

SHELTER FROM THE STORM: PHOENIX ACTIVITY AND THE SAFE HARBOUR

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A 'safe harbour carve out' from insolvent trading liability is intended to encourage directors, particularly of large companies, not to prematurely liquidate financially troubled companies which could be rescued. While the federal government has been successful in introducing this measure, which was part of its 2016 National Science and Innovation Agenda, this article argues that some of the underlying justifications for the safe harbour are flawed and that it may not be effective. A more significant objection is that the safe harbour could lead to a greater prevalence of illegal phoenix activity, sheltering under the appearance of business rescue. The benefit of the liability carve out to the 'big end of town' is not worth this risk.

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I INTRODUCTION

This article is concerned with insolvent trading legislation, which imposes liability on directors for allowing a company to incur new debts when it is no longer able to pay existing debts.¹ Choosing the ‘right’ course of action when insolvency looms has always been difficult for directors. On the one hand, a prompt liquidation ensures that further creditors are not exposed to losses from the company’s collapse, and that available assets are distributed in the liquidation only to those creditors whose losses have become unavoidable. On the other hand, continuing to trade in appropriate circumstances might see a turnaround in the company’s fortunes, so that all creditors are paid or at least receive more than they would have if the company were quickly liquidated. Ensuring that ‘bad’ behaviour is deterred and ‘good’ behaviour is permitted when creditors are facing significant additional risk requires careful drafting of both the insolvent trading liability provision and its defences.²

Company directors benefit from the fact that the company is a separate legal entity and that debts incurred in the company’s name by them as its controllers are payable by the company. Like companies themselves, liability imposed on directors for insolvent trading is a creation of statute, if a ‘somewhat convoluted’ one.³ This article comes in the wake of the federal government’s introduction in 2017 of a ‘safe harbour’ carve out from insolvent trading liability for directors,⁴ primarily aimed at encouraging directors of

¹ *Corporations Act 2001* (Cth) s 588G. Liability is also imposed if the incurring of this debt is the one that renders the company unable to pay this debt and others: at sub-s (1)(b).

² See Jason Harris, ‘Director Liability for Insolvent Trading: Is the Cure Worse than the Disease?’ (2009) 23 *Australian Journal of Corporate Law* 266, 268–9. Street CJ has observed that ‘where a company is insolvent the interests of creditors intrude. They become prospectively entitled, through the mechanism of liquidation, to displace the power of the shareholders and directors to deal with the company’s assets’: *Kinsela v Russell Kinsela Pty Ltd (in liq)* (1986) 4 NSWLR 722, 730.

³ *Fryer v Powell* (2001) 159 FLR 433, 442 [56] (Olsson J).

⁴ *Treasury Laws Amendment (2017 Enterprise Incentives No 2) Act 2017* (Cth) (‘*Treasury Laws Amendment Act*’). The draft legislation followed publication of Treasury, *Australian Government, Improving Bankruptcy and Insolvency Laws* (Proposals Paper, April 2016) 10–16.

large companies not to liquidate the company prematurely.⁵ The aim of the carve out is to allow directors in appropriate circumstances to engage in an informal work-out, rather than placing the company into liquidation or voluntary administration ('VA'), but nonetheless not face liability where debts that the company cannot pay are incurred during the work-out period. Significant safeguards against abuse of the safe harbour have been included in the legislation.

On 28 March 2017, the government released draft legislation and called for public submissions.⁶ The current interest in a safe harbour follows a Treasury discussion paper on the same topic in 2010 ('2010 Safe Harbour Paper') that dealt with the concept of a safe harbour and proposed a business judgment rule as a means to implement it.⁷ The fact that the 2017 safe harbour legislation was passed through federal Parliament is not central to this article. Instead, it makes two arguments: first, that some of the policy justifications for a safe harbour for the directors of large companies are questionable, which leads to the second, that the safe harbour runs the risk of increasing the prevalence of phoenix activity, particularly among small companies,⁸ without achieving a compensating benefit in 'the big end of town'. For policy perspectives, this article relies on Treasury's 2010 Safe Harbour Paper and subsequent submissions. These are used in preference to the explanatory memorandum to the 2017 draft legislation and subsequent submissions, which largely concentrate on the operation of the legislation as proposed rather than whether a safe harbour itself is a good idea. This article also includes the views of the Senate Economics Legislation Committee ('Senate ELC') which were released

⁵ Explanatory Memorandum, Treasury Laws Amendment (2017 Enterprise Incentives No 2) Bill 2017 (Cth) 5–6 [1.7]–[1.10] ('Enterprise Incentives Explanatory Memorandum').

⁶ See Treasury Laws Amendment (2017 Enterprise Incentives No 2) Bill 2017 (Cth) ('Treasury Laws Amendment Bill'); 'National Innovation and Science Agenda: Improving Corporate Insolvency Law', *The Treasury, Australian Government* (Web Page, 28 March 2017) <<http://192.195.49.161/ConsultationsandReviews/Consultations/2017/NISA-Improving-corporate-insolvency-law>>, archived at <<https://perma.cc/SU73-TQCF>>.

⁷ Treasury, Australian Government, 'Insolvent Trading: A Safe Harbour for Reorganisation Attempts outside of External Administration' (Discussion Paper, January 2010) ('2010 Safe Harbour Paper'). The 2010 Safe Harbour Paper proposed, as one of three options, an equivalent to the business judgment rule to apply to insolvent trading: at 16–19 [5.3]. The other two were to maintain the status quo and, alternatively, to insert a moratorium provision.

⁸ Clearly, companies are not just small or large. However, this characterisation is made to simplify the discussion. Here, the term 'small' includes micro-companies which typically have up to four employees.

in August 2017.⁹ It recommended that the Bill be passed without amendment,¹⁰ and it was duly passed with some minor amendments on 12 September 2017.¹¹

Part II sets the scene by briefly outlining our current insolvent trading provision and defences, the relevance of liquidation and VA, and the justifications for, and elements of, the safe harbour. Part III examines the distinguishing features of phoenix activity relevant to insolvent trading, principally insofar as they occur among small companies. Part IV provides the analysis, asking first whether the safe harbour justifications stand up for companies of any size, and second, what difficulties a safe harbour could produce in the deterrence and prosecution of directors of mainly small companies choosing to engage in phoenix activity. Part V concludes that the safe harbour carve out enacted in 2017 is unlikely to be effective for directors of large companies and may well encourage directors of small companies towards phoenix activity.

II BACKGROUND

A Current Insolvent Trading Liability

The current insolvent trading provision is contained in s 588G of the *Corporations Act 2001* (Cth) and it owes much to the recommendations of the *Harmer Report*.¹² The *Harmer Report* justified imposing personal liability on directors for the insolvent trading of their companies thus:

⁹ Senate Economics Legislation Committee, Parliament of Australia, *Treasury Laws Amendment (2017 Enterprise Incentives No 2) Bill 2017 [Provisions]* (Report, August 2017).

¹⁰ *Ibid* 22 [2.78]. The Senate ELC concluded that issues with the details of the provisions would be dealt with by regulations accompanying the legislation, given there had been broad support for the Bill: at 21 [2.76].

¹¹ See *Treasury Laws Amendment Act* (n 4); ‘Treasury Laws Amendment (2017 Enterprise Incentives No 2) Bill 2017’, *Parliament of Australia* (Web Page) <www.aph.gov.au/Parliamentary_Business/Bills_Legislation/Bills_Search_Results/Result?bId=r5886>, archived at <<https://perma.cc/7JW8-CN46>>.

¹² See Law Reform Commission, *General Insolvency Inquiry* (Report No 45, 1988) (*‘Harmer Report’*). In November 1983, the Law Reform Commission had been asked by the federal Attorney-General to review the law and practice of companies, inter alia, in relation to insolvency. Its report was tabled in Parliament in December 1988 and the *Corporate Law Reform Act 1992* (Cth) introduced s 588G into what was then the Corporations Law (the *Corporations Act 1989* (Cth)). For further discussion of the evolution of the insolvent trading provisions, see *Southern Cross Interiors Pty Ltd v Deputy Commissioner of Taxation* (2001) 188 ALR 114, 132 [98]; *Harmer Report* (n 12) 122–5 [277]–[280]; Justin Dabner, ‘Trading whilst Insolvent: A Case for Individual Creditor Rights against Directors’ (1994) 17 *University of New South Wales Law Journal* 546, 552–6; Niall F Coburn, ‘Insolvent Trading in Australia:

The concept of limited liability as a privilege available to the commercial community was introduced into English law by the *Limited Liability Act 1855* (UK). The limited liability company was seen then, and is seen now, as a device for encouraging entrepreneurial activity and promoting economic growth. However, despite these desirable and widely accepted goals, the corporate form was abused. In particular, its use by persons who took advantage of being able to conduct business through a company with a minimum paid up capital was in marked contrast to the original conception of a company as a means of attracting substantial capital to undertake significant projects. There followed attempts to curb the abuses without derogating from the advantages of limited liability. In strict legal theory, the measures taken to curb abuses involve invasion of the principle of the separate entity of the company, although they are sometimes loosely characterised as disturbing the principle of limited liability. Initially, the development of the law of the limited liability company centred upon the protection of investors (shareholders and debenture holders). It was not until some 70 years after the introduction of the concept of limited liability that legislators turned to consider the protection of creditors.¹³

The main elements of s 588G are that the liable person is a director of the company, the company is insolvent at the time the debt is incurred or becomes insolvent by incurring that debt, and 'there are reasonable grounds for suspecting that the company is insolvent, or would so become insolvent, as the case may be'.¹⁴ Certain actions which diminish the company's assets are deemed to be debts, including paying a dividend or entering an uncommercial transaction.¹⁵ Liability for the director is imposed by s 588G(2) where the director is aware of the reasonable grounds for suspecting insolvency or a reasonable person in their position would be so aware. According to s 95A, '[a] person is solvent if, and only if, the person is able to pay all the person's debts, as and when they become due and payable.'¹⁶ The person in question here is, of course, the company.

The Legal Principles' in Ian M Ramsay (ed), *Company Directors' Liability for Insolvent Trading* (CCH Australia, 2000) 73, 73–89.

¹³ *Harmer Report* (n 12) 122–3 [277].

¹⁴ *Corporations Act 2001* (Cth) s 588(1).

¹⁵ *Ibid* s 588(1A) items 1, 7. The significance of the latter for a safe harbour in the context of phoenix activity is discussed further below.

¹⁶ While cash flow is the appropriate test of insolvency, the balance sheet is not irrelevant: *Bell Group Ltd (in liq) v Westpac Banking Corporation [No 9]* (2008) 39 WAR 1, 141 [1072]–[1073] (Owen J).

