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Dear Ms Nero

Reforms to combat illegal phoenix activity – draft legislation

Thank you for the opportunity to provide a submission responding to draft legislation and accompanying materials proposed by the Australian Government to combat illegal phoenix activity.

The Australian Institute of Company Directors (**AICD**) is committed to excellence in governance. We make a positive impact on society and the economy through governance education, director development and advocacy. Our membership of more than 43,000 includes directors and senior leaders from business, government and the not-for-profit sectors.

The AICD strongly supports the government's aim of deterring and disrupting illegal phoenix activity. The AICD also supports administrative measures that would support the detection of illegal phoenix activity. It is for this reason that the AICD has endorsed the government's commitment to introduce 'director identification numbers' (**DIN**) as part of the Modernising Business Registers reforms. The DIN will help enforcement agencies to verify and track the relationships between directors and the entities they are associated with. Fraudulent phoenix activity by a small number of individuals hurts employees, creditors and the broader economy. Directors who are proven to engage in illegal phoenix activity must be held accountable.

In addition, the AICD supports stronger identify verification processes to be implemented for directors as part of the DIN application process. Stronger identity verification processes will prove a valuable safeguard against individuals being registered as directors by third parties without their knowledge or consent, or fictitious individuals being registered as directors.

However, it is also imperative the introduction of the DIN and verification processes be accompanied by the removal of certain personal director information from the Companies

Register (**Register**) maintained and published by the Australian Securities and Investments Commission (**ASIC**). Given the register is available to the general public and contains personal information, including a director's home address, the AICD has a number of concerns related to issues of privacy, cyber-security, and personal safety. These concerns include, but are not limited to, the real risk of identity theft. For this reason, the introduction of DINs affords the government an opportunity to address these legitimate concerns by re-examining what information needs to be available to all members of the public.

This submission focusses on providing feedback on the approach taken by the government in the exposure draft (**Exposure Draft**) and accompanying materials released on 16 August 2018. We have focussed on our comments on areas of specific concern to our members.

1. Executive summary

In summary, the AICD:

- Considers it unnecessary to introduce a new legislative mechanism to recover property in circumstances where a company has sought to avoid creditors, as the existing provisions available to liquidators and ASIC achieve the objects of the provision. However, should the government proceed with this proposed amendment, the AICD has some suggested drafting changes.
- Recommends that the government require ASIC to apply to a Court for an administrative order seeking the return of property which has been transferred as part of a voidable creditor-seeking disposition.
- Does not consider the introduction of a specific phoenix criminal offence targeting officers and advisers as necessary, given that illegal phoenix behaviour is generally a civil or criminal breach of director's duties.
- Does not support the introduction of a civil penalty provision, which risks capturing honest directors who, despite their best intentions or honest belief, approve a transaction that results in a reduction in returns to creditors.
- Supports the government's proposed changes to the Corporations Act regarding back-dating of director resignations;
- Does not support the government's proposed changes preventing the abandonment of companies, and considers the enforcement of existing laws, and particularly directors' duties provisions in the Corporations Act, will likely be more effective in addressing this serious issue.
- Does not support enabling the Australian Tax Office (**ATO**) Commissioner to make directors personally liable for any outstanding GST liabilities through the director penalty regime.

Further detail on each of these issues is outlined below.

2. Voidable creditor-defeating dispositions

General comments

The AICD considers a new legislative mechanism to recover property in circumstances where a company seeks to avoid creditors as unnecessary considering the existing provisions in the Corporations Act that prohibit illegal phoenix activity, including the directors' duties found in ss 180(1) to 184 of the Corporations Act 2001 (**Corporations Act**), the uncommercial and insolvent transactions provisions in ss 588FB and 588FC of the Corporations Act respectively, and the insolvent trading provisions in s 588G(1).

As observed in the report, *Phoenix Activity - Recommendations on Detection, Disruption and Enforcement*, illegal phoenix activity "necessarily involves breaches of directors' duties under the Corporations Act", and "effective enforcement of directors' duties is central to combatting illegal phoenix activity, and the penalty must provide a sufficient deterrent".¹ That is why the AICD has supported the government's proposals to increase the maximum civil pecuniary penalties and criminal fines available for such breaches.

Nonetheless, if law reform is considered by the government to be necessary, we recommend the government instead investigate amendments which would better leverage off existing laws. This has the benefit of reducing the additional complexity created by further substantial changes in the Corporations Act, as well as avoiding disputes arising from new, untested provisions.

