

**Australian Government
Treasury**

**TREASURY LAWS AMENDMENT (2017 ENTERPRISE INCENTIVES NO. 2) BILL
2017**

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We thank Treasury and the Minister for Revenue and Financial Services for this opportunity to make a submission regarding the Exposure Draft of the Treasury Laws Amendment (2017 Enterprise Incentives No. 2) Bill 2017. We are a group of academics currently undertaking an 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.

As well as a series of scholarly and professional publications, we have produced three major reports: *Defining and Profiling Phoenix Activity* (December 2014); *Quantifying Phoenix Activity: Incidence, Cost, Enforcement* (October 2015), and *Phoenix Activity: Recommendations on Detection, Disruption and Enforcement* (February 2017). Please click [here](#) to access these reports.

In this submission, we deal only with the safe harbour proposal. We also take the opportunity to suggest an approach for related party transfers of assets in the context of phoenix activity.

Phoenix Activity and Insolvent Trading

The concept of phoenix activity broadly centres on the idea of a corporate failure ('Oldco') and a second company ('Newco'), 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.

In simplistic terms, insolvent trading liability under the *Corporations Act 2001* (Cth) ('*Corporations Act*')¹ aims to deter directors from trying to 'trade out of their difficulties' – delaying liquidation and incurring new debts when their company is unable to pay existing ones. In that sense, it appears to be the antithesis of the usual conception of phoenix activity – the speedy liquidation of Oldco, with its assets stripped and now in the hands of Newco, run by the same directors.

¹ *Corporations Act* pt 5.7B divs 3 and 4.

However, since 2000, insolvent trading has also included² ‘uncommercial transactions’ as defined by s 588FB of the Act. These are transactions of the company that ‘*a reasonable person in the company's circumstances would not have entered ...*, having regard to:

- (a) the benefits (if any) to the company of entering into the transaction; and
- (b) the detriment to the company of entering into the transaction; and
- (c) the respective benefits to other parties to the transaction of entering into it; and
- (d) any other relevant matter.’³

One of the reasons for including the uncommercial transaction provision in s 588G of the Act was to capture phoenix activity.⁴ For that reason, it is important to evaluate Treasury’s proposed legislation to see what effect, if any, the safe harbour might have on phoenix activity.

The Proposed Legislation

The draft s 588GA(1) safe harbour relates only to s 588G(2) liability, which is a civil penalty breach. Appropriately, it does not apply to criminal liability under s 588G(3) where the breach involves dishonesty. This is not to say that there is a neat bifurcation between ‘honest’ insolvent trading under sub-s (2) and ‘dishonest’ under sub-s (3). Rather, cases will be brought under sub-s (2) where the burden on the prosecution of proving dishonesty makes a civil penalty case prudent.

The safe harbour provision is expressed as a ‘carve out’ in the sense that it says ‘[s]ubsection 588G(2) will not apply’ rather than ‘it is a defence if it is proved that ...’. Nonetheless, it is interesting to note that the notes to draft s 588GA both refer to the section as a defence,⁵ and the title of s 588H is to change from ‘Defences’ to ‘Other Defences’. The important factor here is that, according to draft s 588GA(3), the director bears the evidential burden of proving that they took ‘a course of action that is reasonably likely to lead to a better outcome for the company and the company’s creditors’, as required by draft s 588GA(1). ‘Better outcome’ is ‘an outcome that is better for *both*: (a) the company; and (b) the company’s creditors as a whole’⁶ than they would otherwise have if the company entered some form of external administration under Chapter 5 of the Act.

This is not an easy burden to discharge. Under draft s 588GA(2), the court will look at steps taken: to prevent misconduct; to ensure proper record keeping; to obtain appropriate advice; to remain informed about the company’s financial position; and to develop a restructuring plan for the company to improve its financial position. In particular, s 588GA(1) will not allow the director to utilise the safe harbour if the company fails to provide for employee entitlements and fails to keep up-to-date with taxation documentation in a way that a solvent company would reasonably be expected to do.⁷

² *Corporations Act* s 588G(1A) item 7.

³ Emphasis added.

⁴ Explanatory Memorandum, Corporations Law Amendment (Employee Entitlements) Bill 2000 (Cth), [10]: ‘The inclusion of uncommercial transactions in section 588G(1A) has implications for the protection of employee entitlements, the prosecution of directors involved in “phoenix” activity and recovery actions by liquidators for the benefit of creditors generally.’

⁵ ‘Note 1: The person bears an evidential burden in relation to the defence in this 27 subsection (see subsection (3)). Note 2: For this defence to be available, certain matters must be being done to 29 a reasonable standard (see subsection (4)).’

⁶ Emphasis added.