Contravention of s 588G(2) allows the liquidator to recover from directors by means of civil proceedings.¹⁷ The money recovered is payable to the company and is available for distribution to all unsecured creditors, not just those whose debts were incurred during the period when the director had reasonable suspicions of the company's insolvency.¹⁸ However, in creditor-initiated actions, which are permitted with consent,¹⁹ the amount recovered is payable to the unsecured creditor.²⁰

Liquidator recovery for contravention of s 588G(2) requires the company to be wound up.²¹ This may have been intended to encourage directors to find alternatives to liquidation, such as VA, not only to benefit themselves but also creditors.²² Placing an insolvent company into VA under pt 5.3A of the *Corporations Act* gives an administrator time to explore possibilities for saving the company or its business, failing which the assets are disposed of in a way that 'results in a better return for the company's creditors and members than would result from an immediate winding up of the company'.²³ The *Harmer Report* said, upon recommending the introduction of VA, that

the aim is to encourage early positive action to deal with insolvency. It will be worthwhile and a considerable advantage over present procedures if it saves or provides better opportunities to salvage even a small percentage of the companies which, under the present procedures, have no alternative but to be wound up.²⁴

The submission of the Insolvency Practitioners Association of Australia ('IPAA') to Treasury in 2010 recognised the role of the insolvent trading laws in achieving this aim:

[T]he *Harmer Report* saw the insolvent trading laws as supplementing and supporting the then new voluntary administration regime ... The strictness of the insolvent trading laws were meant to give a serious incentive to directors to

¹⁷ *Corporations Act 2001* (Cth) s 588M.

¹⁸ *Ibid* ss 588Y(1)–(2).

¹⁹ *Ibid* ss 588R (liquidator), 588T (court).

²⁰ *Ibid* s 588M(3).

²¹ *Ibid* s 588M(1)(d).

²² Abe Herzberg, 'Why Are There So Few Insolvent Trading Cases?' in Ian M Ramsay (ed), *Company Directors' Liability for Insolvent Trading* (CCH Australia, 2000) 148, 158.

²³ *Corporations Act 2001* (Cth) s 435A(b).

²⁴ *Harmer Report* (n 12) 29 [53].

focus on their company's financial position, something that the law at that time did not do.²⁵

Choosing to place the company into VA can mean that directors avoid the personal consequences of their culpable behaviour, even where the damage to the creditors is the same.²⁶ However, the Australian Securities and Investments Commission ('ASIC') retains the right to initiate proceedings for insolvent trading in the absence of the company's liquidation,²⁷ and ASIC did so against John Elliott and others despite their Water Wheel companies²⁸ entering VA and executing deeds of company arrangement ('DOCAs').²⁹ The Victorian Court of Appeal held in *Elliott v Australian Securities and Investments Commission* that the court may order compensation as a result of a civil penalty action pursuant to s 588J(1) without the company being wound up.³⁰ As a result of *Elliott*, VA may have lost some of its attraction as a 'safe haven' from personal liability for insolvent trading, and the decline in the popularity of VA may account for the increasing concern over the need for a safe harbour.³¹ The relief from insolvent trading liability prior to the passage of the legislation in 2017,³² where the person has acted honestly³³ and 'having

²⁵ Insolvency Practitioners Association of Australia, Submission to Treasury (Cth), *Insolvent Trading: A Safe Harbour for Reorganisation Attempts outside of External Administration* (18 March 2010) 2 ('IPAA Submission'). Clearly, Harmer was speaking before cases such as *Daniels v Anderson* (1995) 37 NSWLR 438 and *Australian Securities and Investments Commission v Healey* (2011) 196 FCR 291.

²⁶ Dale A Oesterle, 'Corporate Directors' Personal Liability for "Insolvent Trading" in Australia, "Reckless Trading" in New Zealand and "Wrongful Trading" in England: A Recipe for Timid Directors, Hamstrung Controlling Shareholders and Skittish Lenders' in Ian M Ramsay (ed), *Company Directors' Liability for Insolvent Trading* (CCH Australia, 2000) 19, 35.

²⁷ *Corporations Act 2001* (Cth) s 588J(1). The insolvent trading provision itself — s 588G — says nothing about the company being in liquidation.

²⁸ *Water Wheel Mills Pty Ltd and Water Wheel Holdings Ltd*.

²⁹ *Elliot v Australian Securities and Investments Commission* (2004) 10 VR 369, 414–15 [172]–[174].

³⁰ *Ibid* 417–18 [184]–[185]; Colin Anderson and David Morrison, 'Should Directors Be Pursued for Insolvent Trading Where a Company Has Entered into a Deed of Company Arrangement?' (2005) 13 *Insolvency Law Journal* 163, 169–70.

³¹ In 2015–16, there were 10,306 (74.3%) court or creditor winding ups out of a total of 13,853 insolvency appointments, compared to 1,652 (11.9%) voluntary administrations. In contrast, in 2005–06, there were 8,243 (64.9%) court or creditor winding ups out of a total of 12,689 insolvency appointments, compared to 2,909 (22.9%) voluntary administrations: ASIC, *Australian Insolvency Statistics* (Report, June 2017) table 2.3. See also Ron Schaffer, 'The Rise and Fall of Voluntary Administration' (2010) 10 *Insolvency Law Bulletin* 160.

³² *Corporations Act 2001* (Cth) s 1317S. This provision applies to all civil penalty provisions under pt 9.4B of the *Corporations Act*: at sub-s (1)(a).

regard to all the circumstances of the ... the person ought fairly to be excused for the contravention³⁴ is rarely established,³⁵ and therefore does not act as a de facto safe harbour.

Section 588G(2) imposes a positive duty on directors to prevent insolvent trading, subject to a number of defences set out in s 588H. Liability requires little culpability on the part of the director. Directors who choose to take no active part in management have no defence, and, under earlier legislation, wives and mothers who had known nothing of the company's conduct but who merely signed documents had been held liable.³⁶ Defences include an actual expectation of solvency based upon reasonable grounds,³⁷ illness or some other good reason,³⁸ and the taking of all reasonable steps to prevent the incurring of the debt.³⁹ The defences were construed strictly in the *Water Wheel* action and appeal.⁴⁰ The defence under s 588H(3) was not made out where Mr Elliott, an 'experienced businessman and company director',⁴¹ was held to lack reasonable grounds for believing that management was fulfilling its responsibility to him to provide him with adequate information about the company's solvency.⁴²

In summary, as can be seen from this outline, the insolvent trading duty and its defences were not intended to allow scope for directors to engage in workouts prior to liquidation. Where a work-out is appropriate, this could be achieved by VA and the formal appointment of an administrator. The justifications for change will now be considered.

³³ *Ibid* s 1317S(2)(b)(i).

³⁴ *Ibid* s 1317S(2)(b)(ii).

³⁵ Harris, 'Director Liability for Insolvent Trading' (n 2) 284; Patrick J Lewis, 'Insolvent Trading Defences after *Hall v Poolman*' (2010) 28 *Company and Securities Law Journal* 396, 408. See also Jason Harris, 'Relief from Liability for Company Directors: Recent Developments and Their Implications' (2008) 12 *University of Western Sydney Law Review* 152, 166. Case examples include *Hall v Poolman* (2007) 215 FLR 243; *McLellan v Carroll* (2009) 76 ACSR 67.

³⁶ See *Morley v Statewide Tobacco Services Ltd* [1993] 1 VR 423. But see *Metal Manufacturers Pty Ltd v Lewis* (1988) 13 NSWLR 315, 324 (Mahoney JA), 327, 329 (McHugh JA). See also Irene Trethowan, 'Directors' Personal Liability for Insolvent Trading: At Last, a Degree of Consensus' (1993) 11 *Company and Securities Law Journal* 102.

³⁷ *Corporations Act 2001* (Cth) s 588H(2).

³⁸ *Ibid* s 588H(4).

³⁹ *Ibid* s 588H(5).

⁴⁰ See *Australian Securities and Investments Commission v Plymin* (2003) 175 FLR 124, 220-1 [420], 223-4 [424]; *Elliott* (n 29) 401-2 [116].

⁴¹ *Plymin* (n 40) 261 [560].

⁴² *Ibid* 261 [559]-[560].

B *Justifications for a Safe Harbour*

As noted in the introduction, the policy behind insolvent trading liability and its current defences is to deter directors from gambling with creditors' money, while at the same time protecting honest directors who have done their best prior to the company's insolvency. The rationale is that a fear of liability ought to curb improper behaviour, to the benefit of creditors' ability to recover their debts from the company. Directors will avoid decreasing the few assets left for the creditors or incurring further debts which will compete for payment. Credit for the company should be less risky and therefore cheaper,⁴³ leading to a better return for shareholders where the company is successful.

While the newly enacted safe harbour is not limited to companies of any particular size, it appears to be aimed at directors of large companies.⁴⁴ While a director of a small company might be willing to take the risk of trading insolvently in a last-ditch attempt to save their investment and livelihood,⁴⁵ hoping to sail under the regulatory radar, the argument in favour of increased risk-taking as insolvency approaches is unlikely to hold for the directors of large companies. Those directors may have no further incentive to save their positions or to maintain enterprise value for the company's shareholders, and therefore are likely to act cautiously.⁴⁶ 'Insolvency' itself in an extensive and complex business may be hard to ascertain. The gain from successful risk-taking when the company is in significant financial distress — the gamble to 'trade out of its difficulties' or even to engage in an informal work-out⁴⁷ — goes to the company's creditors and shareholders. The loss, if the gamble fails, is on the director themselves, both financially, through insolvent trading liability, and through loss of reputation.

Moreover, for directors of large companies, possible insolvent trading liability may not only deter unduly risky behaviour, but also discourage appropriately risky behaviour which could benefit the company, shareholders and creditors alike. Even before insolvency looms, directors of large companies may concentrate on strategies to minimise the risk of possible liability, rather than on the growth and prosperity of the company for the benefit of its

⁴³ See 2010 Safe Harbour Paper (n 7) 8 [3.9].

⁴⁴ Enterprise Incentives Explanatory Memorandum (n 5) 5–6 [1.7].

⁴⁵ Productivity Commission, Australian Government, *Business Set-Up, Transfer and Closure* (Inquiry Report No 75, 30 September 2015) 367 ('*PC Business Set-Up Report*').

⁴⁶ See Harris, 'Director Liability for Insolvent Trading' (n 2) 274–5.

⁴⁷ Enterprise Incentives Explanatory Memorandum (n 5) 6 [1.13].

shareholders.⁴⁸ The total social cost of directors' risk aversion, including a dampening of entrepreneurial spirit,⁴⁹ could exceed the creditor losses that would result from insolvent trading.⁵⁰

In addition, a fear of personal liability and loss of reputation for directors of large companies may make it difficult for those companies to recruit suitable board candidates.⁵¹ This could be particularly the case where the companies conduct businesses in 'challenging' areas, such as retailing, property development or natural resources, or where the companies are going through difficult times.⁵² Non-executive directors may be especially reluctant to join the boards of these companies.⁵³ Directors who do remain with the company may demand additional compensation for the risks to which they are exposed.⁵⁴ This is because directors, especially executive directors, generally lack the ability to diversify away their risk as a creditor might, and they face unlimited personal liability unless they have actively engaged in personal asset protection strategies. That said, these arguments are theoretical ones, and there is no empirical evidence to suggest that there is actually a

⁴⁸ Mark Byrne, 'An Economic Analysis of Directors' Duties in Favour of Creditors' (1994) 4 *Australian Journal of Corporate Law* 275, 283. As Byrne observes, 'the more serious cost is the effect the liability regime will have on the performance of the director. Their inability to efficiently cope with the liability would logically mean further incentive to avoid the riskier ventures which raise the potential losses. It is this cost which may be seen to be of significant social consequence. It is extremely difficult to measure the size of such cost and, therefore, whether or not it will outweigh the benefits to creditors.'