One possible alternative, for instance, would be to remove the requirement to establish that an uncommercial transaction was an insolvent transaction to meet the requirements of s 588FE of the Corporations Act. This would strengthen the ability of a liquidator to void an uncommercial transaction whilst also drawing on the existing jurisprudence relating to s 588FB(1), thereby creating less uncertainty and potential complexity in the law.

It is also relevant to note that prior to the introduction of s 588FC, in order for a court to declare the sale of an asset void, a liquidator had to prove the sale was made with an intent to defraud creditors.² In other words, the law has already been amended to address concerns relating to the disposition of assets in a way that prejudices the interests of creditors. We suspect that the greater use of this law by liquidators and regulators would likely prove to be a greater deterrent to illegal phoenix activity than the creation of a new and very similar law.

Drafting concerns

Notwithstanding our view, if the government decides to proceed with the proposal, some amendments are necessary to ensure it is appropriately targeted.

¹ Helen Anderson, Ian Ramsay, Michelle Welsh, Jasper Hedges, *Phoenix Activity: Recommendations on Detection, Disruption and Enforcement*, February 2017, p 95.

² John Warde, *Uncommercial Transactions*, Allens Arthurs Robinson, 2003.

In particular, the AICD is concerned that the scope of the definition of a voidable “creditor-defeating disposition” (**CDD**) in the Exposure Draft is too wide, and risks causing legitimate business transactions to be considered voidable.

In our view, the definition of a voidable CDD in ss 588FDB and 588FE(1) would likely capture almost all transactions by a company involving a disposition of property within the 12 months prior to insolvency. This is because it is almost certainly the case that a disposition of property 12 months prior to insolvency, or during insolvency itself, has the effect of preventing that property from being available to creditors.

For this reason, the drafting of the exceptions in s 588FG(7)-(10) become critical to avoid unintendedly capturing legitimate business transactions (such as restructuring efforts) or even subjecting a company’s officers to criminal prosecution. However, we consider the proposed exceptions as being too narrow, namely:

1. The insolvency safe harbour in s 588GA(1)-(2) was applicable to an officer of the company and the disposition (s 588FG(8)); or
2. There is evidence suggesting a reasonable possibility that consideration was paid that was at least the market value of the property at the time of the disposition of the property (s 588FG(9)); or
3. A subsequent purchaser of the property did so in good faith, for market value, without notice of the insolvency or impending insolvency.

Exceptions 2 and 3 require the value of the consideration provided for the property to equal or exceed its market value at the time of the disposition or transaction. In the common law, market value has been defined as “the best price reasonably obtainable for a property in the general market”.³

The AICD is concerned about the reliance on a “market value” test in this provision. During a period of financial distress, companies often quickly sell certain assets in order to maximise the chance of keeping the company solvent. An asset may be sold at the best price the company’s directors honestly believed they could obtain in all the circumstances, but would nevertheless not satisfy the requirement to dispose property at “market value”, as it may have been discounted in order to facilitate an expeditious transaction.

Disposing of assets in these circumstances is a legitimate business activity, and should not be subject to adverse legal consequences. Indeed, a director acting in the best interests of the company may be required to approve the sale of property below market value. In any event, some assets will not have a readily ascertainable market, or no market at all, such as rare or *sui generis* assets. An example of this kind of property might be patent or other intellectual property which has no real on-market equivalent.

Drafting suggestions

To address these concerns, the AICD suggests the following drafting changes:

³ *Brisbane Water County Council v Cmr of Stamp Duties* [1979] 1 NSW 320 at 324.

- Remove the reference to “creditor-defeating” in the CDD, and instead adopt a more neutral description which reflects the wide range of transactions it purports to capture. A better description might be “relevant disposal”.
- Re-frame the legal test in s 588FG(9)(a)(ii) of the Exposure Draft so the focus is on whether reasonable efforts were made by the company to obtain consideration at “market value” in the circumstance, rather than the market value itself. This could be achieved by adopting language similar to that found in s 420A of the Corporations Act, i.e. a CDD would only be voidable if the company did not take reasonable steps to dispose of the property for not less than the market value, or otherwise, the best price reasonably obtainable, having regard to the circumstances existing when the property was sold. In other words, this enables the court to look at the process that the company has gone through in selling the property, rather than the price itself.⁴
- Section 588FG(10) should be re-drafted to remove reference to “market value”. A third-party purchaser who, acting in good faith, purchased a property without notice of the insolvency should not be required to establish that the value of the consideration they provided was at or above market value. The fact that they purchased property for a price lower than market value is irrelevant if they acted in good faith, with no notice of the company’s insolvency or pending insolvency. Instead, the person seeking to void the transaction should be required to establish that the subsequent purchaser acted in bad faith.