⁷ Treasury Laws Amendment (2017 Enterprise Incentives No. 2) Bill 2017 s 588GA(4).

The combination of the onus on directors and the factors that the court will take into account mean that a person intent upon phoenix activity through an uncommercial transaction will struggle to succeed under draft s 588GA(1). The draft legislation also addresses the vexed question of missing books and uncooperative behaviour – a common feature of deliberate phoenix activity. It warns the director that if the company's books and corporate information are not forthcoming as required by the liquidator or court, those cannot be relied on later by the director in seeking to make out the safe harbour.⁸

Therefore, we believe that Treasury's draft safe harbour proposal is unlikely to have the effect of encouraging insolvent trading that involves uncommercial transactions in the context of phoenix activity.

However, in our opinion, significant difficulties remain in the regulation of uncommercial transactions in the context of phoenix activity. Our research has found that asset transfers between Oldco and Newco are considered problematic to liquidators and ASIC because of a lack of evidence of wrongdoing. The transfer itself proves nothing: Newco may have been the highest or only bidder for the assets. Costly investigations must be undertaken. This is problematic in the phoenix context where commonly Oldco has few assets to pay for the liquidator's time. The *Corporations Act* expressly states that the liquidator is not required to do this work for free.⁹

While not expressly part of the current consultation, we take this opportunity to suggest that Treasury give consideration to the introduction of a reverse onus or rebuttable presumption for related party asset transfers undertaken where the transferor enters liquidation. In action by ASIC or the liquidator for breach of directors' duties, there would be a rebuttable presumption that a related party transfer of assets is not arm's length. The presumption could be rebutted by an independent valuation or such other evidence as the court considers appropriate. It is then open to Oldco's directors to decide whether there is a risk of the transfer being challenged by an external administrator or ASIC and thus whether they should spend the time and money on an independent valuation. To avoid unfairly harsh operation, there would need to be limits on the time period over which the presumption would operate. Twelve months prior to insolvency seems reasonable.

What constitutes an independent valuation would need to be carefully considered. Options here include valuation by an accredited valuer holding professional indemnity insurance, mandatory public auctions of assets over a certain value, or a more holistic approval of a transaction as a whole by a panel of experts, approved by ASIC. ASIC has indicated to us that there are now compromised 'independent' valuers who are willing to make false certifications for a fee. One way to overcome this would be for ASIC to assign a 'first cab off the rank' valuer to the task.

The rebuttable presumption should only operate for transfers of assets over a particular value. The sum of \$5,000 is used in Chapter 2E of the *Corporations Act* to exempt small related party transactions from requiring member approval.¹⁰ One difficulty with setting a value is that it may encourage the undervaluing of assets. This would not only benefit the recipient,

⁸ Treasury Laws Amendment (2017 Enterprise Incentives No. 2) Bill 2017 s 588GB.

⁹ *Corporations Act* s 545(1). Only the statutory report and other documentary obligations to ASIC must be done, regardless of whether the liquidator is paid: s 545(3).

¹⁰ *Corporations Act* s 213(1); *Corporations Regulations 2001* (Cth) reg 2E.1.01.

Newco, but it would also avoid the operation of the rebuttable presumption. The alternative would be to set no limit, but this might lead small business people to allege it is an overly burdensome provision, in effect requiring an independent valuation for the most trivial transfer. We favour having a value limit. To tackle avoidance behaviours – for example, multiple transfers below the limit – the value limit could be expressed as ‘asset transfer or transfers totalling \$5,000 over a 12 month period’. Outside of the proposed independent valuation presumption regime would remain the power of both liquidators and ASIC to attack uncommercial transactions as insolvent trading should the \$5,000 limit be abused.

‘Related party’ would *not* have the meaning assigned under s 228 of the *Corporations Act* for the purpose of related party transactions by public companies. That curious section’s definitions of a related party include a company run by a director’s spouse’s parents but not the siblings or close associates of the director. A starting point for developing a more useful definition is the ‘connected party’ definition outlined in the UK’s Graham Review.¹¹ This definition is based on those controlling a company, whether formally appointed or otherwise, and their associates who include a wide range of relatives, business partners, and joint controllers of businesses.¹²

Conclusion

We applaud Treasury for its efforts in legislating to assist legitimate business rescues while not allowing scope for deliberate wrongdoing to be hidden. We would be happy to assist Treasury further, either in relation to the safe harbour proposal or our suggestion for related party transfers of assets in the phoenix context.

¹¹ Theresa Graham CBE, *Graham Review into Pre-pack Administration: Report to The Rt Hon Vince Cable MP* (June 2014) [9.5].

¹² *Insolvency Act 1986* (UK) s 435.