⁴⁹ 2010 Safe Harbour Paper (n 7) 8 [3.8].

⁵⁰ See Victor CS Yeo and Joyce Lee Suet Lin, 'Insolvent Trading: A Comparative and Economic Approach' (1999) 10 *Australian Journal of Corporate Law* 216, 234–5.

⁵¹ Enterprise Incentives Explanatory Memorandum (n 5) 5–6 [1.7]; Dabner (n 12) 561; Oesterle (n 26) 29–30. Oesterle remarked that 'executives on boards will be more likely to resign at the first sign of trouble. Firms may find themselves looking for directors to fill vacancies and to make critical decisions just when good business people will slam the door on inquiries': at 30.

⁵² See Oesterle (n 26) 31, 34.

⁵³ *The Age* reported that non-executive directors 'face legal risks (they can be sued) and reputational risks (they are vilified if the company goes bust). ... And while their pay packet might appear to be nominally decent to the average worker, it seems it is not enough to attract and keep non-executive directors': Gabrielle Costa, 'More Non-Execs Wonder if the Pay Is Worth the Pain', *Business News, The Age* (Melbourne, 25 September 2004) 5. Oesterle commented: 'Expose [non-executive] directors to personal liability and one will see many resign from all but the healthiest of companies. Firms cannot pay them enough to compensate them for the personal risk. Sadly, outside directors are the least needed in the best running companies and are the most needed in companies that are suffering through difficult times': Oesterle (n 26) 31.

⁵⁴ Byrne (n 48) 282–3.

shortage of quality directors in large companies or that they demand unreasonably high remuneration packages to compensate them for the possibility of insolvent trading liability.

This leads to the issue of early and unnecessary liquidation. Perhaps directors are willing to take board positions in large companies without demanding excessive compensation because they plan to appoint a liquidator at the first sign of trouble,⁵⁵ whether or not the company could have been saved. This attitude has consequences not only for each affected company and its stakeholders, but also for the economy as a whole. Employees lose their jobs, taxes are not remitted, and unpaid trade creditors themselves may face financial crises.

Although directors facing corporate financial distress do not need to place the company into liquidation, given the availability of VA, the motivation for the 2010 Safe Harbour Paper was an attempt to add a third option — informal work-out:

It has been asserted that the insolvent trading laws may have the effect of aiding in business rescue by inducing directors to place companies into external administration [ie VA] while there is still a possibility to reorganise and rescue the company (or at least its business). However, concerns have also been raised in respect of the insolvent trading laws' effects on work-outs. It has been asserted by some stakeholders that the laws may cause companies to be placed into external administration prematurely or in circumstances where external administration is not appropriate, by directors who fear personal liability if the company engages in insolvent trading while attempting some sort of informal work-out.⁵⁶

The question therefore is, why is there a need for *informal* workouts outside of VA? The 2010 Safe Harbour Paper acknowledged that

[v]oluntary administration provides an efficient, non-court based, procedure to enable a company to come to a binding arrangement with its unsecured creditors. However, placing a company into external administration may not always be the most appropriate method to affect a business rescue or to otherwise real-

⁵⁵ See Yeo and Lin (n 50) 231–2. The 'haste effect' is seen in the United Kingdom even with different provisions: Rizwaan J Mokal, 'An Agency Cost Analysis of the Wrongful Trading Provisions: Redistribution, Perverse Incentives and the Creditors' Bargain' (2000) 59 *Cambridge Law Journal* 335, 365–7.

⁵⁶ 2010 Safe Harbour Paper (n 7) 8 [3.12].

ise value for the benefit of the company's creditors and members. Such objectives may more appropriately be effected through a work-out.⁵⁷

An informal work-out, as an unregulated restructure of the company's affairs, has the advantages of maximum flexibility and less cost than the appointment of an external administrator.⁵⁸ It can also avoid triggering ipso facto clauses, which precipitate the withdrawal of key contracts underpinning the business.⁵⁹ The ability of existing management to maintain control of the business is also a major factor.⁶⁰ This allows companies to maintain whatever goodwill is attached to the participation of these individuals, and can give the appearance of 'business as usual' so that customers are not scared away, resulting in lost enterprise value.⁶¹ KordaMentha's submission noted that retaining customer confidence was particularly vital in businesses with prepayments, such as travel businesses, or with ongoing service commitments.⁶² Although the data is somewhat dated, it appears that VA as a way of a company returning to normal business does not have a high rate of success,⁶³ and Schaffer has

⁵⁷ Ibid 2 [1.8].

⁵⁸ Ibid 11–12 [4.3.7]–[4.3.8].

⁵⁹ Note that the *Treasury Laws Amendment Act* (n 4) also includes legislation to allow for the removal of ipso facto clauses. According to the accompanying explanatory memorandum, '[a]n ipso facto clause creates a contractual right that allows one party to terminate or modify the operation of a contract upon the occurrence of some specific event. In the current insolvency context, such rights may allow one party to terminate or modify the contract solely due to the financial position of the company (including insolvency) or due to the commencement of formal insolvency proceedings, such as on the appointment of an administrator. This type of termination can occur regardless of the counterparty's continued performance of its obligations under the contract': Enterprise Incentives Explanatory Memorandum (n 5) 25 [2.3]. This article does not consider the ipso facto legislation and only notes the relevance of these clauses in the context of informal work-outs.

⁶⁰ 2010 Safe Harbour Paper (n 7) 11 [4.3.2]. Directors lose control of the company when entering VA: *Corporations Act 2001* (Cth) s 437A(1).

⁶¹ 2010 Safe Harbour Paper (n 7) 11 [4.3.3]–[4.3.5].

⁶² KordaMentha, Submission to Treasury, *Insolvent Trading: A Safe Harbour for Reorganisation Attempts outside of External Administration* (2 March 2010) 3.

⁶³ Parliamentary Joint Committee on Corporations and Financial Services, Parliament of Australia, *Corporate Insolvency Laws: A Stocktake* (Report, June 2004) 74 [5.12]. The Parliamentary Joint Committee on Corporations and Financial Services quoted a 1998 survey of companies in VA by ASIC's predecessor, the Australian Securities Commission. Of 5,760 companies surveyed, only 592 had resumed trading: Australian Securities Commission, 'A Study of Voluntary Administrations in New South Wales' (Research Paper No 98/01, 1998) app 2, 20. Nor does VA appear to be a cheap option or lead to a high rate of return for creditors. More recent research into VAs and DOCA reports that, of the administrations sampled, 'the average remuneration of the administrators — for the period from their appointment to the execution of the subsequent DOCA — was \$54,670': Mark Wellard, *A Sample*

described VA as ‘the scenic route to winding up’.⁶⁴ On the other hand, it is possible that directors delay entry into VA for too long, possibly so they do not lose control of the company, and this can jeopardise the VA’s chance of success.⁶⁵ One of the recommendations of the Productivity Commission’s 2015 investigation into business set-up, transfer and closure was that the administrator of a VA must certify within a month of taking the appointment that the company is capable of being a viable business, in the absence of which the company must be liquidated.⁶⁶

The 2010 Safe Harbour Paper did not lead to any draft legislation. However, the idea of a safe harbour was revived as part of the Turnbull government’s National Science and Innovation Agenda in 2016.⁶⁷

C Elements of the 2017 Safe Harbour Carve Out

Draft legislation was released in March 2017 with calls for feedback to the government.⁶⁸ According to the Minister for Revenue and Financial Services, the draft legislation was intended ‘to promote a culture of entrepreneurship and innovation and help reduce the stigma associated with business failure’ with the aim of driving jobs and business growth through cultural change.⁶⁹

A key element of the legislation is that s 588GA(1) operates as a ‘carve out’ from, rather than a defence to, s 588G liability. While the director bears the burden of adducing evidence that they took ‘one or more courses of action that are reasonably likely to lead to a better outcome for the company’,⁷⁰ it is still necessary for the liquidator or regulator to establish the elements of the s 588G(2) breach, and now additionally, to overcome the evidence of

Review of Deeds of Company Arrangement under Part 5.3A of the Corporations Act (ARITA Terry Taylor Scholarship Report, 19 May 2014) 17 (emphasis omitted). Across 71 DOCAs sampled, there was ‘a weighted average dividend of 5.86 cents in the dollar’: at 14.

⁶⁴ Schaffer (n 31) 160.

⁶⁵ James Routledge and David Morrison, ‘Voluntary Administration: Patterns of Corporate Decline’ (2009) 27 *Company and Securities Law Journal* 95, 98–9.

⁶⁶ *PC Business Set-Up Report* (n 45) 377 recommendation 14.1.

⁶⁷ *Improving Bankruptcy and Insolvency Laws* (n 4) 10–16.

⁶⁸ ‘National Innovation and Science Agenda: Improving Corporate Insolvency Law’ (n 6).

⁶⁹ *Ibid.*

⁷⁰ *Corporations Act 2001* (Cth) s 588GA(1)(a), as inserted by *Treasury Laws Amendment Act* (n 4) sch 1 item 2. The first iteration of the legislation included the words ‘and the company’s creditors’, but these were later removed: Exposure Draft, *Treasury Laws Amendment (2017 Enterprise Incentives No 2) Bill 2017* (Cth) sch 1 item 2.

entitlement to claim the safe harbour.⁷¹ In contrast, the burden of proving entitlement to the defences under s 588H is on the director. This is a significant difference.

Nonetheless, adducing evidence of the safe harbour carve out will not be easy. Under 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, the director cannot utilise the safe harbour under s 588GA(1) 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.⁷² The legislation also addresses the vexed question of missing books and uncooperative behaviour. It warns the director that if the company's books and corporate information are not forthcoming as required by the liquidator or court, they cannot be relied on later by the director in seeking to make out the safe harbour.⁷³

As a result of the safeguards built into the safe harbour, it might appear to be simply a harmless signal of encouragement to directors of large companies not to liquidate prematurely and risk losing enterprise value. However, since the safe harbour has no limitations in relation to the size of the company to which it can apply, the carve out is equally available to directors of small companies. This has the potential to encourage illegal phoenix activity, which will be explained in the next part.