As an alternative in relation to s 588FG(9), the government could adopt the suggestion of the Australian Restructuring Insolvency and Turnaround Association (**ARITA**) in its submission to this consultation, by narrowing the scope of a CDD to exclude dispositions in the “ordinary course of business”. This would ensure that behaviour such as selling stock at a reduced price to improve cash flow would not be inadvertently captured.

3. ASIC order regarding voidable transactions

The AICD is concerned about the drafting of the proposed ASIC administrative power in the Exposure Draft. In addition to the concerns we have already expressed in relation to voidable CDDs, the AICD is concerned that this power is overly complex and could lead to significant legal disputes.

In addition, the nature of the power is very significant, as it enables ASIC to compel the transfer of property to the company under its own initiative. This type of administrative power is analogous to a power to acquire property compulsorily. The AICD is concerned to ensure there are sufficient checks and balances in place to avoid this power being used inappropriately.

For this reason, the AICD recommends the government re-frame this power to require ASIC to seek a Court order to unwind the effect of a voidable CDD. The order could be obtained *ex parte* to avoid delay or unnecessary costs.

⁴ *Artistic Builders Pty Ltd v Elliot & Tuthill (Mortgages) Pty Ltd* [2002] NSWSC 16.

Court oversight has several benefits, including the following:

- It ensures there is a degree of independent oversight over the use of this new power, which is a significant power by any measure;
- It ensures that a body of case law can develop to assist regulators in interpreting the provisions;
- It reduces the possibility that there will be protracted disputes relating to the use of ASIC's administrative powers;
- It requires ASIC to ensure that it can provide evidence satisfying the legal tests in the section, providing parties with more certainty over the legal authority of the order; and
- It enables the government to re-frame the somewhat complicated operation of s 588FGAA(4) of the Exposure Draft. At present it requires ASIC to make an assessment about what a court might do. We consider it preferable, and much simpler, to provide the court with the task of considering the relevant factors in ss 588FG(8), (9) or (10).

For all these reasons, the AICD considers it preferable that ASIC be required to seek the voidable order from a Court. We emphasise that the costs of an *ex parte* hearing can be lower than an ordinary hearing, and would, in some instances, save money in the longer term by reducing ASIC's legal costs associated with defending appeals to the Administrative Appeals Tribunal (**AAT**).

4. Officer's duty to prevent creditor-defeating disposition

A new criminal offence

Given the prevalence of illegal phoenix activity in Australia's economy, and the need to send a strong message, the AICD supports the government's determination to end the practice of illegal phoenix activity.

However, as acknowledged in the Consultation Paper released by the government on 12 September 2017, conduct which constitutes illegal phoenix behaviour is generally a civil or criminal breach of director's duties, and may also constitute conduct intended to defraud the company or its creditors under s 596 of the Corporations Act, or even fraud under state criminal statutes.⁵

For these reasons, the AICD does not consider it necessary to introduce a new criminal offence. However, if such an amendment proceeds, it is essential that the offence is appropriately framed and allows directors to avail themselves of appropriate defences.

The proposed criminal offence in the Exposure Draft

The AICD is concerned that the proposed offences in the Exposure Draft risks criminalising legitimate business transactions approved by directors in the 12 months leading up to insolvency.

⁵ See, for instance, s 192E of the *Crimes Act 1900* (NSW).

Specifically, the issues relating to the “market value” exceptions referred to above equally apply to ss 588GAA(3) and 588GAB(3) of the Exposure Draft, as they fail to address the situation where, for instance, a distressed asset must be disposed of quickly. For this reason, in a similar way to our suggestion regarding s 588FG(9), the offence would benefit from an amendment so that the legal test in s 588FG(9)(a)(ii) enables a director to raise a defence that reasonable efforts were made by the officer to obtain consideration at “market value” in the relevant circumstance.

A new civil penalty provision

The AICD strongly opposes the introduction of a new civil penalty provision, especially given the breadth of the proposed CDD amendment. The civil penalty provision sits uncomfortably with the policy objectives of the government in attempting to combat directors and advisers who deliberately abuse the corporate form to deprive creditors of assets upon insolvency. The elements of intention and recklessness in the criminal offence operate as an important safeguard against unintended consequences. The absence of these safeguards renders the civil penalty provision too broad in its application, and would potentially capture honest and well-meaning directors who approve transactions which subsequently result in an adverse outcome for creditors in insolvency.

