Mendelsons
National Debt Collection Lawyers

PRU$HKA
FAST DEBT RECOVERY
NO RECOVERY - NO CHARGE

Submission to Proposed Reforms to Combat Illegal Phoenix Activity

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DETAILS OF PARTIES MAKING THE SUBMISSION

1) This submission is made on behalf of Mendelsons National Debt Collection Lawyers Pty Ltd ACN 125 099 701 ('Mendelsons') and Prushka Fast Debt Recovery Pty Ltd ACN 005 962 854 ('Prushka').

2) Mendelsons is the in house law firm of Prushka and it focusses on debt recovery and insolvency in all Australian jurisdictions, specializing in commercial debt collection.

3) Prushka has a 42 year history and handles debt collection work for over 56,000 businesses across Australia, mostly being SMEs but also for larger corporate clients. Prushka acts on the No Recovery – No Charge basis and has a strong presence across regional Australia.

4) This submission is written by Roger Mendelson, Principal Lawyer of Mendelsons and CEO of Prushka and Alison Lee, Special Counsel and Practice Manager of Mendelsons.

ILLEGAL PHOENIXING

5) The act of registering a new company to take over a failed or insolvent business of a predecessor is not in and of itself is not illegal. In some instances, is a legitimate form of business rescue.

6) It becomes fraudulent when it is carried out to intentionally avoid paying creditors by stripping the old company of assets to avoid paying liabilities and leaving it insolvent.

PROPOSALS

Creditor-Defeating Dispositions

7) Schedule 1 introduces new offences to prohibit creditor-defeating dispositions of company property, penalise those who engage in or facilitate such activity and extends the existing asset clawback provisions to allow liquidators and ASIC to recover any such property.

8) A creditor-defeating disposition is one that has the effect of preventing, hindering or significantly delaying the property becoming available to meet the demands of the company's creditors in the event of a winding-up.

9) A transaction may be voidable if it is a creditor-defeating disposition and is made when the company is insolvent, or, because of the disposition, the company immediately becomes insolvent or enters external administration within the following 12 months.

10) The amendments provide that:

    (a) Liquidators can seek the recovery of assets or other consideration through the Courts for the benefit of the company's creditors;

    (b) ASIC can make orders to recover assets for the company's creditors;

    (c) Liquidators (and in some instances, creditors) can recover compensation from a company's officers and other persons responsible for a company making a creditor-defeating disposition;

    (d) It is a criminal offence for officers to engage in conduct that results in a company making a prohibited creditor-defeating disposition. Civil penalties also apply;

    (e) It is a criminal offence for a person to procure, incite, induce or encourage a company to make a prohibited creditor-defeating position. Civil penalties also apply;

    (f) The safe harbour provisions are also available to officers and/or other persons as a defence against alleged contravention of the creditor-defeating disposition prohibitions.

11) We support the prohibition and introduction of a new creditor-defeating deposition as the sections appear to operate in a similar way to the already existing and comparative provisions in the *Bankruptcy Act 1966* and brings consistency between the corporate and individual insolvency regimes in this regard. It is another way in which the corporate veil is being pierced to hold individual directors accountable in circumstances where the corporate structure should not protect them from such behavior.

12) Whilst a lot of investigation may still be required by a liquidator to establish the existence of a creditor-defeating disposition, with the targeted activity now being explicitly stated as being an offence will hopefully significantly reduce the cost of actions being taken to recover the property and/or to seek compensation for loss suffered arising from same.

13) The amendments are intended to ensure that ASIC has the power to take effective action against illegal phoenix activity and protect the interests of legitimate creditors. This is a positive step in acknowledging and assisting to alleviate the difficulties faced by liquidators where the company has insufficient funds to cover the cost of any Court action. Whether ASIC will have the resources to actually take effective action is a separate issue.

14) Targeting pre-insolvency advisers and the like is welcomed. Not all are unscrupulous and intentionally provide tax avoidance and/or creditor-defeating disposition advice. However, we feel that the introduction of these reforms will help to ensure the quality of any advice given in this space and limit those that are currently taking advantage of the system.