III PHOENIX ACTIVITY

This part will describe the common characteristics of phoenix activity relevant to insolvent trading, which will be scrutinised in terms of the safe harbour carve out in Part IV. Phoenix activity typically involves the corporate failure of one company, 'Oldco', and a second company, 'Newco', arising from

⁷¹ Enterprise Incentives Explanatory Memorandum (n 5) 19 [1.75]. The carve out and evidential burden on the director is based on criminal law concepts of burdens of proof, drawn from the *Criminal Code Act 1995* (Cth) pt 2.6 div 13.

⁷² *Treasury Laws Amendment Act* (n 4) s 588GA(4)(a). The legislation is not draconian in this regard, because the inability to rely on the safe harbour due to a failure to comply with employee entitlements and tax obligations only occurs if 'that failure: (i) amounts to less than substantial compliance with the matter concerned; or (ii) is one of 2 or more failures by the company to do any or all of those matters during the 12 month period ending when the debt is incurred': at sub-s (b).

⁷³ *Ibid* s 588GB.

Oldco's ashes where Newco's controllers and business are essentially the same as Oldco's.⁷⁴ Phoenix activity can be legal where the previous controllers start another similar company in order to genuinely rescue the failed company's business.⁷⁵ Illegal phoenix activity is procedurally similar but is distinguished by an intention to exploit the corporate form at the expense of unsecured creditors, usually via the speedy liquidation of Oldco, with its assets sold for less than they are worth to Newco.⁷⁶ This is a breach of the duties of Oldco's directors to act for a proper purpose, and not to misuse their positions in respect of the company and its creditors.⁷⁷

Illegal phoenix activity is frequently, although not exclusively, the realm of small business,⁷⁸ because the failed company has little reputation to lose by liquidating and being resurrected unobtrusively through another company, possibly with a similar name.⁷⁹ The relatively small size of these companies means that ASIC, with limited resources for investigations and prosecutions,⁸⁰ does not bring actions against these directors for insolvent trading where phoenix activity is involved.⁸¹ At most, those caught 'red-handed' are likely to

⁷⁴ Helen Anderson et al, *Defining and Profiling Phoenix Activity* (Research Report, Melbourne Law School and Monash Business School, December 2014) 1; Helen Anderson et al, 'Profiling Phoenix Activity: A New Taxonomy' (2015) 33 *Company and Securities Law Journal* 133, 133.

⁷⁵ Anderson et al, *Defining and Profiling Phoenix Activity* (n 74) 1; Anderson et al, 'Profiling Phoenix Activity' (n 74) 133.

⁷⁶ Anderson et al, *Defining and Profiling Phoenix Activity* (n 74) 1; Anderson et al, 'Profiling Phoenix Activity' (n 74) 133.

⁷⁷ *Corporations Act 2001* (Cth) ss 181–2.

⁷⁸ See, eg, Treasury, Australian Government, *Action against Fraudulent Phoenix Activity* (Proposals Paper, November 2009) 6 [2.3]. See also Fair Work Ombudsman and PwC, *Phoenix Activity: Sizing the Problem and Matching Solutions* (Report, June 2012) 4 [2.1].

⁷⁹ For a discussion of the difficulty of detecting phoenix activity, see generally Helen Anderson, 'Sunlight as the Disinfectant for Phoenix Activity' (2016) 34 *Company and Securities Law Journal* 257.

⁸⁰ See ASIC, 'ASIC's Approach to Enforcement' (Information Sheet No 151, September 2013) 2. ASIC's decision process involves asking the following questions: 'What is the extent of harm or loss? What are benefits of pursuing the misconduct, relative to the expense? How do other issues, like the type and seriousness of the misconduct and the evidence available, affect the matter? Is there an alternative course of action? ... What is the nature and seriousness of the misconduct? What was the post-misconduct behaviour of the offender? What is the strength of the case? What impact will the remedy have on: the person or entity? the regulated population? the public? Are there any mitigating factors?'

⁸¹ Michelle Welsh and Helen Anderson, 'The Public Enforcement of Sanctions against Illegal Phoenix Activity: Scope, Rationale and Reform' (2016) 44 *Federal Law Review* 201, 220–1.

be disqualified administratively by ASIC.⁸² External administrators regularly report large numbers of suspected instances of insolvent trading to ASIC at the conclusion of their insolvency engagements.⁸³ For example, in 2015–16, it was the top of the ‘top 3 alleged possible misconduct’, with civil breaches alleged in ‘5,736 or 61% of reports.’⁸⁴ In addition, there were allegations of 150 instances of criminal insolvent trading,⁸⁵ with evidence held by the liquidator in 93 of those cases.⁸⁶ However, comparatively little appears to be done in response to those reports.⁸⁷

Because insolvent trading liability 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 ones⁸⁸ — it appears to be the antithesis of the usual conception of phoenix activity. However, since 2000,

⁸² See *Corporations Act 2001* (Cth) s 206F. See, eg, ASIC, ‘ASIC Bans Director of Failed Companies for Maximum Five Year Period’ (Media Release No 16-295MR, 6 September 2016) <<http://asic.gov.au/about-asic/media-centre/find-a-media-release/2016-releases/16-295mr-asic-bans-director-of-failed-companies-for-maximum-five-year-period/>>, archived at <<https://perma.cc/83WN-L7M7>>. See also Helen Anderson et al, *Phoenix Activity: Recommendations on Detection, Disruption and Enforcement* (Research Report, Melbourne Law School and Monash Business School, February 2017) 57–9 [2.2.1]; Jasper Hedges et al, ‘Harmful Phoenix Activity and Disqualification from Managing Corporations: An Unenforceable Regime?’ (2018) 36(1) *Company and Securities Law Journal* (forthcoming).

⁸³ See Helen Anderson, Ian Ramsay and Michelle Welsh, ‘Illegal Phoenix Activity: Quantifying Its Incidence and Cost’ (2016) 24 *Insolvency Law Journal* 95, 100. This reporting is done in compliance with ASIC, *External Administrators: Reporting and Lodging* (Regulatory Guide No 16, July 2008). The form completed by the external administrator is Form EX01 (‘Report to ASIC under s 422, s 438D or s 533 of the Corporations Act 2001 or for Statistical Purposes’): at sch B.

⁸⁴ ASIC, *Insolvency Statistics: External Administrators’ Reports (July 2015 to June 2016)* (Report No 507, December 2016) 7.

⁸⁵ *Ibid* 25 [52].

⁸⁶ *Ibid* 39.

⁸⁷ Comprehensive data on disqualification orders imposed by ASIC under s 206F of the *Corporations Act* is not available to the public. It is therefore impossible to comment precisely on how many s 206F orders have been made in the context of phoenix activity and insolvent trading. However, in a search of ASIC’s media releases from 1 January 2004 to 30 June 2014, there were 32 media releases reporting that 51 directors were disqualified under s 206F in circumstances involving phoenix activity. This amounts to an average of about 4.9 orders reported in ASIC’s media releases per year. For data on other forms of enforcement action taken against illegal phoenix activity, see Helen Anderson et al, *Quantifying Phoenix Activity: Incidence, Cost, Enforcement* (Research Report, Melbourne Law School and Monash Business School, October 2015) 63–81; Anderson, Ramsay and Welsh (n 83) 103, 109–10.

⁸⁸ See Helen Anderson et al, Submission to Treasury (Cth), *Treasury Laws Amendment (2017 Enterprise Incentives No 2) Bill 2017 [Provisions]* (7 April 2017) 1.

insolvent trading has also included ‘uncommercial transactions’,⁸⁹ as defined by s 588FB of the *Corporations Act*, expressly to capture phoenix activity.⁹⁰ Uncommercial transactions are ones that ‘a reasonable person in the company’s circumstances would not have entered ... having regard to’:⁹¹

- (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.⁹²

Undervalued transfers of assets from Oldco to Newco are clearly within the section’s reach. Unfortunately, it is not known how many of the liquidator reports of insolvent trading, noted above, relate to uncommercial transactions, because the question is not asked on the external administration reporting form, nor is there a question about suspected illegal phoenix activity.⁹³ It is also difficult to estimate how many actions by liquidators against directors for insolvent trading are avoided by the director making a payment towards meeting the debts of the company. Indeed, this was expressly contemplated as an outcome by the *Harmer Report*⁹⁴ and could therefore be seen, broadly speaking, as a ‘successful’ application of the law. Pragmatically, the *Harmer Report* recognised that ‘settlement of a claim by a payment to forestall legal proceedings is a common and recognised phenomenon in all areas of civil litigation.’⁹⁵

⁸⁹ *Corporations Act 2001* (Cth) s 588G(1A) item 7.

⁹⁰ Explanatory Memorandum, Corporations Law Amendment (Employee Entitlements) Bill 2000 (Cth) 4 [10] (‘Employee Entitlements Explanatory Memorandum’): ‘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.’ See also David Morrison, ‘The Addition of Uncommercial Transactions to s 588G and Its Implications for Phoenix Activities’ (2002) 10 *Insolvency Law Journal* 229, 232–3.

⁹¹ *Corporations Act 2001* (Cth) s 588FB(1) (emphasis added).

⁹² *Ibid.*

⁹³ For further discussion of deficiencies in the external administrator reporting process, see Jasper Hedges et al, ‘No “Silver Bullet”: A Multifaceted Approach to Curbing Harmful Phoenix Activity’ (2017) 35 *Company and Securities Law Journal* 277, 280; Anderson et al, *Phoenix Activity* (n 82) 15–17 [1.2.2].

⁹⁴ *Harmer Report* (n 12) 129–30 [288].

⁹⁵ *Ibid.*

In small company liquidations, secured lenders such as banks seize the secured assets and are typically repaid.⁹⁶ Comparatively, with the exception of employees, unsecured creditors including revenue authorities, and trade creditors are left wholly or partly unpaid in a higher proportion of cases.⁹⁷ This is in contrast to the situation in large company insolvencies which are the focus of the safe harbour. A joint submission to Treasury in 2010 by the Law Council of Australia, the IPAA and the Turnaround Management Association Australia pointed out that

in an informal work-out of a major corporation, it is usually the case that the claims of its financiers are so significant as a percentage of its total liabilities, that it is in their commercial interests to permit the company to continue to trade under agreed funding arrangements while a restructuring is pursued. In such cases, the business continues to operate and trade creditors are paid in the ordinary course of business during the period of restructuring.⁹⁸

Again, small companies differ from large companies when it comes to handing documentation to the company's external administrator. It is an offence for a director to fail to provide books and records to a company's external administrator at the commencement of the administration,⁹⁹ but directors of small companies, with little personal reputation at stake, may still choose to destroy books and records to thwart regulator or liquidator action for more serious breaches. While this is the most common area for ASIC insolvency enforcement,¹⁰⁰ the 'slap on the wrist' fine of what currently

⁹⁶ *Insolvency Statistics* (n 84) 48.

⁹⁷ *Ibid* 50, 53. Even though employees are priority creditors in a liquidation (*Corporations Act 2001* (Cth) ss 556(1)(e)–(h)), in 2015–16 '\$281.51 million was paid to 14,337 claimants under the Fair Entitlements Guarantee', a scheme administered by the Department of Employment that makes advances to the employees of insolvent employers, incorporated or unincorporated: Department of Employment, Australian Government, *More Jobs. Great Workplaces: Annual Report 2015–16* (Annual Report, 20 June 2016) 45.