Safe harbour defence

The AICD strongly supports the proposed amendment to the safe harbour in s 588GA of the Corporations Act, to enable directors to continue to make use of the safe harbour without fear of liability for the proposed new offences and civil penalty provisions. Such an amendment prevents the new laws from undercutting the anticipated benefits of the 2017 safe harbour amendments.

5. Resignation of directors – when resignation takes effect

The AICD supports the government’s proposed changes to the Corporations Act regarding backdating of director resignations. The AICD considers this reform important to reduce the incidence of illegal phoenix activity, and the introduction of a rebuttable presumption ensures the balance is struck between ensuring compliance and providing some flexibility for ASIC and the courts to deal with extraordinary circumstances. However, the AICD considers a 1-year criminal penalty for non-compliance with the requirement to notify ASIC within 2 days of a Court order to backdate the effective date of a director’s resignation to be excessive. The AICD recommends that the period be extended to five days, or alternatively, that the provision be a civil penalty provision only.

In relation to the provisions relating to abandonment of companies, while the AICD acknowledges this is a serious issue which needs to be addressed, the AICD is concerned that this new provision will not achieve the government’s objectives. The abandonment of a company by a director already constitutes a breach of directors’ duties, and a director resigning will not result in the director escaping liability.

In addition, the AICD is concerned that this change to the law may perversely encourage directors of troubled companies to resign early to ensure that they do not become the sole director on the board, and thereby become precluded from resigning. This could drain a company of talented and experienced directors at a time when they are acutely needed to guide the company through difficult circumstances. Finally, the proposed change will not prevent directors from simply abandoning a company without resigning (albeit they remain legally liable).

For these reasons, the AICD considers the best option to address the issue of abandonment is strong enforcement action against directors who abandon companies through use of existing laws, and particularly the directors duties provisions of the Corporations Act.

6. GST estimates and director penalties

The AICD does not support enabling the ATO to make directors personally liable for any outstanding GST liabilities through the director penalty regime. In our view, it is inappropriate, without a compelling justification, for the government to expand the risk of personal liability for all company directors to address misconduct by a relatively small number of non-compliant directors and entities.

We are concerned that the government's approach is not appropriately targeted, as it would effectively impose a new and significant risk of personal liability on every company director in Australia, including numerous small business owners and entrepreneurs. This would run counter to the policy objective of the government, which is to address an issue with a limited cohort of individuals who abuse the corporate form to avoid paying their GST liabilities.

In our view, this is not a proportionate response to address the relevant issue. Instead, the AICD recommends the government explore more targeted solutions to address the policy issues raised in paragraphs 4.23 and 4.24 of the draft Explanatory Memorandum. This could be achieved, for instance, by funding a special taskforce to pursue directors who liquidate a company while taking the GST credits elsewhere for breaches of their directors' duties, and other relevant legal obligations.

The AICD is also concerned the proposal may adversely and seriously impact on the ability for companies to attract and retain talented individuals who are willing to accept such a significant degree of personal financial risk.

In addition to our overarching concerns, the AICD has long expressed concern with specific features of the defences in s 269-35 of the *Taxation Administration Act 1953* (Cth) (**TAA**). Pursuant to s 269-35 of the TAA:

You are not liable to a penalty under this Division if, because of illness or for some other good reason, it would have been unreasonable to expect you to take part, and you did not take part, in the management of the company at any time when:

- (a) You were a director of the company; and*
- (b) The directors were under the relevant obligations under subsection 269-15(1).*

Thus, the defence recognises that there will be circumstances where a director is not involved in the management of a company and therefore should not be personally liable for conduct that has occurred during that period. However, this defence does not apply to new directors, who were not involved in the company when the relevant tax liabilities accrued. .

The AICD considers this position to be unjust and in need of rectification. Before any change is made to the director penalty notice regime, the AICD strongly recommends this defence be amended to ensure that directors who were not directors at the time the relevant conduct occurred are able to make use of the defence. It is not clear to the AICD why a director who was ill and could not take part in the company's management has a defence, but a person who was not a director at the relevant time the liabilities accrued does not.

This particular anomaly already risks discouraging some individuals from becoming directors or remaining as directors. It would be further exacerbated by the expansion of the regime to GST without any appropriate modification of the defences.

7. Next steps

We hope our comments will be of assistance to you. If you would like to discuss any aspect of this submission, please contact Matt McGirr, Policy Adviser, on (02) 8248 8431 or mmcgirr@aicd.com.au.

Yours sincerely,



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