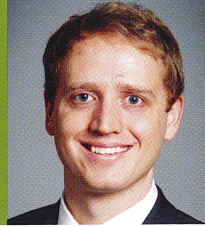




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feature

ILLEGAL PHOENIX ACTIVITY FROM THE INSOLVENCY PRACTITIONER'S PERSPECTIVE

The striking results from a survey of ARITA members on illegal phoenix activity.

Illegal phoenix activity is a significant social and economic problem in Australia. In 2009 the Australian Taxation Office (ATO) estimated that phoenix activity and related practices cost the Australian economy between \$1 billion and \$2.4 billion each year.¹

PricewaterhouseCoopers has estimated the total cost to employees, business and government revenue at between \$1.78 billion and \$3.19 billion annually.² Although it is difficult to accurately measure illegal phoenix activity, these estimates suggest that the cost is significant, ranging from about 0.06 to 0.19 percent of Australia's GDP.³ It's estimated that there are between 2,000 and 6,000 phoenix companies operating in Australia.⁴

The term 'phoenix activity' refers to the idea of a successor company, which may be a newly incorporated company or an existing company in a corporate group, arising from the ashes of its failed predecessor where the successor company's controllers and business are essentially the same as those of the predecessor.

In a typical illegal phoenix activity scenario, the predecessor company's assets are transferred to the successor prior to the predecessor being placed into external administration or left dormant, depriving unsecured creditors, employees and taxation authorities of their entitlements.

In November 2015 researchers at Melbourne Law School and Monash Business School conducted a survey of ARITA members to find out what they think about illegal phoenix activity and to learn about their encounters with phoenix operators. The survey was sent to 2,155 members, 213 of whom responded to the survey.

The respondents, who on average had 16 years of experience working in the insolvency field, expressed concerns about the frequency of illegal phoenix activity and damaging consequences for creditors, poor industry practices that increase the risk of illegal phoenix activity, and the failure of regulatory authorities to adequately address the phoenix problem.

ILLEGAL PHOENIX ACTIVITY: WIDESPREAD AND COSTLY

The survey respondents reported frequent encounters with illegal phoenix operations. Thirty-two percent of respondents said that they 'often' or 'always' encounter liquidations where they believe that phoenix activity has occurred, and 51 percent said that they 'sometimes' encounter phoenix activity. In such situations, 24 percent of respondents 'always' alleged a breach of civil obligations in an external administration report (EXAD report), 29 percent 'often' alleged, and 23 percent 'sometimes' alleged civil breaches.

These results are of significant concern, as they suggest that, not only is the rate of phoenix activity relatively high, but it is often accompanied by alleged civil wrongdoing. The rate of alleged criminal activity was lower but still significant, with 12 percent of respondents saying that they 'often' or 'always' allege criminal activity in an EXAD report, and 33 percent saying they 'sometimes' allege criminal activity, where they believe that phoenix activity has occurred.

The survey results also reveal that liquidations involving illegal phoenix activity more often than not result in poor returns to creditors. Twenty-seven percent of respondents said that liquidation of a company involving phoenix activity 'always' results in zero returns to creditors, while 60 percent

¹ Australian Taxation Office, *Targeting Tax Crime: A Whole-of-Government Approach* (July 2009) 16. ² PricewaterhouseCoopers, *Phoenix Activity: Sizing the Problem and Matching Solutions* (June 2012) ii-iii. ³ Australian Bureau of Statistics, *1345.0 - Key Economic Indicators, 2016* [23 August 2016]. ⁴ Productivity Commission, *Business Set-up, Transfer and Closure: Productivity Commission Inquiry Report No. 75* [30 September 2015] 423.

Illegal phoenixing

‘There is now an abundance of pre-insolvency advisors who are not subject to any regulations assisting and advising directors to undertake phoenix activity and how to defeat creditors.’

said that this ‘often’ occurs. In other words, illegal phoenix operators are typically very successful in shifting their assets out of the reach of creditors, employees and taxation authorities.

POOR INDUSTRY PRACTICES SOWING THE SEEDS FOR ILLEGAL PHOENIX ACTIVITY

The survey respondents raised a number of concerns about potential precursors to illegal phoenix activity, such as poor business skills and attitudes on the part of failed company directors, the prevalence of directors who are involved in multiple failed companies, and the rise of the largely unregulated pre-insolvency advice market.