⁹⁸ Law Council of Australia, the IPAA and the Turnaround Management Association Australia, Joint Submission to Treasury, *Insolvent Trading: A Safe Harbour for Reorganisation Attempts outside of External Administration* (2 March 2010) 2 n 1 ('Insolvency Professionals Joint Submission').

⁹⁹ *Corporations Act 2001* (Cth) ss 438B(1)–(2) (voluntary administration), 530A(1) (liquidation).

¹⁰⁰ A 2013 Australian Institute of Criminology study found that, between 2006 and 2010, an average of 80% of successful summary prosecutions by ASIC were for breaches of ss 475 and 530A of the *Corporations Act*: Peter Keenan, *Convictions for Summary Insolvency Offences Committed by Company Directors* (Report No 30, Australian Institute of Criminology, Australian Government, February 2013) 4. Section 475 relates to the Report as to Affairs ('RATA'), a document that directors are obliged to give the external administrator at the

amounts to up to \$10,500¹⁰¹ means that it is a useful strategy to adopt.¹⁰² While a 2013 study showed that 96% of all prosecutions resulted in fines, this was an average of just \$917.85 per fine.¹⁰³

IV ANALYSIS

A *Do the Safe Harbour Justifications Stand Up?*

1 *Premature Liquidation*

While both the 2010 Safe Harbour Paper and the explanatory memorandum to the 2017 legislation suggest that insolvent trading liability could cause premature liquidation,¹⁰⁴ it is unclear whether this is actually true. The submission of the Australian Institute of Company Directors ('AICD') to Treasury in 2010 quoted a series of statistics to support the contention that the fear of personal liability resulted in 'overly cautious' decision-making.¹⁰⁵ The Insolvency Professionals Joint Submission cited the example of the Henry Walker Eltin group, 'where the directors, citing concerns regarding insolvent trading liability, placed the company into administration. Ultimately, all creditors were paid 100¢ in the dollar, and the destruction of enterprise value was experienced at the shareholder level.'¹⁰⁶

commencement of the insolvency engagement: see ASIC, 'Report as to Affairs' (Form 507, 20 September 2017). The Keenan study did not examine voluntary administrations, so there is no data available on summary prosecutions of directors for failure under s 438B to provide administrators with books and records: Keenan (n 100) 2.

¹⁰¹ *Corporations Act 2001* (Cth) sch 3 items 123, 134. Offences under ss 438B and 530A can also be punished by imprisonment for up to one year, but in practice prison sentences are very rarely imposed: Keenan (n 100) 5.

¹⁰² Helen Anderson et al, 'Illegal Phoenix Activity: Is a "Phoenix Prohibition" the Solution?' (2017) 35 *Company and Securities Law Journal* 184, 196.

¹⁰³ Keenan (n 100) 5–6. This figure relates to the period 2006–10.

¹⁰⁴ 2010 Safe Harbour Paper (n 7) 8 [3.12]; Enterprise Incentives Explanatory Memorandum (n 5) 5–6 [1.7].

¹⁰⁵ For example, according to a survey of the top 200 listed companies, '78 per cent said the risk of personal liability occasionally or frequently made them take an "overly cautious" approach to decision making. ... 45 per cent of Survey respondents said that the duty to prevent insolvent trading ... was responsible to a medium to high degree for overly cautious approach decision making': AICD, Submission to Treasury, *Insolvent Trading: A Safe Harbour for Reorganisation Attempts outside of External Administration* (2 March 2010) 4.

¹⁰⁶ Insolvency Professionals Joint Submission (n 98) 7–8 [3.11]. The circumstances surrounding this group's administration were complex: see 'Case Studies: Henry Walker Eltin Group Limited', *McGrathNicol* (Web Page, 2017) <www.mcgrathnicol.com/case-studies/henry-walker-eltin-group-limited-2/>, archived at <<https://perma.cc/2B8E-SJ8G>>.

However, MacFarlane disputes that fear of personal liability leads to early entry into external administration,¹⁰⁷ and KordaMentha's 2010 submission to Treasury, based on a review of 20 large administrations and liquidations conducted by themselves and other practitioners, agreed. Their submission said:

[W]e found that in all but a few cases those involved did not believe that the external administration had occurred predominantly because of the trading whilst insolvent laws ... We found that the decision to appoint external administrators occurred mainly because the company had run out of options. The fundamental problem was the loss of key stakeholder support, without which any form of restructuring could not have occurred.¹⁰⁸

2 Director Penalty Notices

All the attention on a company's premature liquidation, to the exclusion of an informal work-out, seems to be focused on possible insolvent trading liability. However, a more potent reason to enter external administration — liquidation or VA — is liability for unremitted withholding taxes and unpaid superannuation.¹⁰⁹

A director is required to 'cause the company to comply with its obligation' to pay certain withholding tax liabilities.¹¹⁰ This obligation continues until the company has paid that tax or is liquidated or placed into VA. Directors become liable for a penalty, equal to the amount owing by the company, through the issuance of a 'standard' director penalty notice ('DPN') if they do not do one of those three things within 21 days.¹¹¹ The DPN regime was amended in 2012 to make directors personally liable not only for their company's unpaid Pay-As-You-Go (Withholding) instalments, but also for

¹⁰⁷ Anna MacFarlane, 'Safe Harbour Reforms: Should Insolvent Trading Provisions Be Reformed?' (2010) 18 *Insolvency Law Journal* 138, 144.

¹⁰⁸ KordaMentha (n 62) 2. The Henry Walker Eltin group was one of the case studies examined by KordaMentha: at 1.

¹⁰⁹ See, eg, *Deputy Commissioner of Taxation v Arora* [2017] NSWSC 1016, where the director was liable to pay \$1,894,929 under a director penalty notice. '[I]t cannot be of any relevance whether the money will ultimately be found in the liquidation to pay the amounts that were formerly due by the company. At the relevant time, the Defendant became liable for those amounts as a primary and principal debtor ... Accordingly, what is pleaded in this way as a defence to the claim is no defence at all': at [38].

¹¹⁰ *Taxation Administration Act 1953* (Cth) s 269-15.

¹¹¹ *Ibid* ss 269-20–269-25.

superannuation guarantee charge liabilities.¹¹² The 2012 amendments also limited the circumstances in which directors can discharge a DPN by placing their company into liquidation or VA. This was through the introduction of so-called ‘lockdown’ DPNs, which are issued where the amount owing by the company was not reported in a timely manner to the Australian Taxation Office (‘ATO’) and the relevant amount was not paid.¹¹³ This deprives the director of the ability to avoid personal liability for the unremitted amounts by placing the company into external administration. ‘Standard’ DPNs, as described above, remain available for reported, but unpaid, withholding taxes.

Given the incentive towards formal external administration — either liquidation or VA — to avoid personal liability for these unpaid taxes via a ‘standard’ DPN, it seems clear that the safe harbour proposed in 2010 would not have provided sufficient encouragement towards informal workouts.¹¹⁴ The 2017 legislation approached the matter from a different angle, depriving the director of the safe harbour carve out under s 588GA(1) where the company is failing to ‘give returns, notices, statements, applications or other documents as required by taxation laws (within the meaning of the *Income Tax Assessment Act 1997*)’.¹¹⁵ However, this is not the same as saying that the taxes themselves need to be paid, in contrast to employee entitlements where payment is explicitly required.¹¹⁶

Therefore, directors who report company tax liabilities and may otherwise be entitled to rely on the 2017 safe harbour carve out may still be exposed to personal liability for unremitted withholding taxes and unpaid superannuation via a ‘standard’ DPN because they did not place the company into formal external administration within the 21-day period. The issue of DPNs was considered by the Productivity Commission in 2015 and it concluded, in response to suggestions that the safe harbour extend to DPNs, that

¹¹² The *Taxation Administration Act 1953* (Cth), as amended by the *Tax Laws Amendment (2012 Measures No 2) Act 2012* (Cth) and the *Pay As You Go Withholding Non-Compliance Tax Act 2012* (Cth), came into effect on 29 June 2012.

¹¹³ *Taxation Administration Act 1953* (Cth) s 269-30(2) item 1, as inserted by *Tax Laws Amendment (2012 Measures No 2) Act 2012* (Cth) s 8.

¹¹⁴ See also MacFarlane (n 107) 146: ‘Without reform to directors’ personal liability for unremitted tax, reforms to insolvent trading provisions are meaningless.’

¹¹⁵ *Treasury Laws Amendment Act* (n 4) s 588GA(4)(a)(ii). See also Enterprise Incentives Explanatory Memorandum (n 5) 20 [1.79].

¹¹⁶ *Treasury Laws Amendment Act* (n 4) s 588GA(4)(a): ‘the company is failing to do one or more of the following matters: (i) pay the entitlements of its employees by the time they fall due’.

[t]he Commission disagrees, and considers that *the defence should only apply to insolvent trading*, as its purpose is to remove distorted incentives arising from the fear of insolvent trading liability, and thus improve opportunities for ongoing solvency or restructure. It should not be used to excuse directors from other existing regulatory requirements.¹¹⁷

In the footnote to this passage, the Productivity Commission then commented that,

[o]f course, the appointment of a safe harbour adviser could still be used as a component in existing [DPN] defences. For example, it could indicate that the director had taken ‘all reasonable steps’ to ensure that the company paid the amount outstanding, appointing an administrator or winding up the company depending on the advice received — that is, fulfilled defences which can negate liability for a director penalty.¹¹⁸

With respect, this misses the point entirely. The DPN defences, as stated, involve the company actually paying the tax or placing the company into external administration. A safe harbour informal work-out does not require any of these things. The appointment of an advisor does not satisfy any of the DPN defences,¹¹⁹ which are considerably more strict than the current insolvent trading defences. In addition, the DPN cannot be avoided through the *Corporations Act* power to grant relief against liability ‘in any civil proceeding against a person to whom [s 1318] applies for negligence, default, breach of trust or breach of duty.’¹²⁰

While it is likely that a director will receive a DPN,¹²¹ it is considerably less likely that insolvent trading action will be brought. This is now considered.

3 *The Likelihood of Insolvent Trading Action*

Deterrence of improper behaviour at the time of the company’s insolvency is a function both of the liability and defence provisions themselves, and the extent to which they are enforced. In 2000, David Knott, then Deputy

¹¹⁷ *PC Business Set-Up Report* (n 45) 386 (emphasis in original).

¹¹⁸ *Ibid* 386 n 63 (citations omitted).

¹¹⁹ *Taxation Administration Act 1953* (Cth) s 269-35(2).

¹²⁰ *Corporations Act 2001* (Cth) s 1318(1). See *ibid* s 269-35(5).

