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# Consultation on reform to combat illegal phoenix activity Submission on Exposure Draft

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## Executive summary

1. Thank you for the opportunity to make submissions on the Exposure Draft of the *Treasury Laws Amendment (Combating Illegal Phoenixing) Bill 2018* (the **Exposure Draft**).
2. This submission addresses the measures contained in Schedule 1 of the Exposure Draft. In summary, the amendments we propose:
  - (a) refine the definition of a “creditor-defeating disposition”;
  - (b) remove any causative element in the test for whether a creditor-defeating disposition is a voidable transaction;
  - (c) clarify the “market value” defence; and
  - (d) expand ASIC’s power to make administrative orders so as to include orders against facilitators of illegal phoenixing activity.

## Creditor-defeating disposition

3. The “creditor-defeating disposition” is central to the amendments proposed in Schedule 1 to the Exposure Draft. We propose the following refinements to the definition:

### 588FDB Creditor-defeating disposition

- (1) A disposition of property of a company is a **creditor-defeating disposition** if the disposition is a transaction, or forms part of a series of transactions, by which the company disposes of all or a substantial part of its property or undertaking and has the effect of:
  - (a) preventing the property from becoming available for the benefit of the company’s creditors in the winding-up of the company; or
  - (b) substantially diminishing the value of the business conducted by the company; or
  - ~~(b)~~(c) hindering, or significantly delaying, the process of making the property available for the benefit of the company’s creditors in the winding-up of the company.

4. In our submission, the proposed definition better captures the substance of phoenix activity by:
  - (a) limiting the provision to “substantial” dispositions, thus avoid incidental and inconsequential disposals of property being caught;

- (b) making clear that a disposition might involve a number of transactions involving different entities; and
- (c) removing any doubt that transactions that have the effect of diminishing the prospects of a business being sold as a going concern (by, for example, permitting the novation of contracts to another entity) may also attract the operation of the legislation.

## Voidable transactions

### ***Where a company enters external administration after disposition***

5. We submit that proposed subsection 588FE(6B) be amended as follows:

- (6B) The transaction is voidable if:
- (a) it is a creditor-defeating disposition of property of the company; and
  - (b) at least one of the following applies:
    - (i) the transaction was entered into, or an act was done for the purposes of giving effect to it, when the company was insolvent;
    - (ii) the company became insolvent because of the transaction or an act done for the purposes of giving effect to the transaction;
    - (iii) less than 12 months after the transaction or an act done for the purposes of giving effect to the transaction, the start of an external administration (as defined in Schedule 2) of the company occurs ~~as a direct or indirect result of the transaction or act;~~ and
  - (c) the transaction, or the act done for the purpose of giving effect to it, was not entered into, or done:
    - (i) under a compromise or arrangement approved by a Court under section 411; or
    - (ii) under a deed of company arrangement executed by the company; or
    - (iii) by a liquidator of the company; or
    - (iv) by a provisional liquidator of the company.

6. In our submission, it is not necessary or desirable to introduce a causative element into the test for whether a creditor-defeating disposition is voidable. It should be enough that a disposal of a substantial part of the company's property or undertaking for substantially less than market value has occurred within 12 months of an external administration.

7. The introduction of a causative element leaves the door open for directors to argue alternative bases for the company's administration, thus creating an additional, unnecessary, burden on liquidators pursuing phoenix activity.
8. For example, assume a transaction occurs which would otherwise offend the proposed amendments. The directors thereafter manufacture a dispute about the direction of the company, or agree to pass a resolution which has the effect of unfairly diluting a shareholder's interest. In either case an application could be made (by an ostensibly aggrieved director or shareholder) to the Court for a winding up on the just and equitable ground, or on the basis of alleged oppression. Would such an order satisfy the causative element proposed by the legislation? Arguably not.
9. The above observations also apply to proposed sections 588GAA and 588GAB.

### **Market value consideration**

10. Valuations can be an important ingredient in phoenix activity. They are relatively easy to manipulate and are often nothing more than transparent attempts of financial gaslighting. For example, the goodwill component of a business that is a going concern might be ignored. A (fallacious) "fire sale" basis of valuation might be adopted, or some other methodology that does not reflect the notion of market value as articulated in paragraph 2.28 of the Explanatory Materials.
11. Proposed sub-section 588FG(9) provides:

- (9) A court is not to make, solely on the grounds of subsection 588FE(6B) (about a creditor defeating disposition of property), an order under section 588FF materially prejudicing a right or interest of a person to whom the disposition of property was made if:
  - (a) there is evidence before the court that suggests a reasonable possibility that:
    - (i) consideration was given for the disposition; and
    - (ii) the value of the consideration was at least the market value of the property at the time of the disposition or at the time the relevant agreement (as defined in section 9) was made for the disposition; and
  - (b) the court is not satisfied that subparagraph (a)(ii) does not apply.