15) Having been introduced into law only recently, the safe harbour provisions are still yet to be subject to any judicial determinations. How the safe harbour provisions are being used and/or attacked in the context of insolvent trading claims against directors is yet to be seen and we now follow with interest how and if they will translate to achieve a balance between legitimate business rescue and illegal phoenix activity.

Accountability of Directors

16) Schedule 2 ensures that directors are held accountable for misconduct by preventing directors from improperly backdating resignations or ceasing to be a director when this would leave the company with no directors.

17) Accurate timelines of when directors and officeholders are appointed or resign is important. Equally as important is directors complying with their obligations to ensure that registered offices and their own contact addresses, as they appear on company searches, are up to date.

18) In our practice, we have come across company searches that clearly contain a notation that ASIC has received return mail from the company's registered office and/or the director's residential address. Yet, there are no adverse dealings or action against the company that can immediately be seen from public records and for all intents and purposes, the company remains registered to continue to trade and/or to incur debts whether engaging in illegal phoenixing activity or not. In these instances, ASIC has been put on notice that the status of the company should be investigated further and it has not seemingly commenced any such inquiries of its own motion. ASIC will need to be the ones to hold directors accountable as the legislation alone will not do it.

19) For creditors, simply having a name without current contact details for the director can be the difference between the recovery of a debt and in the more severe of circumstances, financial distress if unrecovered.

20) Ensuring that a company is not left without a director is not enough if the details of the remaining director and/or newly appointed director are not somehow verified.

21) The introduction of the Director Identification Numbers (**DIN**) will assist to some extent in this regard, but it can only go so far if:

    (a) Directors are not required to provide proof of identity by way of 100 points of identification to verify their details;

    (b) Aliases, Anglicised names and spelling variations are not investigated or identified;

    (c) Individuals qualify as being appointed as directors by being ordinarily resident in Australia but who go overseas for extended and lengthy periods of time are not flagged, as the effect of this upon creditors is akin to leaving the company without a director;

    (d) Appropriate considerations and measures are not given to shadow directors who may intentionally avoid the DIN "tracking" system.

22) Part 2D.6 of the *Corporations Act 2001* already provides a statutory regime to identify and disqualify high risk individuals from managing corporations. Section 206D, in particular, targets the disqualification of persons from managing companies if, amongst other things, the failure of the company is linked to insolvency and the non-payment of debts.

23) The extent to which directors have been disqualified under Part 2D.6 is, to our knowledge, limited. We hope that the increased and targeted focus on illegal phoenixing activity together with the introduction of Director Identification Numbers will change this.

24) We welcome these reforms, although query the extent to which the information submitted by directors will be scrutinised and whether action will indeed be taken in practice. Again, the resourcing of ASIC to monitor this is crucial.

Tax Liabilities

25) Schedule 3 allows the Commissioner to collect estimates of anticipated GST liabilities and make company directors personally liable for their company's GST liability in certain circumstances.

26) Schedule 4 authorises the Commissioner to retain tax refunds where a taxpayer has failed to lodge a return or provide other information that may affect the amount the Commissioner refunds. This ensures taxpayers satisfy their tax obligations and pay outstanding amounts of tax before being entitled to a tax refund.

Related Creditors

27) Through proposed amendments to the *Insolvency Practice Rules (Corporations) 2016* the reforms prevent related creditors from facilitating phoenix activity by unduly influencing the removal or replacement of external administrators. The aim is to reduce the incidence of illegal phoenixing activity, its effect on creditors and to help ensure the independence of external administrators.

28) The manner in which the amendments seeks to achieve the above is to limit related creditors' voting rights to the value of the consideration they paid for an assigned debt when conducting a poll for a resolution concerning the appointment or removal of an external administrator. External administrators will now be required to ask creditors (whether related creditors or not) to provide evidence in writing in relation to any assigned debt and the consideration provided for the assignment.