¹²¹ For statistics as to the numbers of DPNs issued between 2010 and 2015, see Anderson et al *Quantifying Phoenix Activity* (n 87) 79. In total, there were 23,674 companies where one or more of their directors were issued a DPN during that period. No statistics are available to show how many of those notices resulted in director liability, ie where the director did not cause the company to pay the amount owing or enter liquidation or VA within 21 days.

Chairman of ASIC, recognised the ‘notoriously complex and resource intensive’ nature of insolvent trading prosecutions because of the high evidentiary burdens that must be discharged.¹²² It is very difficult to obtain information about the extent to which ASIC brings insolvent trading action. The 2004 empirical study by James, Ramsay and Siva, which looked at the prevalence of insolvent trading actions, noted that there had been only 103 cases since 1961, as at the time of that study.¹²³ More recently, ASIC has produced six-monthly enforcement reports but they do not refer to the particular section under which action has been brought.¹²⁴ While media releases reveal that ASIC does bring some insolvent trading actions against large companies,¹²⁵ this is not always the case.¹²⁶

¹²² David Knott, ‘Regulatory Issues Impacting on Insolvency’ (Speech, National Conference of the Insolvency Practitioners Association of Australia, Adelaide, 13 October 2000) 5 <http://download.asic.gov.au/media/1339298/insolvency_speech.pdf>, archived at <<https://perma.cc/L6SB-69LP>>.

¹²³ Paul James, Ian Ramsay and Polat Siva, *Insolvent Trading: An Empirical Study* (Research Report, Clayton Utz and Centre for Corporate Law and Securities Regulation, The University of Melbourne, 2004) 14. The study noted that this statistic excludes actions which were settled, or where the directors pleaded guilty to insolvent trading charges. See also Jasper Hedges et al, ‘The Policy and Practice of Enforcement of Directors’ Duties by Statutory Agencies in Australia: An Empirical Analysis’ (2017) 40 *Melbourne University Law Review* 905, 945.

¹²⁴ At the time of writing, the latest is ASIC, *ASIC Enforcement Outcomes: January to June 2017* (Report No 536, August 2017).

¹²⁵ See, eg, ASIC, ‘Former Kleenmaid Director Sentenced to Nine Years Imprisonment for Fraud and Insolvent Trading’ (Media Release No 16-257MR, 15 August 2016) <<http://asic.gov.au/about-asic/media-centre/find-a-media-release/2016-releases/16-257mr-former-kleenmaid-director-sentenced-to-nine-years-imprisonment-for-fraud-and-insolvent-trading/>>, archived at <<https://perma.cc/5AAS-JBNB>>.

¹²⁶ According to the Adelaide *Advertiser*, ‘Tagara Builders went into liquidation owing 800 creditors up to \$27m’, with a firm having completed \$630,000 worth of work for the company the previous day. ‘[I]nvestigations by Tagara’s liquidator Clifton Hall determined directors Tullio Tagliaferri and John Kassara, whose company went bust in June last year, were trading insolvent for “some time” prior to putting their company into administration. But Clifton Hall partner Simon Miller told creditors at a meeting on Tuesday that ASIC would not act on his company’s investigations because the corporate watchdog had limited resources’: Renato Castello, ‘Tagara Creditor Angry that ASIC Won’t Investigate Insolvent Trading’, *The Advertiser* (Adelaide, 13 October 2016) <www.adelaidenow.com.au/business/tagara-creditor-angry-that-asic-wont-investigate-insolvent-trading/news-story/979b29bc7698050630d4bf3b58c6d142>.

4 Difficulties for Liquidators

Liquidators are also in a difficult position in bringing insolvent trading proceedings against directors. The IPAA submission to the 2010 Safe Harbour Paper stated:

[T]he discussion paper proceeds on a misapprehension that a company is either 'solvent' or 'insolvent'. While this is so in legal terms, our members find that, despite their experience in assessing insolvency, determining whether any business of even moderate size is insolvent is difficult unless it is clearly insolvent.¹²⁷

The IPAA remarked that this difficulty is compounded by the fact that 's 588G claims ... are litigation intensive',¹²⁸ citing *Hall v Poolman*¹²⁹ as an example.¹³⁰ Reasons include a conservative approach to the question of whether there were suspicions of insolvency at the relevant time, whether the action may be defeated by the raising of defences under s 588H or a relief claim under s 1317S, and whether there is a prospect of recovery from the director.¹³¹ So while there might be concerns from the director's perspective that they should liquidate unless there is clear solvency, it appears from the liquidator's, and perhaps ASIC's, perspective that they should steer away from action unless there is clear *insolvency*.

There are two further complications for liquidators where there is a 'safe harbour' period claimed. The first is simply that corporate assets might be diminished during that period if the rescue fails, leaving less for the company's creditors, both pre-safe harbour and newly incurred. The second is the more complicated issue of voidable transactions. Under pt 5.7B of the *Corporations Act*, liquidators have the right to 'claw back' amounts paid by the company prior to liquidation in various circumstances.¹³² The right to recover these amounts is in part determined by the time when the payment is made relative to the date of the company's entry into external administration. This is known as the 'relation-back' day.¹³³ For example, the liquidator can recover the value of transactions entered into when the company was insolvent if this

¹²⁷ IPAA Submission (n 25) 4.

¹²⁸ *Ibid* 5.

¹²⁹ *Hall* (n 35). See also *Hall v Poolman* (2009) 75 NSWLR 99.

¹³⁰ IPAA Submission (n 25) 5 n 8.

¹³¹ *Ibid* 5–6.

¹³² *Corporations Act 2001* (Cth) s 588FE.

¹³³ *Ibid* s 91.

occurs within six months before the relation-back day.¹³⁴ Uncommercial transactions,¹³⁵ discussed above, and unfair preferences,¹³⁶ can be clawed back if they occur within two years of the relation-back day.¹³⁷ Anything that delays the start of the liquidation — in this case, the safe harbour — has the potential to place these voidable transactions beyond the reach of the liquidator and therefore could diminish the amount of money available for distribution to creditors.

Tax payments as voidable preferences require special mention. As noted earlier, the safe harbour requires the company to be up to date in its tax reporting. This may well result in the directors of a company that is struggling to pay its debts in a timely manner, and is therefore technically insolvent, causing the company to pay the tax owing to avoid a DPN being issued to themselves. This tax payment is just as susceptible to recovery by the liquidator from the Commissioner of Taxation as any other preferential payment. If the liquidator is successful in clawing back the payment from the Commissioner of Taxation, the directors themselves may then be personally liable for it.¹³⁸ The voidable preference provisions therefore provide significant incentive for directors to pay tax liabilities, invoke the safe harbour by complying with its requirements, and delay entry into formal external administration, if it comes to that, by at least six months. This delay might have the practical consequence of elevating the claims of the Commissioner of Taxation above those of other unsecured creditors.

Liquidators are not the only professionals who may be adversely affected by the safe harbour carve out. The next section considers how the safe harbour may operate for restructuring advisors.

5 *Advisors*

One of the ways in which a director can show that they have developed a course of action that is reasonably likely to lead to a better outcome for the company is through obtaining appropriate advice.¹³⁹ The pre-existing defence under s 588H(3) makes it clear that the advice directors should seek is about

¹³⁴ Ibid s 588FE(2), picking up ‘insolvent transaction’ from s 588FC.

¹³⁵ Ibid s 588FB.

¹³⁶ This is a payment of a debt giving a creditor more than they would receive if they proved their debt in a liquidation: *ibid* s 588FA(1).

¹³⁷ Ibid s 588FE(3).

¹³⁸ Ibid s 588FGA(2).

¹³⁹ Ibid s 588GA(2)(d); Enterprise Incentives Explanatory Memorandum (n 5) 12 [1.43], 13 [1.48], 15–16 [1.62], 16–19 [1.66]–[1.74].

whether the company is solvent,¹⁴⁰ *not* whether the company could trade out of its difficulties or whether a work-out would be more beneficial to creditors than an immediate liquidation.

ASIC's 2010 regulatory guide about insolvent trading is somewhat less clear. It states that

[d]irectors should consider obtaining advice on:

- (a) the solvency of the company and whether there is a risk that the company is trading while insolvent;
- (b) the options available to the company to deal with its financial difficulties; and
- (c) whether it is realistically possible for the company to continue to trade while attempting to restructure the company's affairs to enable it to meet its obligations (including whether it can renegotiate its obligations) and return the company to long-term financial health.

Advisers may also be able to assist directors to prepare cash flow budgets and negotiate with creditors.¹⁴¹

The safe harbour carve out certainly provides some clarity about what advice the director may obtain when a company faces these 'financial difficulties'. It is advice that allows the director to start 'developing one or more courses of action that are reasonably likely to lead to a better outcome for the company'.¹⁴² However, while the safe harbour might clarify an advisor's role within the company in relation to the insolvent trading liability of *the director who normally runs the company*, there is a risk that the advisor themselves might face liability as a shadow director. This may result in high-quality company restructuring advice being unavailable precisely when it is needed most. The Insolvency Professionals Joint Submission to Treasury in 2010 commented that a chief restructuring officer would likely be considered a shadow director,

¹⁴⁰ *Corporations Act 2001* (Cth) s 588H(3): 'it is a defence if it is proved that, at the time when the debt was incurred, the person: (a) had reasonable grounds to believe, and did believe: (i) that a competent and reliable person (the other person) was responsible for providing to the first-mentioned person adequate information about whether the company was solvent; and (ii) that the other person was fulfilling that responsibility; and (b) expected, on the basis of information provided to the first-mentioned person by the other person, *that the company was solvent at that time and would remain solvent* even if it incurred that debt and any other debts that it incurred at that time' (emphasis added).

¹⁴¹ ASIC, *Duty to Prevent Insolvent Trading: Guide for Directors* (Regulatory Guide No 217, July 2010) 13–14 [RG 217.41]–[RG 217.42].

¹⁴² *Treasury Laws Amendment Act* (n 4) s 588GA(1)(a).

and that '[i]t is unlikely that many sensible professionals would be prepared to assume that risk'.¹⁴³ Under s 9 of the *Corporations Act*, a person is defined as a director even if not appointed to that position, if 'the directors of the company or body are accustomed to act in accordance with the person's instructions or wishes'.

