Via email: phoenix@treasury.gov.au

The General Manager
Business Tax Division
The Treasury
Langton Crescent
Parkes ACT 2600

Dear Sir or Madam,

Options to Address Fraudulent Phoenix Activity

I refer to earlier letters of 22 January 2010 and 10 February 2010 lodged by the Secretary-General, Bill Grant.

As foreshadowed by Mr Grant, I have pleasure in enclosing a submission on the Proposals Paper "Action against fraudulent phoenix activity" issued in November 2009.

The submission has been prepared by the Insolvency and Reconstruction Law Committee of the Business Law Section of the Law Council of Australia. The submission has been endorsed by the Business Law Section. Owing to time constraints, it has not been considered by the Directors of the Law Council of Australia.

If you have any questions in relation to the submission, in the first instance please contact the Committee Chair, Richard Cowen.

On behalf of the Committee, I apologise for the lateness of the submission. However, as indicated in the submission, the Committee has been extremely busy responding to a number of enquiries and proposals from the Federal Government in relation to insolvency issues.

Yours sincerely,

Margery Nicoll
Acting Secretary-General

4 March 2010

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Business Law Section

Insolvency and Reconstruction Law Committee

Response to Treasury Proposals regarding Phoenix Activity

Introduction

The Insolvency and Reconstruction Law Committee of the Business Law Section of the Law Council of Australia ('the Committee') apologises for the lateness of this response, and requests that it be given consideration despite the lateness. Part of the reason for the delay is the large number of enquiries and proposals from government in relation to insolvency presently underway in Australia.

A. Purpose of this Response

1. The Federal Treasury has issued a Proposals Paper entitled 'Action against fraudulent phoenix activity' dated November 2009 ('the Paper').

B. What does the Paper propose?

2. The Paper addresses what is referred to as 'fraudulent phoenix activity'. This is described (not defined) as involving *'the evasion of tax and other liabilities such as employee entitlements through the deliberate, systematic and sometimes cyclic liquidation of related corporate trading entities'*.

3. It notes that the biggest impact on tax revenue from phoenix activity has come from companies failing to remit withholding taxes such as PAYG and describes some of the reasons that (a) the director penalty regime (b) the promoter penalty regime and (c) the general Part IVA anti-avoidance provisions do not adequately address the problem. It notes that directors who engage in fraudulent phoenix activity might breach the prohibition on insolvent trading or the provisions of Part 5.8A (avoidance of employee entitlements), and may lead to disqualification for involvement in multiple corporate failures.

4. The proposals canvassed in the Paper are as follows (each is addressed below):

   a. *Amend the director penalty regime* under ITAA so that directors become automatically liable for unpaid withholding tax debts after a fixed period (3 months is suggested) rather than their becoming so liable only after the service of and non-compliance with a notice served by the ATO;

   b. *Extend the director penalty regime* to tax debts other than the present withholding taxes;

   c. *Amend the promoter penalty and anti-avoidance provisions* so that they cover non-payment of tax liabilities (as opposed to the reduction of the amount of tax payable), and so that the ATO could pursue the other entity (ie Newco) that has actually benefited;

d. *Make it an offence* for which directors could be held liable, to fail to remit withholding taxes;

e. *Deny directors (and relatives) tax credits* if relevant withheld taxes have not been remitted, and possibly make claiming such credits an offence;

f. *Extending ASIC's power to disqualify directors* so that they can be disqualified as 'unfit' if they engage in fraudulent phoenix activity, even if they have not yet been involved in two corporate collapses;

g. *Restricting the use of similar names by successor companies* and making directors personally liable for certain debts if they breach this restriction;

h. *Strengthen the ATO's ability to require a bond* for likely tax payable;

i. *Adopt a doctrine of 'inadequate capitalisation'* to enable the piercing of the corporate veil in phoenix situations.

C. Submissions

Definitional issues and general approach

5. There is a recognition implicit in the use of the descriptor 'fraudulent' that not every case of 'phoenix' activity is inappropriate. This can readily be accepted if one defines phoenix activity merely as the phenomenon by which a person or persons who have been controlling company A carry on the same or substantially the same business through company B, often with the same or substantially the same name, following the demise of company A. It is immediately possible to envisage circumstances where this might happen quite legitimately – eg where a director buys the business, including the right to use the name, from the liquidator.