12. The drafting of proposed subsection 588FG(9) should be simplified. In particular, the double negative in proposed sub-paragraph 588FG(9)(b) makes it difficult to understand.
13. It is not clear whether proposed subsection 588FG(9) is intended to operate so that a person who has received relevant property may avoid an order so long as evidence is produced that establishes a reasonable possibility that market value consideration was paid. If that is the case, this evidentiary

hurdle is, in our submission, too low. As observed in *R v Khazaal* [2012] HCA 26 adducing or pointing to evidence that suggests a reasonable possibility requires “no more than slender evidence”,<sup>1</sup> that is “at least capable of supporting the inference that the matter to which the evidential burden applies.”<sup>2</sup>

14. As drafted, proposed subsection 588FG(9) leaves open the possibility that a deliberately manipulated (though not necessarily by the purchaser) valuation may be relied upon to avoid an order under section 588FF.
15. In our submission, proposed subsection 588FG(9) should be amended as follows:

- (9) A court is not to make, solely on the grounds of subsection 588FE(6B) (about a creditor defeating disposition of property), an order under section 588FF materially prejudicing a right or interest of a person to whom the disposition of property was made unless the court is satisfied that the value of the consideration given for the disposition was substantially less than the market value of the property at the time of:
  - (a) the disposition; or
  - (b) the relevant agreement (as defined in section 9) was made for the disposition.
- (10) A person who wishes to rely on subsection (9) bears an evidential burden in relation to that matter.
- (11) “**evidential burden**”, in relation to a matter, means the burden of adducing or pointing to evidence that suggests a reasonable possibility that the matter exists or does not exist.

16. The provisions we suggest in substitution for proposed subsection 588FG(9) adequately balance the rights of third party purchasers of company property and the company’s creditors. Requiring that a person acquiring property by a creditor-defeating transaction establish that the consideration was not substantially below market value will ensure *bona fide* acquisitions are not caught.

## Administrative orders

17. We agree that the matters referred to in paragraph 2.42 of the Explanatory Memorandum impede the effective enforcement of measures to address illegal phoenix activity.

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<sup>1</sup> Per Gummow, Crennan and Bell JJ at [74].

<sup>2</sup> Per French CJ at [12].

18. The controllers of companies and “pre-insolvency advisors” are a key driver of illegal phoenix activity. Exposing facilitators to civil and criminal penalty is important, however, the time and expense involved in enforcing those provisions means that most facilitators will remain (practically) out of reach. Consequently, the civil and criminal penalty provisions will not, without more, be an effective deterrent.
19. We submit that the administrative orders available to ASIC ought to be augmented to permit orders to be made against facilitators of phoenix activity as follows.

**588FGAA ASIC may order undoing of effect of creditor-defeating dispositions by company being wound up**

*Scope of this section*

(1) This section applies if:

- (a) a company for which a liquidator has been appointed has made a creditor-defeating disposition of property; and
- (b) the disposition is voidable under subsection 588FE(6B); and
- (c) a person has:
  - (i) received any money or property as a direct or indirect result of:
    - (A) the disposition; or
    - (B) the person’s acquisition of the property after the disposition; or
  - (ii) procured, incited, induced or encouraged the making by the company of the disposition.

Note: The person may receive money or property as an indirect result of acquiring (by the creditor-defeating disposition or a later transaction) the property of the company that was the subject of the creditor-defeating disposition, and later disposing of that property and receiving money or property as consideration for the later disposal.

*Liquidator may request order*

- (2) Within 12 months of a liquidator of the company first being appointed, the company’s liquidator or a creditor of the company may request ASIC to make an order under subsection (3). ASIC must decide whether to grant the request.

*Orders by ASIC*

- (3) ASIC may, on request under subsection (2) or on its own initiative, make one or more of the following orders in writing given to the person:
- (a) an order directing the person to transfer to the company property that was the subject of the disposition;

- (b) an order requiring the person to pay to the company an amount that, in ASIC's opinion, fairly represents some or all of the benefits that the person has received (directly or indirectly) because of the disposition;
- (c) an order requiring the person to transfer to the company property that, in ASIC's opinion, fairly represents the application of proceeds of property that was the subject of the disposition;
- (d) an order requiring the person to pay to the company:
  - (i) an amount representing any benefit received by the person from the company in connection with the disposition; and
  - (ii) an amount by way of compensation for the detriment suffered by the company as a result of the disposition.

Note 1: Subsection (5) sets out matters ASIC must consider in deciding whether to make an order.

Note 2: Section 588FGAB provides further for the content of orders.

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- 20. In our submission, creditors should be able to request that ASIC make an administrative order. This will ensure that enforcement activity is not hampered by a liquidator who is complicit in the illegal phoenix activity.
- 21. Subparagraph 588FGAA(3)(d)(i) is intended to recover any payments received by the advisor from the company for services connected with the phoenix activity. In our experience, such payments can be substantial, out of all proportion to the services rendered and often (by design) leave the company with no funds from which a liquidator can fund investigations.
- 22. The compensation referred to in subparagraph 588FGAA(3)(d)(ii) is somewhat analogous to the liability of a party who knowingly assists a breach of trust (the second limb of *Barnes v Addy*).

## Conclusion

- 23. The means to address illegal phoenix activity largely already exist in the Corporations Act and in the unwritten law. Phoenix activity has flourished because those laws cannot, for reasons touched upon at paragraph 2.42 of the Explanatory Materials, be enforced effectively against the key drivers of phoenix activity: companies' controllers and advisors.
- 24. A regime that effectively addresses illegal phoenix activity must contain measures that:
  - (a) empower the regulator to take swift action against the key drivers of illegal phoenix activity; and

(b) as a consequence, act as a sufficient deterrent.

25. There are, in our submission, few alternatives to the proposed augmentation of the scope of ASIC's power to make administrative orders against facilitators of phoenix activity. ASIC must assume a greater role in the regulation of "pre-insolvency advisors".
26. Please contact us should you have any queries or require us to elaborate upon any of the above matters.