29) We support the proposed reforms. It will be imperative, however, for liquidators to have the resources to confirm, identify and verify the information provided to it as not all related parties or creditors placed to influence votes are always immediately clear without further scrutiny and cross-referencing of information.

GENERAL

30) The proposed reforms create penalties and monetary outcomes that can be imposed upon and recovered from directors personally.

31) It will be interesting to see how this interacts with the anticipated introduction of the 1 year bankruptcy and whether this will minimise the intended impact on personal liability.

SUMMARY

32) In our October 2017 submissions addressing the draft proposals on illegal phoenixing activity released for consultation at that time, we suggested that there already exists a variety of laws and measures dealing with acts that may constitute such activity. What has been lacking is the allocation of resources to counter such activity. Whilst we welcome the proposed reforms that creates additional offences and increased penalties, our position on this point remains the same.

33) The proposed reforms provide ASIC with more powers. This means that ASIC will need to find the time and personnel to ensure that it utilises those powers effectively and efficiently. It will also concurrently need to monitor companies and address any public complaints made

either directly to it or through the 'whistleblower hotline'. Unfortunately, our experience and observations of ASIC to date, is that it has lacked the ability to be "the enforcer" over incorporated entities of many of its already existing rights and responsibilities. ASIC will need to demonstrate that it has the capacity to undertake what it needs to, in order for a large number of these reforms to work as intended.

34) In more recent years, ASIC has seemingly initiated more actions against directors in furtherance of its commitment to tackling illegal phoenixing activities. We hope that this is not as a result of the current hype around combatting illegal phoenixing activity and is maintained.

35) We experience phoenixing on a daily basis. Most of it is not intentional but is as a result of poor business decisions and often directors operating business which have little hope of success. From the point of view of creditors, the result is the same.

36) We set out again our proposals for a Statutory Demand Register, Solvency Statements and the Deregistration process implementing those ideas would be simple, cheap and largely wipe out incidental phoenixing actively.

REGISTER OF STATUTORY DEMANDS

37) Under the Corporations Law (Section 459E), it is possible to serve a Statutory Demand on a company where the debt owed exceeds $2,000.00 and where it is not subject to dispute. No judgment is required.

38) Mendelsons use the Statutory Demand process on a regular basis and obtain good results from it.

39) The benefits are that there are no external disbursements payable and it is quick and cheap.

40) The way the process works is that the Statutory Demand is served on the company by post at its registered address and it details the amount demanded. The debtor-company has 21 days in which to "satisfy the Demand" or otherwise, to take action in the court to seek an order that there is a genuine dispute about the account or that otherwise, the company is solvent.

41) In our experience, it is rare for a company to respond to the Statutory Demand by seeking a court order and the greatest response is usually to pay or settle the amount demanded.

42) If the Statutory Demand is not satisfied and no action is taken by the debtor-company, then from that time onward, the debtor-company is deemed to be insolvent and if it continues trading, the directors are personally exposed to insolvent trading action in relation to any losses suffered by creditors after that date. From that time, the creditor may then use the failure to satisfy the Statutory Demand as a ground for commencing wind-up action of the company.

43) The problem is that many companies simply do not respond to a Statutory Demand and continue trading, in the knowledge that the creditor is unlikely to incur the cost of wind-up action (approximately $5,000.00), on the basis that it is unlikely to provide a financial return.

STATUTORY DEMAND REGISTER (‘REGISTER’)

44) Our first proposal is that a register be set up by ASIC of companies which have been subject to a Statutory Demand which has not been satisfied, where the debtor company has not initiated legal action in relation to the Statutory Demand and where the creditor has a reasonable belief that the amount demanded is still owed.

45) This is not the place to go into the proposed detailed workings of the Register but we believe that it could be set up simply, through an online process and it could be easily searched, without charge by businesses which plan to allow credit to the company. There could be a simple objection process, to ensure that the system is not abused.

