Australian Government
The Treasury

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TREASURY SUBMISSION TO THE SENATE ECONOMICS LEGISLATION COMMITTEE INQUIRY INTO THE TREASURY LAWS AMENDMENT (COMBATING ILLEGAL PHOENIXING) BILL 2019

All references are to the *Corporations Act 2001*, unless otherwise specified.

INTRODUCTION

Illegal phoenix activity is becoming increasingly sophisticated and difficult to detect and prosecute under existing legal frameworks. It is evident that our current laws and regulatory framework have not been successful in deterring this illegal activity, which is viewed as cheap and easy by those who engage in this conduct.

The Government announced in the 2018-19 Budget on 8 May 2018 that it would reform the corporations and tax laws to provide the regulators with additional tools to assist them to deter and disrupt illegal phoenix activity.

To implement this package the Treasury Laws Amendment (Combating Illegal Phoenixing) Bill 2019 (the Bill) was introduced into Parliament on 13 February 2019. The Bill will give regulators additional enforcement and regulatory tools to better detect and disrupt illegal phoenix activity and to prosecute or penalise directors and others who engage in or facilitate this illegal activity.

The Bill was referred to this Committee on 14 February 2019 and the Committee has invited Treasury to make a submission.

Treasury is providing this submission to assist the Committee's understanding of the substantive differences between the Exposure Draft Bill and the final Bill, which reflect amendments that have been made to ensure that the reforms strike the right balance.

Stakeholder feedback on the Exposure Draft Bill was varied and provided a wide range of views on where the right balance lies. In light of the submissions received, the Government is mindful that the legislation requires a fine balance between competing considerations of minimising unintended impacts on legitimate business on the one hand and on the other the need to give regulators effective tools to deter and take action against phoenix activity.

We have outlined below the consultation process for the Bill, the stakeholder feedback received and the amendments made to the Exposure Draft Bill following consultation to address stakeholder feedback.

Consultation process

Consultation on a discussion paper was conducted between 28 September 2017 and 27 October 2017. 50 submissions were received.

Consultation on draft legislation was conducted between 16 August 2018 and 27 September 2018. 38 submissions were received. Consultation meetings were held in Sydney on 3 September 2018 and Melbourne on 5 September 2018.

Non-confidential submissions can be viewed on the Treasury website at: www.treasury.gov.au.

Summary of stakeholder feedback

Consultation Paper

The 2017 consultation paper sought feedback on eleven proposals to address illegal phoenix activity.

Feedback indicated that stakeholders across the market acknowledged the significance of the problem of illegal phoenix activity and supported targeted reforms to address the problem.

Stakeholders expressed support for six of the eleven proposals, as they were viewed as likely to be the most effective in addressing the common behaviours and strategies associated with illegal phoenixing. Two of these proposals have already been implemented by the Government: establishing a Phoenix Hotline and restricting the voting rights of related creditors in external administrations.

The remaining four proposals which received support are being implemented through the Bill. These are:

- introducing new phoenix offences to target those who conduct or facilitate phoenix activity, including company officers and pre-insolvency advisers;
- preventing directors improperly backdating resignations to avoid liability or prosecution and limiting the ability of directors to resign when this would leave the company with no directors;
- extending the Director Penalty Regime to GST, Luxury Car Tax (LCT) and Wine Equalisation Tax (WET), making directors personally liable for these debts of the company; and
- expanding the ATO's power to retain refunds where there are outstanding tax lodgements.

The following five proposals were viewed by stakeholders as either redundant in the context of the other proposals, or ineffective at addressing illegal phoenix activity. In some cases it was also identified that these proposals could have significant unintended impacts on legitimate businesses or existing commercial practices:

- providing a mechanism for identifying and targeting high risk entities;
- extending existing promoter penalty laws to apply to promoters or facilitators of illegal phoenix activity;
- strengthening the effectiveness of the ATO's power to require a business to pay a security deposit for an existing or future tax liability at high risk of not being paid;
- removing the 21 day waiting period for a director penalty notice for directors of high risk phoenix businesses; and
- appointing liquidators on a cab rank basis (rather allowing directors to select a liquidator).

In response to the concerns raised by stakeholders those five proposals were not progressed as part of the Bill.

Stakeholders overwhelmingly agreed that timely and effective enforcement of existing law, supported by adequate funding, is also critical to effectively address illegal phoenixing.