6. This makes clear that *defining* the objectionable activity may be both difficult and important. Possible approaches in this regard appear to include:

   a. defining unacceptable phoenix behaviour simply by reference to its consequences – eg 'where X is a director of company A which goes into liquidation and also a director of company B which carries on substantially the same business as company A within 6 months of the commencement of the liquidation';

   b. defining unacceptable behaviour by reference to the intention of the participants – eg outlawing particular activities if done with the intention of avoiding payment of taxes or other debts.

7. An additional 'definitional' issue is whether it is appropriate to try to formulate some general definition of phoenix activity, or unacceptable phoenix activity, and take measures to discourage such activity, or whether it is preferable to identify common indicia of such activity and take steps to deal with those indicia, rather than seeking to create and then defeat some new 'concept'. An example of the second of these approaches is sections 216-217 of the UK's Insolvency Act 1986, which is addressed further below.

8. Related to these questions is the question whether innocent directors who might otherwise be accidentally caught by any new anti-phoenix provisions are afforded greater protection by

    a. making liability dependent on some *dolus malus* (fraudulent or wrongful intention), which would protect the innocent, but perhaps make it harder successfully to prosecute the guilty; or

    b. outlawing particular activities generally, subject to the ability for innocent directors to bring themselves within exceptions?

9. **It is submitted**:

    a. that it is preferable not to try to introduce a wholly new concept, especially given that it is one which the Paper notes is inherently difficult to define;

    b. that a better course is to identify particular indicia of the problem and take steps to outlaw such indicia; and

    c. that consistently with this approach, the better course is to carefully consider the circumstances whereby the present law is deficient in addressing illegitimate phoenix activity, and address those deficiencies. This may best be done by collating examples of illegitimate conduct that was not, and could not, be addressed under the present law. The Committee is not aware of any such example at present.

Scope and focus

10. The loss of tax revenues is a serious social problem. However, it is a different problem from the problem of phoenix activity. While the ATO may commonly be a victim of phoenix activity, it is by no means the only victim. There are many cases in which directors of a company cause the company to run up debts or incur obligations and then ‘switch’ companies, leaving those creditors or contract counterparties with a remedy only against an assetless company.

11. **It is submitted** that inappropriate phoenix activity should be addressed as a standalone issue, recognizing that the ATO is in no different a position – as a victim of such activity – from any other creditor left with recourse to an empty shell.

12. **It is submitted** that there is no basis for praying in aid the ATO’s former (pre-1993) priority as a reason for treating the ATO any differently in this respect. Even if the ATO still enjoyed its former priority, that priority would avail it nothing in a situation where a company had been left assetless, and its business and activities taken over by another (phoenix) company.

13. For this reason, **it is submitted** that the better course is to discourage phoenix activity by enforcing the present provision of the law, and if demonstrably necessary, changes to the Corporations legislation, rather than, for example, by reference to the general or specific tax avoidance legislation.

Proposed amendments to the director penalty regime

14. **The Committee does not favour** an amendment to the director penalty provisions which would have the effect that a company director automatically becomes liable for unremitted withholding taxes 3 months (or any other period) after the date they should have been remitted. The Committee’s concerns about such an amendment are:

a. first, that it might catch many directors not engaged in phoenix activity of any sort who may, for example, be reasonably engaged in proper attempts to restructure a company's affairs;

b. secondly, that it does not appear to the Committee sufficiently obviously to target the issue of phoenix activity;

c. thirdly, that it appears to the Committee to give an unwarranted advantage to the ATO as compared with other creditors. Whether the ATO should have such an advantage seems to the Committee to be a matter of public policy which should be considered separately from the issue of phoenix activity (and also, the Committee considers, separately from the fact that previously the Crown enjoyed priority in respect of certain tax claims – a fact which the Committee considers now to be of no more than historic interest).