Nonetheless, the status of shadow director is likely to be found only in very limited circumstances. For a start, s 9 makes it clear that the director definition 'does not apply merely because the directors act on advice given by the person in the proper performance of functions attaching to the person's professional capacity, or the person's business relationship with the directors or the company or body'. Nor are courts willing to label advisors as shadow directors on the basis of isolated advice. In *Re Akron Roads Pty Ltd (in liq) [No 3]*, the Supreme Court of Victoria considered a claim for insolvent trading brought by a liquidator against a management consulting company, on the basis that it was a shadow director of Akron Roads.¹⁴⁴ Applying *Buzzle Operations Pty Ltd (in liq) v Apple Computer Australia Pty Ltd*,¹⁴⁵ Robson J concluded that even deep involvement in the management and administration of Akron was insufficient to establish that the management consulting company was a shadow director.¹⁴⁶ This was because it had not overborne the directors of Akron nor had Akron's directors acted in accordance with its wishes or instructions.¹⁴⁷ The shadow director's instructions or wishes must be habitually complied with by the appointed directors over a period of time even though those instructions or wishes do not need to cover every aspect of running the company.¹⁴⁸

Therefore, even though an advisor is unlikely to be found to be a shadow director, the risks for advisors, particularly in lengthy and complex workouts of large companies, are considerable. If such a finding were made, it would expose them to the full range of directors' duties and responsibilities under the *Corporations Act*, including insolvent trading liability in their own capacity. More concerning for advisors is that being considered a *Corpora-*

¹⁴³ Insolvency Professionals Joint Submission (n 98) 9 [3.25].

¹⁴⁴ (2016) 348 ALR 704.

¹⁴⁵ (2011) 81 NSWLR 47.

¹⁴⁶ *Re Akron Roads* (n 144) 755–6 [318]–[320].

¹⁴⁷ *Ibid* 755–6 [318].

¹⁴⁸ *Ibid* 746–7 [271].

tions Act director allows a DPN to be issued by the ATO in applicable circumstances.¹⁴⁹

6 Out of the Frying Pan?

Even if directors are able to invoke the safe harbour against insolvent trading liability by complying with its various requirements, they still face the potential for other forms of liability. In addition to liability under a DPN, as discussed above, directors may become criminally liable for insolvent trading where their behaviour is considered to be dishonest,¹⁵⁰ because s 588GA does not apply beyond civil penalty liability.¹⁵¹ Curiously, honesty is not one of the requirements for the safe harbour carve out.

Directors may also face liability for breach of their duty of care to the company, and while that duty does have the benefit of the business judgment rule, its applicability has different requirements to the safe harbour carve out.¹⁵² There is no business judgment rule defence for other relevant breaches of directors' duties, including acting for an improper purpose and conflicts of interest.¹⁵³ This is a genuine risk, particularly where the informal work-out has not led to the company's salvation and the directors have gained something for themselves during the safe harbour period. Again, avoiding a conflict of interest is not a requirement of the safe harbour carve out. There is also a possibility of liability for directors of companies with continuous disclosure obligations, where the directors have caused the company to engage in a 'business as usual' informal work-out without informing the market.¹⁵⁴ When the company is teetering on the brink of insolvency, an

¹⁴⁹ *Taxation Administration Act 1953* (Cth) s 269-15(1): 'The directors (within the meaning of the *Corporations Act 2001*) of the company (from time to time) ... must cause the company to comply with its obligation.'

¹⁵⁰ *Corporations Act 2001* (Cth) s 588G(3).

¹⁵¹ Enterprise Incentives Explanatory Memorandum (n 5) 6 [1.14].

¹⁵² See *Corporations Act 2001* (Cth) s 180(2). The business judgment rule requires that the directors '(a) make the judgment in good faith for a proper purpose; and (b) do not have a material personal interest in the subject matter of the judgment; and (c) inform themselves about the subject matter of the judgment to the extent they reasonably believe to be appropriate; and (d) rationally believe that the judgment is in the best interests of the corporation.'

¹⁵³ *Ibid* ss 181-2.

¹⁵⁴ Listed and other disclosing entities are subject to disclosure requirements in the *Corporations Act 2001* (Cth) ss 674 and 675 respectively. A director who gives, or authorises or permits the giving of, materially false or misleading information to the ASX, without taking reasonable steps to ensure that the information was not false or misleading, breaches s 1309(2). Directors as accessories face up to two years jail for this offence: at sch 3 item 337. Because breaches of ss 674 and 675 are included in pt 9.4B as financial services civil penalty provisions

undisclosed informal work-out unfairly exposes new creditors to a greater risk of loss, as the market cannot price credit properly in the absence of sufficient information.

The concern here is that the safe harbour might lure unwitting directors towards an informal work-out that exposes them to other forms of liability. The same arguments, with the exception of continuous disclosure, apply to the directors of small companies. While directors of large companies are likely to be in receipt of good legal advice on this matter, honest small company directors may inadvertently be encouraged by the safe harbour to engage in an informal work-out and find themselves saddled with personal liability, particularly via a DPN. The effect of the safe harbour carve out on their less honest brethren, determined to use the corporate form to separate their business from its debts, will now be discussed.

B *The Safe Harbour, Small Companies and Illegal Phoenix Activity*

1 *Inapplicability of Safe Harbour Justifications*

It was seen above that the justification for the introduction of a safe harbour was to overcome directors' fears of insolvent trading liability, leading to risk-averse behaviour, particularly through premature liquidation of the company. However, it is important to differentiate directors of small companies from those of large companies. As a broad generalisation, directors of small companies may take excess risks around the time of insolvency because they have less to lose in terms of their reputation and more to gain in their capacity as shareholders compared to the directors of large companies.¹⁵⁵ Directors of small companies are the ones who are most likely to succumb to 'moral

(ss 1317DA (definition of 'financial services civil penalty provision'), 1317E item 14), there is also the potential for a \$200,000 pecuniary penalty order (s 1317G(1B)(a)) and for a compensation order in favour of the company (s 1317HA). See also *PC Business Set-Up Report* (n 45) 366; Luke Hastings, 'Enforcing the Continuous Disclosure Regime: Three Case Studies' in Michael Legg (ed), *Regulation, Litigation and Enforcement* (Lawbook, 2011) 133, 136–8.

¹⁵⁵ Yeo and Lin (n 50) 231: 'The argument that the debtor's self-interest will restrain unnecessary risk-taking does not stand when the company is in financial distress. As the company may have no future to think about, accordingly it is less likely to be concerned about its credit rating. Self-interest may cause the company to take only a short-term perspective of the gain from high-risk activity.'

hazard',¹⁵⁶ and engage in risky behaviour in a last-ditch attempt to save not only their directorship but also their livelihood.¹⁵⁷

The 2010 Safe Harbour Paper acknowledged that directors of companies in financial difficulties could be tempted to engage in insolvent trading to benefit themselves as shareholders, at the expense of creditors.¹⁵⁸ It recognised that the 'laws against insolvent trading are therefore an important tool in addressing phoenix company behaviour' because 'phoenix company behaviour involves the transfer of assets out of a company instead of applying them toward the payment of the company's liabilities, [so] it commonly involves the company, at some point, carrying on business without the capacity to meet its liabilities as they become due'.¹⁵⁹

In cases of illegal phoenix activity, where an informal work-out is attempted, there is no real intention to save the company, because that would involve the resurrected company being obliged to pay its debts. On the contrary, the aim may be to separate the company from its remaining assets via a sale of those assets to Newco *before* the liquidator is appointed and the directors are displaced from management. Liquidation is anything but premature, as the less-than-11-cents-in-the-dollar recovery for unsecured creditors would confirm,¹⁶⁰ and there is no destruction of enterprise value for shareholders, who are commonly also the directors. The value of the enterprise is in fact maintained through Newco and it is the creditors of Oldco who suffer. For these reasons, by encouraging an informal workout, the safe harbour sends the opposite message to the one that needs to be sent, which is that directors need to preserve the assets of Oldco for the benefit of its creditors, not

¹⁵⁶ See Helen Anderson, 'FEG, Moral Hazard and the Innovation Agenda' (2016) 28(2) *Australian Restructuring Insolvency and Turnaround Association Journal* 28.

¹⁵⁷ Some commentators have even advocated an unlimited liability regime for these companies as a means of reducing the incentive to transfer the risk of insolvency to creditors: Paul Halpern, Michael Trebilcock and Stuart Turnbull, 'An Economic Analysis of Limited Liability in Corporation Law' (1980) 30 *University of Toronto Law Journal* 117, 147–9. See also Judith Freedman, 'Limited Liability: Large Company Theory and Small Firms' (2000) 63 *Modern Law Review* 317, 331: 'law and economics analysts are concerned primarily with public quoted corporations, precisely because their theories are designed to explain that phenomenon. ... The result is that the close corporation is seen as something of an irritant, a problem for the theorists or an exception to a general rule rather than a widespread phenomenon in its own right which appears in numerous forms.'

¹⁵⁸ 2010 Safe Harbour Paper (n 7) 7 [3.5].

¹⁵⁹ *Ibid* 7 [3.6].

¹⁶⁰ *Insolvency Statistics* (n 84) 7.

themselves, and that doing otherwise is a breach of their duty not to misuse their position to make a gain for themselves or someone else.¹⁶¹

The Senate ELC report in August 2017 briefly touched on the relevance of the safe harbour to illegal phoenix activity and reported the views of submitters who considered it would act as a ‘disincentive’ to illegal phoenix activity.¹⁶² The report quoted the AICD’s submission that ‘the reforms proposed in the bill will not encourage, increase or support illegal phoenixing activity’.¹⁶³ It went on to say that

[t]he ASBFEO [Australian Small Business and Family Enterprise Ombudsman] *echoed this view*, asserting that:

The introduction of a safe harbour provision should be an incentive to directors try and save their businesses, generating greater accountability and loyalty to the ongoing existence of an entity. This may reduce incentives to ‘phoenix’ companies and this may create greater stability for stakeholders such as employees and suppliers.¹⁶⁴

This shows an unfortunate conflation of legal phoenix activity with illegal phoenix activity.¹⁶⁵ It may well be true that an honest small business owner, faced with debts that the company cannot pay, will take the chance to enter the safe harbour rather than liquidating. If the director takes that option, the company remains saddled with those debts unless creditors can be persuaded to enter a compromise as part of a restructure. The other legal, and more appealing, option is to place the insolvent company into liquidation and start the business again through a new company with an entirely clean slate. Illegal phoenix activity, on the other hand, is the deliberate liquidation of the company, in breach of directors’ duties, precisely to shed those debts or other legal obligations.¹⁶⁶ As discussed above, the safe harbour carve out will not discourage this sort of behaviour and has the capacity to make it more prevalent.

¹⁶¹ *Corporations Act 2001* (Cth) s 182(1)(a).

¹⁶² Senate ELC (n 9) 16 [2.47]–[2.48].

¹⁶³ *Ibid* 16 [2.47].

¹⁶⁴ *Ibid* 16 [2.48] (emphasis added).

¹⁶⁵ For further discussion of the distinction between these concepts, see Anderson et al, ‘Profiling Phoenix Activity’ (n 74).

¹⁶⁶ For example, the avoidance of product warranties, or of paying employee entitlements: see Fair Work Ombudsman and PwC (n 78) 7.