While stakeholders raised a number of concerns about the effectiveness of existing penalties, these were being considered by Government in the context of the ASIC Enforcement Review, which has subsequently resulted in the passage of legislation by Parliament to increase corporate and financial sector penalties (*Treasury Laws Amendment (Strengthening Corporate and Financial Sector Penalties) Act 2019*).

Exposure Draft Bill

Stakeholders agreed with the aims of the reforms in the draft legislation to address the problem of illegal phoenix activity.

Several stakeholders raised the need to ensure that the new phoenix offences, civil penalty provisions and asset recovery provisions are flexible enough to allow legitimate asset sales and restructures undertaken when a company is in financial distress.

Some stakeholders also raised the need to ensure that the new asset recovery provisions are sufficiently different to the existing asset recovery provisions and that all reforms are supported by adequate funding for ASIC and liquidators to effectively pursue enforcement and recovery action.

Other stakeholders were concerned that some elements of the offences and civil penalty provisions were not strong enough or would be easy to avoid. Several stakeholders also raised the need to expressly refer to illegal phoenix activity in the legislation to enhance the deterrence effect of the new provisions.

The remaining corporations and tax measures received strong support from most stakeholders.

Post-consultation Amendments

A number of amendments have been made to the offence, civil penalty and asset recovery provisions to address certain stakeholder feedback. These amendments aim to strike the right balance between deterring and penalising asset stripping behaviours that are a key part of illegal phoenix activity, while minimising any impact on legitimate business rescue.

Details of the substantive amendments made to the Exposure Draft Bill before it was introduced into Parliament as the final Bill are set out at **Attachment A**.

Additional post-consultation Government Action to combat illegal phoenix activity

As part of the package, the Government amended the Insolvency Practice Rules on 11 December 2018 (*Insolvency Practice Rules (Corporations) Amendment (Restricting Related Creditor Voting Rights) Rules 2018*). The amended Rules restrict the voting rights of certain creditors related to the phoenix company to ensure the interests of honest creditors are not affected by those complicit in illegal phoenix activity.

As part of the 2018-19 Mid-Year Economic and Fiscal Outlook, the Government announced it will provide an additional $8.7 million over 4 years from 2018-19 to increase funding for the Assetless Administration Fund (AAF). This additional funding will increase ASIC's ability to fund liquidators, who play a vital role in investigating and reporting illegal phoenix activity.

The AAF finances preliminary investigations and reports by liquidators into the failure of companies with few or no assets, where it appears to ASIC that enforcement action may result from the investigation and report. A particular focus of the AAF is to curb fraudulent phoenix activity.

Director Identification Numbers (DIN) are being progressed as part of the Modernising Business Registers program to ensure that the DIN is integrated with other important registry data. This will provide greater insights to regulators, businesses and individuals on the identity of directors. Having all business registry data linked will help with risk profiling and help reduce illegal phoenixing.

Legislation to introduce DINs, contained in Treasury Laws Amendment (Registries Modernisation and Other Measures) Bill 2019, was introduced into the House of Representatives on 13 February 2019. That legislation has also been referred to this Committee.

ATTACHMENT A – DETAILS OF POST-CONSULTATION AMENDMENTS

Phoenix Offences and Asset Recovery Mechanisms

Phoenix Offences and Asset Recovery Mechanisms

Schedule 1, subsection 588FDB(1)

Explanatory memorandum, paragraphs 2.16-2.25

The Exposure Draft Bill included a defence for the offences, civil penalty provisions and asset recovery mechanisms for disposals of company property made at market value. This would have required a defendant (such as the director of the company involved in phoenix activity or the recipient of the property) to prove the company received consideration that is equal to or exceeds the market value of the property to avoid liability.

Under the final Bill, market value has been incorporated as an element of the creditor-defeating disposition which forms the basis of the offences, civil penalty provisions and recovery mechanisms. The effect is that in all instances either ASIC or the liquidator (as applicable) must also establish that the relevant disposal was not for market value in order to establish criminal or civil liability (for the offences and civil penalty provisions) or that the disposal is voidable (for the asset recovery provisions).

This amendment will significantly narrow the scope of transactions which will be captured by the provisions and will ensure legitimate commercial transactions are not inadvertently caught. This addresses stakeholder feedback that having market value as a defence (rather than an element) made it likely that legitimate transactions would be captured.