Eighty-three percent of respondents said that directors of failed companies ‘often’ or ‘always’ have inadequate business skills, while 47 percent said that directors of companies in liquidation have ‘often’ or ‘always’ been directors of other failed companies. One respondent commented, ‘It is time that directors be required to have some rudimentary training. Why is it easier to become a director than getting a driver’s licence?’

Strikingly, 70 percent of respondents ‘agreed’ or ‘strongly agreed’ that directors or managers of failed companies tended to display little regard for the company’s creditors.

One quarter of respondents said that they ‘often’ or ‘always’ encounter liquidations where the company has already seen a pre-insolvency practitioner or debt restructuring, while 53 percent of respondents said that they ‘sometimes’ encounter the work of pre-insolvency advisors. The ATO and ASIC are increasingly concerned that some pre-insolvency advisors are encouraging and facilitating

illegal phoenix activity,⁵ which is a concern shared by some of the survey respondents.

As one respondent commented, ‘There is now an abundance of pre-insolvency advisors who are not subject to any regulations assisting and advising directors to undertake phoenix activity and how to defeat creditors.’

NOT ENOUGH IS BEING DONE TO CURB ILLEGAL PHOENIX ACTIVITY

The survey results revealed a high level of dissatisfaction with how illegal phoenix activity is currently regulated by ASIC and taxation authorities. In particular, respondents were concerned that the pre-insolvency advice market is inadequately regulated and insufficient funding and information is provided to insolvency practitioners for the purposes of conducting investigations.

Overwhelmingly, the survey responses indicated that there is inadequate regulation of the pre-insolvency advice market. Seventy-seven percent of respondents ‘disagreed’ or ‘strongly disagreed’ that pre-insolvency practitioners are sufficiently regulated by ASIC, while an equal percentage ‘agreed’ or ‘strongly agreed’ that such practitioners should be forced to be part of a professional association.

Sixty-nine percent of respondents ‘agreed’ or ‘strongly agreed’ that pre-insolvency practitioners should be subject to the same legal duties as external administrators. An even higher 80 percent of respondents ‘agreed’ or ‘strongly agreed’ that these practitioners should not be allowed to advertise their services to the public without safeguards against improper advice being put in place.

With regard to funding of investigations, respondents showed dissatisfaction with all facets of the Assetless Administration Fund, giving an average score ranging from 2.81 to 3.71 out of 10 in relation to the ease of the application process, the response time from ASIC, the outcomes of their applications, and the amount of funding provided in each case.

The respondents were equally critical of the level of funding provided by taxation authorities. About three quarters of respondents said that, where the ATO is a creditor, it has ‘rarely’ or ‘never’ agreed to fund an investigation, while two thirds of respondents said that, where the state revenue office is a creditor, it has ‘rarely’ or ‘never’ agreed to fund an investigation.

Respondents were even more concerned about the level of information made available to them by ASIC for the purposes of carrying out investigations. Eighty-seven percent of respondents ‘agreed’ or ‘strongly agreed’

⁵ Australian Taxation Office, ‘Phoenix Taskforce Swoops on Pre-insolvency Industry’ (12 August 2016).

that ASIC should provide liquidators with information it holds about directors of failed companies at the start of a liquidation involving those directors.

As many as 92 percent of respondents 'agreed' or 'strongly agreed' that ASIC should allow liquidators free use of its registers to enhance the quality of their investigations for the purpose of reporting to ASIC under *ASIC Regulatory Guide 16 External Administrators – Reporting and Lodging*.⁶

WHAT MORE CAN BE DONE?

In addition to addressing these more general regulation, funding and information deficits, a number of specific proposals were put to the survey respondents to address illegal phoenix activity. These proposals received strong support from the survey respondents, with around 80 to 90 percent of respondents 'agreeing' or 'strongly agreeing' that:

- all company directors should be issued with a Director Identification Number enabling ASIC and the ATO to track directors of multiple failed companies
- directors of multiple failed companies should be prohibited from managing another company unless they can prove that they are capable of doing so, and
- ASIC should add a tick box to EXAD reports so liquidators can indicate whether they believe that breaches of civil or criminal obligations have occurred in the context of phoenix activity.

These survey results show that there is much that can be done, and much that needs to be done as a matter of priority, to better protect creditors, employees and taxation authorities from the devastating effects of illegal phoenix activity. ▲

⁶ Australian Securities and Investments Commission, *Regulatory Guide 16: External Administrators – Reporting and Lodging* (July 2008).

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