46) If the Register is in place, it would be the first time there would be visibility by both the public and the regulators to Statutory Demands which are being served and which are not satisfied.

47) If this in place, recalcitrant companies which have not satisfied Statutory Demands would find it difficult to obtain credit.

SOLVENCY STATEMENTS

48) Our second proposal is that directors of a company should be obliged to sign a “Solvency Statement”, if requested to by a business which intends providing credit of over a fixed sum of say $5,000.00 to that company.

49) The Solvency Statement would be signed by all directors and would state that, as at the time of the Statement, the directors are of the reasonable belief that the company is solvent (defined as being able to pay its debts as and when they fall due).

50) If the company ultimately fails to pay a genuine debt for over $5,000.00 and the creditor has received the Solvency Statement, the creditor would then be entitled to sue the directors for the amount of the debt and the sole defence of the directors would be that as at the time of the statement, the company was solvent but that a later event occurred which rendered the company unable to pay its just debts.

COMBINING STATUTORY DEMAND REGISTER WITH SOLVENCY STATEMENTS

51) An extension of the ideas expressed above would be to provide that any company which appears on the Statutory Demand Register should also be required to complete a Solvency Statement within a 14 day period, in order that it be allowed to continue trading. If it fails to provide the Solvency Statement then ASIC should have the ability to investigate the company to determine whether or not it is engaging in any of the “designated phoenixing activities” (as proposed) or to otherwise appoint an external administrator.

52) Failure to lodge a Solvency Statement in the circumstances described in paragraph 33 could also lead to deregistration of the company by ASIC.

IMPROVEMENT IN DEREGISTRATION OUTCOMES

53) Deregistration of a company can be made either by ASIC (usually for failure to lodge annual returns and pay fees) or by the directors themselves.

54) Voluntary deregistration is initiated by the directors and it involves them in signing a Statutory Declaration declaring, inter alia, that the company has no creditors when submitting the request to ASIC for it to be deregistered.

55) We come across numerous circumstances where we know that the declaration made by the directors is false, usually because we are actually dealing with the company at that time in relation to an outstanding debt.

56) In our experience, ASIC does nothing about these false declarations, which leaves creditors with no further action to take.

57) Our suggestion is that ASIC encourage creditors to lodge a complaint when a company has been deregistered by the directors and there is clearly at least one debt outstanding. The action taken should be to prosecute the directors for perjury, in that the claim would be that they have knowingly sworn a declaration which they must have known to be false.

58) Following that process would significantly reduce the number of voluntary deregistrations, which is basically regarded by shady directors as an easy and cheap way to "get rid of the company". Liquidation is expensive and a liquidator is bound to investigate past transactions which potentially would give rise to claims made against directors and shareholders.

DEREGISTRATION BY ASIC

59) A large number of companies are deregistered by ASIC each year, usually due to the failure to lodge annual returns or to pay annual fees.

60) Upon deregistration of a company, all of its assets are supposed to vest with ASIC. However, this is, to our knowledge, never undertaken. Assets include loans made by the company to associated parties, including directors and shareholders and technically these "assets" should pass to ASIC and should then be enforced as debts owing to the company, but they never are.

61) If a creditor believes that there may be assets which have simply been "spirited" away from the deregistered company, the only option is to make application to the court to reinstate the company, naming ASIC as a party and then appointing a liquidator of the company, in order that he may then review all concerning transactions undertaken by the company and undertake recovery. This is rarely done because of the high cost and risk.

62) The current process for deregistration by ASIC is simply aiding both fraudulent phoenix operators and otherwise dodgy company directors and basically acts as a barrier against recovery of debts by SMEs.

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Contact

Roger Mendelson
Direct: (03) 9872 7229
Mobile: 0438 906 181
Email: roger@mendelsons.com.au
8 Station Street
Mitcham VIC 3132

Alison Lee
Direct: (03) 9872 7237
Mobile: 0412 772 232
Email: alison.lee@mendelsons.com.au
8 Station Street
Mitcham VIC 3132