present, the return submitted to ASIC requires a tick-box to indicate that breaches of duty and other civil or criminal offences are suspected.[15] These forms should be amended to allow for comments to be made. In addition, a further tick-box could be inserted so that administrators could report that the breach occurred in a suspected phoenix context. This data would be enormously beneficial for regulators who seek to understand the scope of the problem.

We urge the Productivity Commission to view insolvency reporting requirements as more than 'costs' to be minimised. They not only provide valuable information to ASIC but also make it clear to the failed companies' controllers and administrators that ASIC will be armed with the information to take action in appropriate circumstances.

The Issues Paper queries where the balance should lie between creditors and debtors in insolvency arrangements. Debtor companies should be liable to the same extent as individual debtors.[16] Incorporation of businesses undoubtedly favours those individuals or companies that invest equity capital in debtor companies. We support the retention of the corporate veil

[14] ASIC Form 507.

[15] ASIC Regulatory Guide 16. The form is EX01 Schedule B of Regulatory Guide 16 - Report to ASIC under s422, s438D or s533 of the Corporations Act 2001 or for statistical purposes.

[16] We make no recommendations at this stage on the issue of whether companies should be required to incorporate with, or retain, a certain amount of capital to protect creditors. We also make no comment on a safe harbour against insolvent trading liability for directors of companies seeking to restructure.

that shields shareholders from corporate debts in general circumstances.[17] However, liquidators acting on behalf of creditors should be able to recover from company controllers personally where their behaviour has breached the law. This is the present position in relation to breaches of directors' duties. The ATO has, and should retain, rights of recovery from company directors issued with director penalty notices.

In terms of employee entitlements, we hear anecdotally that the existence of GEERS and FEG present a moral hazard which encourages businesses to make inadequate provision for payment, knowing that the employees will be taken care of. We have no empirical evidence to support this contention or the contention that business closures have grown disproportionately in number since the forerunner of these schemes was introduced in 2001.[18] We strongly urge the Productivity Commission to recommend the retention of a government-funded safety net scheme. It has significantly contributed to a reduction in industrial action in support of unpaid workers.[19] It is also superior to other alternative means of protecting employees of insolvent businesses.[20]

In the phoenix context, there is no advantage in transferring ownership of the company itself because the company retains liability for its debts despite the change of ownership of its shares. The essence of the phoenix procedure is that the old company is either liquidated, placed in voluntary administration and then liquidated or deregistered, or remains dormant. The business or its assets are transferred to a new corporate entity. The debts of the old company are only adopted by the new company to the extent that the new company needs to remain on good terms with that particular creditor. The danger with these transfers of the business or its assets is that a fair market price may not be paid. The Productivity Commission should consider whether to recommend requiring independent valuations of these assets where the purchaser is controlled by some or all of the people behind the previous company. While requiring an independent valuation might appear to be the addition of more red tape, it in fact benefits the economy where creditors, including the ATO, receive a fairer payout. In addition, it acts as a disincentive to illegal phoenix activity and therefore benefits law-abiding competitor businesses.

We would be pleased to assist the Productivity Commission, should it wish to speak with us or require further written detail.

[17] We make no recommendation at this stage on liability of holding companies in possible phoenix circumstances.
[18] See Helen Anderson, *The Protection of Employee Entitlements in Insolvency: An Australian Perspective*, 2013.
[19] Ibid, ch 6.
[20] Ibid, ch 9.