2 Difficulties for Liquidators (Again)

In addition to the difficulties for liquidators outlined above, the lack of transparency and accountability surrounding informal arrangements within small companies, particularly where they might in time be followed by a formal liquidation, raises concerns.¹⁶⁷ This has echoes of the debate concerning ‘pre-pack administrations,’ which have been examined recently in the UK.¹⁶⁸ Its review, led by Teresa Graham, was particularly concerned with connected-party sales as almost two-thirds of the 499 companies it examined involved such a sale.¹⁶⁹ The *Graham Review* stated:

Allegations made particularly against connected party sales are:

- By perpetuating a failed business it interferes with the process of productive churn, which is the process by which the weak businesses fold and finance can be freed-up for new entrants. ...
- By enabling a company to resume trading shorn of many of its debts to the benefit of its existing owners, this allows it to unfairly undercut its rivals;
- It allows ‘bad businesses’ with poor business models to continue — that the pre-pack delays the inevitable and that the business will fail again, in its new corporate guise taking down more creditors on its way;
- It allows balance sheet re-engineering of businesses that may be technically rather than actually insolvent;
- The most damning allegation is that the whole thing was a sham simply to ditch debt and that a pre-pack was ‘always on the cards’ at some point.¹⁷⁰

It might be assumed that in the event that directors do breach their duties as described above, the liquidators can bring action against them in the name of the company. However, this is unlikely to be the case where phoenix activity is involved. Recovery action brought by liquidators must be funded. Asset transfers between Oldco and Newco are considered problematic to liquidators because of a lack of evidence of wrongdoing. The transfer itself proves

¹⁶⁷ 2010 Safe Harbour Paper (n 7) 12–13 [4.4.3]–[4.4.10].

¹⁶⁸ Teresa Graham, *Graham Review into Pre-Pack Administration: Report to The Rt Hon Vince Cable MP* (Report, June 2014).

¹⁶⁹ *Ibid* 37 [7.50].

¹⁷⁰ *Ibid* 36 [7.46].

nothing: Newco may have been the highest or only bidder for the assets. To establish fault, costly investigations must be undertaken. This is challenging in the phoenix context where commonly Oldco has few assets to pay for the liquidator's time.¹⁷¹ The *Corporations Act* expressly states that the liquidator is not required to do this work for free.¹⁷² Compounding this problem is the Assetless Administration Fund ('AAF') 'Catch-22'.¹⁷³ The liquidator needs funding to look for evidence of wrongdoing, but in the absence of evidence, the AAF will not make a grant to the liquidator.¹⁷⁴

In the event that the company does have money remaining, liquidators have a difficult decision to make about spending it. Do they pay it out to creditors or do they use it on an action against the directors in an attempt to bolster what can be distributed? They risk being criticised by creditors in the event that the litigation is unsuccessful and its costs diminish the pool of company assets, but they share none of the upside if the action is successful. The trouble with the safe harbour carve out is that when the liquidator comes to deciding whether to use that remaining money, the path to a successful recovery action is harder than ever. Where a director is intent upon phoenix activity in breach of their director's duties, the conditions for a safe harbour can be confected. A small company director might ensure that employee entitlements are paid and tax returns are up to date. A set of books and records, accurate or not, are handed to a restructuring advisor who may be complicit in the behaviour.¹⁷⁵ The company fails to achieve 'rescue' during the safe harbour period and is eventually liquidated. Even with suspicions that the safe harbour may not stand up to close scrutiny, the liquidator, keen to ensure

¹⁷¹ Helen Anderson et al, 'The Productivity Commission, Corporate Insolvency and Phoenix Companies' (2015) 33 *Company and Securities Law Journal* 425, 426–8.

¹⁷² *Corporations Act 2001* (Cth) s 545(1). Only the statutory report and other documentary obligations to ASIC must be done, regardless of whether the liquidator is paid: at sub-s (3).

¹⁷³ The AAF is administered by ASIC. With funds provided by the government, it finances insolvency practitioners in their work on behalf of companies with few or no assets. The aim of the fund is to overcome the inability of liquidators to make proper investigations due to financial constraints. 'A particular focus of the AA Fund is to curb fraudulent or illegal phoenix activity': ASIC, *Assetless Administration Fund* (Regulatory Guide No 109, November 2012) 6 [RG 109.6].

¹⁷⁴ *Ibid* 7 [RG 109.10]. A survey of members of ARITA revealed low levels of satisfaction with AAF funding: Helen Anderson et al, 'At the Coalface of Corporate Insolvency and Phoenix Activity: A Survey of ARITA and AICM Members' (2016) 24 *Insolvency Law Journal* 209, 212.

¹⁷⁵ See generally Helen Anderson and Jasper Hedges, 'Catching Pre-Insolvency Advisors: The Hidden Culprits of Illegal Phoenix Activity' (2017) 35(8) *Company and Securities Law Journal* (forthcoming).

that creditor money is not wasted on fruitless investigations and litigation, and now with the additional forensic obligation to disprove the safe harbour carve out, simply concludes the engagement and reports their suspicions to ASIC.

3 *Advisors (Again)*

The situation for advisors of small companies is arguably the opposite of that for restructuring advisors of large companies outlined above. Pre-insolvency advisors are an increasing source of concern for ASIC and others.¹⁷⁶ As noted above, some of these turnaround specialists facilitate the stripping of the assets of Oldco and the creation of Newco, to ensure that there are few assets within the company to fund a liquidator's investigations. As a result, ASIC receives little information that would help it take action against the director or the pre-insolvency advisor as their accessory. In addition, a pre-insolvency advisor of a small company can undertake the work in a very short time — closing Oldco down, establishing Newco and selling it Oldco's assets — making it unlikely that they would be a shadow director of the failed company.

The issue of pre-insolvency advisors was raised in submissions to the Senate ELC on the draft 2017 provisions which speak of 'obtaining advice from an appropriately qualified entity who was given sufficient information to give appropriate advice'.¹⁷⁷ The Law Council of Australia, ASIC and the Australian

¹⁷⁶ ASIC, *ASIC's Strategic Outlook* (Report, October 2014) 8. '[Liquidators] don't want to bite the hand that feeds them. That I think goes to the crux of the issue': ARITA, 'Pre-Insolvency Advisors Behaving Badly: The Profession's View on the Pre-Insolvency Phenomenon' (2016) 28(3) *Australian Restructuring, Insolvency and Turnaround Association Journal* 15, 16. This comment was attributed to Adrian Brown, ASIC Senior Executive Leader — Insolvency Practitioners: Dan Oakes and Sam Clark, 'Investigators Raid Offices of Melbourne Man Linked to Multi-Million-Dollar Tax Avoidance Scheme', *ABC News* (Online, 3 April 2017) <www.abc.net.au/news/2017-04-03/investigators-raid-offices-man-linked-to-tax-avoidance-scheme/8411256>, archived at <<https://perma.cc/594P-K3Y8>>. See also ASIC, 'Turnaround Business Advisor Sentenced for Aiding and Abetting Breach of Director's Duty' (Media Release No 16-127MR, 28 April 2016) <<http://asic.gov.au/about-asic/media-centre/find-a-media-release/2016-releases/16-295mr-asic-bans-director-of-failed-companies-for-maximum-five-year-period/>>, archived at <<https://perma.cc/GQ7W-JTX6>>; Dan Oakes and Sam Clark, 'Pre-Insolvency Business Advisers Investigated by ASIC and ATO over Missing Millions', *ABC News* (Online, 12 April 2017) <www.abc.net.au/news/2017-04-12/pre-insolvency-business-advisors-being-investigated-by-asic-ato/8438562>, archived at <<https://perma.cc/3V8U-R2EV>>.

¹⁷⁷ Treasury Laws Amendment Bill (n 6) cl 2.

Restructuring Insolvency and Turnaround Association ('ARITA')¹⁷⁸ all sounded similar notes of caution about unregulated pre-insolvency advisors,¹⁷⁹ although other voices preferred the more flexible, less prescriptive approach that was eventually enacted.¹⁸⁰

V CONCLUSION

The 2017 safe harbour carve out legislation has been passed. Its objective of encouraging directors not to liquidate prematurely, resulting in loss of enterprise value for shareholders and other economic detriment to society more broadly, is laudable. It is clear that the current insolvent trading liability and its defences do not, and were not intended to, allow scope for informal work-outs. Meanwhile, formal work-outs through VA have become increasingly unpopular.

This article does not set out to critique the provisions of the legislation or the shortcomings of the VA regime that might be fuelling the repeated call for a safe harbour. Rather, it highlights deficiencies in the justifications for encouragement towards informal workouts, including whether companies are in fact prematurely liquidated because of a fear of liability for insolvent trading, or whether DPNs might play a greater role. The safe harbour will create a forensic burden for liquidators in addition to requiring that they prove the already difficult factual issue of insolvency at the relevant time. It will interfere with the recovery of preferences, which will have an adverse effect on creditor recovery. Unwitting, honest directors risk exposing themselves to other forms of liability, such as a DPN, while avoiding what is a reasonably unlikely action for insolvent trading. Advisors need to be careful, particularly in lengthy complex workouts, that they do not become shadow directors of the company.

For the directors of small companies who are likely to also be the main shareholders, the situation is different. Some will attempt to use the liquidation of their company as a strategy to continue their business, minus its debts, through a new company. Because liquidation is already necessary to shed those debts, these directors will avoid a DPN provided they liquidate within

¹⁷⁸ The Australian Institute of Credit Management ('AICM') supported ARITA's views: Senate ELC (n 9) 15 [2.42]. See also Jason Harris and Anil Hargovan, 'Productivity Commission Safe Harbour Proposal for Insolvent Trading' (2016) 68 *Governance Directions* 9, 11.

¹⁷⁹ Senate ELC (n 9) 14 [2.38] (Law Council of Australia), 14 [2.39] (ASIC) and 14–15 [2.40] (ARITA).

¹⁸⁰ Ibid 15–16 [2.43]–[2.46].

21 days of its issue. Insolvent trading liability under s 588G(2) is unlikely, and therefore the uncommercial transaction ‘deemed debt’ provision, inserted expressly to target asset transfers in phoenix circumstances, becomes useless.

The safe harbour as enacted has multiple disadvantages. Liquidators face an additional burden in court of establishing their case where a safe harbour has been claimed. However, given the unlikelihood of action by ASIC or the liquidator, the main concern with the safe harbour is the message it sends. Pre-insolvency advisors, already on regulators’ radars, can take on the appearance of respectability in a confected safe harbour informal workout. Liquidators, suspicious of what has taken place but struggling to fund their investigations of a company with few or no assets, simply report their limited findings to ASIC. ASIC, in the absence of evidence of wrongdoing, does not act. Consequently, while the safe harbour legislation fails to provide the expected reassurance to the ‘big end of town’, illegal phoenix activity shelters under the cloak of a pro-rescue measure that has ignored or misunderstood it.

It is pleasing to see that the legislation as passed contains an amendment providing that there must be an independent review after two years of the commencement of the legislation to consider the impact of the availability of the safe harbour on directors of companies, their conduct, and the interests of creditors and employees of those companies.¹⁸¹ At that time, it is vital that the government looks not only at the benefits, if any, to large company rescues but also at the effect of the legislation on small company insolvencies.

¹⁸¹ *Treasury Laws Amendment Act (n 4) s 588HA(1)*.