15. The Committee notes that it is sometimes said of unremitted withholding taxes that a company's use of them is more morally culpable because they are in the nature of trust monies. The Committee is unpersuaded that this is an appropriate analysis/analogy, or, if it is, that this justifies a more favourable treatment of the ATO in respect of these taxes. In this respect the Committee notes:

    a. that the withhold-and-remit system is a system of tax collection enacted for the administrative benefit of the taxing authority;

    b. that it imposes on the withholder a duty to collect and remit the tax, and this imposition differentiates the withholder from most trustees, who accept the burden of trusteeship consensually; and

    c. that there is as much moral culpability in stretching credit terms beyond what a trade creditor agrees to, and thus using capital which ought to be paid to that creditor to finance the company's business as there is in using monies which ought to be remitted to the ATO.

16. If (contrary to the Committee's submission) the director penalty provisions are to be amended in the way suggested, then Committee considers:

    a. that the period of time should be longer than 3 months – the Committee suggests at least 4, and possibly 6 months;

    b. that directors should have an absolute defence if they can show that they were not aware that the relevant taxes were unremitted and that a reasonable person in their circumstances would not have been so aware;

    c. that they should also have a defence if they can establish grounds, *mutatis mutandis,* such as set out in the present section 588H(4) (did not take part in management of company due to illness or other reason) or 588H(5) (took all reasonable steps to ensure taxes were remitted);

    d. that directors should also have a defence if, before the expiry of the relevant period, they have engaged with the ATO and obtained agreement from the ATO (such as might be forthcoming where it is clear the directors are trying to restructure the company in good faith) that they will not be held liable.

Extension of director penalty regime

17. For the reasons already given **the Committee does not favour** extending the director penalty regime to non-withholding taxes as part of a regime aimed at discouraging

phoenix activity. Whether such amendments are appropriate ought, the Committee believes, to be considered as part of a coherent review of the effectiveness of the tax collecting legislation.

Amending the promoter penalty and anti-avoidance regimes

18. For the reasons already given **the Committee does not favour** extending the promotor penalty regime or the general anti-avoidance provisions as part of a regime aimed at discouraging phoenix activity. Whether such amendments are appropriate ought, the Committee believes, to be considered as part of a coherent review of the effectiveness of the tax collecting legislation.

Create an offence of failing to cause company to remit taxes

19. For the reasons already given **the Committee does not favour** creating such an offence as part of a regime aimed at discouraging phoenix activity. Whether such an offence should be created ought, the Committee believes, to be considered as part of a coherent review of the effectiveness of the tax collecting legislation.

20. If, however, any such offence were to be created, the Committee would favour a self-contained set of provisions which make it easy for directors to understand that they may be prosecuted, rather than provisions which have to be activated through linkage with other existing provisions for corporate liability.

Denying PAYG(W) credits and creating offence of claiming non-remitted credits

21. For the reasons already given **the Committee does not favour** either of these options as part of a regime aimed at discouraging phoenix activity. Whether such amendments are appropriate ought, the Committee believes, to be considered as part of a coherent review of the effectiveness of the tax collecting legislation.

Expanding the ability to disqualify directors

22. The Committee considers it most unlikely that, as a matter of practice, the phoenix activity of a director who has only been involved in a single collapse will come to the attention of ASIC early enough to warrant amendments which would allow ASIC to act on a single corporate failure.

23. The Committee is also concerned that allowing disqualification through an administrative process (as opposed to a judicial one) in circumstances where a director has only been involved in a single collapse might represent an unwarranted extension of ASIC's powers which could be utilized in situations quite different from those the subject of the Paper.

24. Accordingly, **the Committee does not favour** expanding the ability to disqualify directors.

Restricting the use of similar names

25. There are two primary features of phoenix activity. Though they need not always both be present, they frequently are. They are:

    a. the phoenix company usually carries on the same or substantially the same business as the predecessor company (often with no apparent change at all from the point of view of third parties dealing with the business); and

    b. the phoenix company usually has the same or a colourably similar name as the predecessor company and/or carries on the business under the same or a colourably similar name as it was carried on by the predecessor company.

26. Accordingly, these seem to the Committee to be the matters which need to be regulated, if there is to be further regulation in the area.