Schedule 1, subsection 588FDB(1)

Explanatory memorandum, paragraphs 2.16-2.25

The market value element has also been expanded in the final Bill to include the 'best price reasonably obtainable in the circumstances'. As a result, transactions will only be captured where ASIC or the liquidator has established that the transfer was less than both the market value and the best price reasonably obtainable in the circumstances.

This expanded, more flexible test will address situations where a company is in financial distress and disposes assets legitimately at a discount to market price, for example, after following a sales process. This amendment addresses stakeholder feedback that the creditor-defeating disposition as defined in the Exposure Draft Bill was too broad and would capture legitimate asset sales undertaken in times of financial distress.

Schedule 1, section 111Q and subsection 588E(4A)

Explanatory

The Exposure Draft Bill included a rebuttable presumption of insolvency where a company has failed to keep or maintain financial records.

The final Bill includes an additional rebuttable presumption that a disposal is not for market value or the best price reasonably obtainable in the

memorandum, paragraphs 2.22-2.25

circumstances where the company did not maintain adequate records relating to the disposition. This presumption does not apply in relation to the criminal offence, consistent with the application of the presumption of insolvency, which also applies in the same way for the existing insolvent trading provisions.

This has the effect that generally, in relation to the new civil penalty provision and the ASIC and liquidator asset recovery mechanisms, the onus will be on either ASIC or the liquidator to prove the required elements of a creditor-defeating disposition. An exception to this general position will operate where a company has failed to comply with its existing obligations to maintain adequate books and records. In such cases, the onus of proof will shift onto the defendant for certain matters. The defendant will then have to prove that the company was not insolvent or that the disposal of company property was for market value or the best price reasonably obtainable.

Where the records are not available because they have been destroyed or concealed by a person, the presumption will not apply to a third person unless they were involved in the destruction or concealment.

These presumptions will ensure that those engaging in illegal phoenix activity cannot avoid enforcement action by ASIC or liquidator recovery action by destroying or concealing a company's book or records, which is known to commonly occur as part of illegal phoenixing. This addresses stakeholder concerns that a lack of evidence available to the liquidator or ASIC would hinder the effectiveness of the new offences and recovery mechanisms.

Phoenix Offences

Schedule 1, section 588GAA

Explanatory memorandum, paragraph 2.65

The Exposure Draft Bill did not include the terms "phoenix" or "phoenixing" but had defined its scope by reference to the nature of particular transactions that are known to form part of phoenixing activity. This initially had been done because the term 'phoenixing' does not have a precise legal definition.

However, the final Bill includes an objects clause which sets out the object of the new Subdivision B for the offence and civil penalty provisions, which refers to deterring the practice of disposing of assets as part of activity sometimes called phoenixing. This amendment responds to strong stakeholder feedback that using explicit language referring to phoenixing will maximise the deterrence effect of the new provisions.

Schedule 1, paragraph 588GAB(1)(d)

Explanatory memorandum, paragraphs 2.26-2.36

In the Exposure Draft Bill, it was an element of the offences and civil penalty provisions that the creditor-defeating transfer of property was made at a prohibited time, being either:

- when the company is insolvent or becomes insolvent as a result of the transfer; or

- the transfer is made within 12 months prior to the company being placed in external administration and the appointment of the external administrator was a direct or indirect result of the disposition.

The requirement for the transfer to occur at one of these prohibited times was included because dispositions made outside of insolvency and the 12 months prior to entering external administration are more likely to be undertaken for legitimate commercial reasons.

The 12 month 'look back' test was included as an alternative to the insolvency test to address the cost and uncertainty associated with establishing that a company was insolvent at a particular time, which is perennial obstacle under current insolvency law.

Under the final Bill, for the offences and civil penalty provisions only, in addition to the above, a creditor defeating disposition is also prohibited if it is made within the 12 months prior to the company ceasing to carry on business altogether and that ceasing is a direct or indirect result of the disposition. This rule only applies where the company has permanently ceased to carry on all business activities. It does not apply merely because a company ceases one of a number of businesses it carries on, changes businesses or is not carrying on any business for a limited time.

This will help address the common situation where directors involved in phoenix activity strip a company's assets and abandon the company without taking steps to appoint an administrator or a liquidator to wind-up the company. It may be easier in some instances to establish that a company ceased to carry on business altogether shortly after a disposition took place than to establish insolvency. This addresses stakeholder feedback that the Exposure Draft Bill should do more to combat this common phoenixing strategy of leaving behind a 'zombie company' with no directors.