27. As the Paper notes, both the UK and New Zealand have provisions whose effect is:

    a. to prohibit a person who was a director/shadow director of the predecessor company within 12 months of its liquidation from being a director or concerned in the management of another company with the same or a similar name for a period of 5 years;

    b. to render a person who contravenes the prohibition liable to a fine;

    c. to render such a person personally liable for the debts incurred by the successor company.

28. In each case, there are exceptions to the general prohibition. These can be summarised as follows:

    a. where the successor company acquires the business of the predecessor company from its liquidator/receiver or under a DOCA and duly notifies creditors of the circumstances of the acquisition and certain other details;

    b. where the court grants leave, and for an interim period pending the determination of an application for leave;

    c. where the successor company had been known by the similar name throughout the 12 months prior to the predecessor's liquidation and was not dormant during that period.

29. **The Committee supports** the introduction of a similar regime because it considers that it addresses the principal indicia of phoenix activity, while admitting of exceptions sufficient to accommodate legitimate trading through successor companies or companies with similar names.

30. However, the Committee would recommend the following change to the regimes enacted in the UK and New Zealand. **The Committee suggests** that where phoenix activity occurs (as described in para 29 above) and none of the exceptions (as described in para 30 above) applies, the new company should be made liable for the old company's debts.

31. This, it seems to the Committee, would strike at the very purpose of, and take away the whole incentive for, phoenix activity, which is to take the assets/business of the old company forward but leave the liabilities behind in a company which no longer has assets from which to meet them. In this way, creditors of the old company should still have recourse to what were formerly its assets and business and which have been 'phoenixed' into the new company.

Bonds

32. For the same reasons that the Committee does not favour other ATO-specific measures, **the Committee does not favour** extending bond provisions as part of a regime aimed at discouraging phoenix activity. Whether such amendments are appropriate ought, the Committee believes, to be considered as part of a coherent review of the effectiveness of the tax collecting legislation.

Doctrine of inadequate capitalisation

33. The Committee considers that the adoption of the (so-called) doctrine of inadequate capitalisation would represent a fundamental, and potentially far-reaching change to Australian company law, central to which is the idea of the separate legal personality of individual companies.

34. The Committee thinks that it is undesirable – indeed, dangerous - that such a radical change should be enacted to address a specific issue such as phoenix activity given the far-reaching consequences it might have. The Committee also considers that it is unnecessary to address the phoenix activity issue, which can be dealt with in the manner discussed above, as it is in other jurisdictions.

35. The Committee notes that to some extent holding companies – those who would presumably be damnified under the doctrine of inadequate capitalization – are to some extent already at risk if they knowingly allow their subsidiaries to trade when undercapitalised, as they may be liable for insolvent trading under section 588V if the degree of undercapitalisation means that the subsidiary is insolvent.

A note on the New Zealand and United Kingdom experience

The Committee would sound a note of caution about adopting even a modified form of the UK/NZ provisions against use of similar names.

These similar provisions have not been used in NZ (in the two years since they came in), and there are problems with the wording of the legislation and extent of liability for debts. There has been articles written about this particularly by academic commentators (for example, Patricia Keeper (this year's INSOL Scholar for the Pacific Region)).

Secondly, of course, the way those provisions work is to impose liability on directors who have been involved in one or more failed companies and a new company with a similar name. The suggestion in the Paper that instead, the new company should be liable (rather than the director) would render those overseas precedents pretty hard to follow as they are based on director liability. Experience suggests that drafting the NZ provisions was very difficult, because it is hard to capture the unlawful phoenix activity (even with exceptions) in the wording with sufficient precision to make such provisions effective.

It is worth exploring the overseas models in more detail as one option to address phoenix activity, though recognising there have been significant interpretation issues for the English courts, and that the NZ provisions have not been taken up in practice.

D. Interaction with other submissions

Subject to the specific comments above, the Committee supports the submissions of:-

1. The Corporations Law Committee of the Law Council of Australia;
2. The Taxation Committee of the Law Council of Australia; and
3. The Insolvency Practitioners Association of Australia.