Asset Recovery Mechanisms

Schedule 1, paragraph 588FE(6A)(c)(iii)

Explanatory memorandum, paragraphs 2.46-2.49

The Exposure Draft Bill included an exception for disposals of assets by registered liquidators, such that a disposal that would otherwise be a creditor-defeating definition would not be voidable where it was made by an appointed liquidator.

The final Bill extends this exception to include voluntary administrators, who may undertake sales during voluntary administration to help a business continue trading. The exception is only extended for the asset recovery provisions and not for the offence or civil penalty provisions.

The exception for transactions made by a liquidator, provisional liquidator or external administrator is consistent with the operation of the existing voidable transaction provisions and reflects liquidators' and administrators' duties under

the Act as officers of the company. This change addresses the lack of an exception for external administrators noted by some stakeholders.

Schedule 1, subsections 588FG(1), 588FG(2) and 588FG(9)

Explanatory memorandum, paragraphs 2.37-2.41

Under the Exposure Draft Bill, there was no good faith defence for initial purchasers. Subsequent purchasers had a defence where they could establish both market value and good faith (i.e. that they did not know the original transaction was voidable).

Under the final Bill, the amended market value test has become an element of the cause of action and good faith is generally available as a defence. This is a consistent application of the existing good faith defence under subsection 588FG(2).

The only situation where good faith is not a defence is in relation to an initial recipient where the action is based on the company entering administration within 12 months of the disposition. This is because the good faith test that applies under subsection 588FG(2) is that:

i. the person had no reasonable grounds for suspecting that the company was insolvent at that time or would become insolvent; and
ii. a reasonable person in the person's circumstances would have had no such grounds for so suspecting.

Preventing recipients from relying on this good faith defence in circumstances where the company has entered administration within 12 months of a disposition is necessary to ensure the 12-month lookback rule applies effectively and operates as an alternative to proving insolvency.

Under the final Bill, a subsequent purchaser has a general good faith defence (i.e. that they did not know the original transaction was voidable) and, consistent with moving the market value test to become an element of the action, no longer needs to establish market value consideration.

Improving the accountability of resigning directors

Preventing inappropriate backdating of director resignations and preventing the abandonment of companies

Schedule 2, subsection 1661(2)

Explanatory memorandum, paragraph 3.31

The Exposure Draft Bill had anticipated that the measures to increase the accountability of resigning directors would commence immediately after Royal Assent.

The final Bill includes a transitional period of 12 months for these reforms to allow ASIC sufficient time to make the appropriate registry and IT changes required to facilitate this legislative change.

Preventing inappropriate backdating of director resignations

Schedule 2, subparagraph 203AA(5)(b)(ii)

Explanatory memorandum, paragraph 3.21

The Exposure Draft Bill included a 12 month period within which an individual could apply to the Court to backdate a resignation.

The final Bill provides that an individual can seek leave of the Court to bring an application outside 12 months.

This provides the Court with discretion to deal with genuine cases outside the 12 month period, such as where an inadvertent failure to lodge notice of the resignation is not identified until years later. This addresses stakeholder concerns that without such discretion the provisions could operate unfairly and impact honest directors.

Schedule 2, Schedule 3, table item 40A

Explanatory memorandum, paragraph 3.22

The Exposure Draft Bill included a penalty of 60 penalty units ($12,600), 1 year imprisonment, or both, for an applicant's failure to notify ASIC within 2 days of a Court order to backdate the effective date of a director's resignation.

The final Bill amends this penalty to make it consistent with the treatment of strict liability offences in Treasury Laws Amendment (Strengthening Corporate and Financial Sector Penalties) Act 2019 by removing imprisonment and increasing the financial penalty to 120 penalty units ($25,200).

GST estimates and director penalties

Schedule 3, subsection 269-10(1) in Schedule 1 to the *Taxation Administration Act 1953*

Explanatory memorandum, paragraphs 4.22, 4.41

The Exposure Draft Bill expanded the director penalty regime to allow the Commissioner of Taxation to recover director penalties in relation to companies' unsatisfied liabilities to pay assessed net amounts.

Certain entities are entitled to elect to pay GST by instalments. If an entity elects to pay GST by instalments, the instalment liabilities are subtracted from the entity's net amount for the relevant tax period.

The final Bill allows the Commissioner of Taxation to recover director penalties in relation to companies' unsatisfied liabilities to pay assessed net amount and GST instalments under the GST Act.

Retention of tax refunds

No changes to the Exposure Draft Bill.