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Phoenix rising: Update on illegal phoenixing legislation

BY ECE MUSTAFA-AY AND DAVID GRANT - JUN 02, 2023 8:40 AM AEST

SNAPSHOT

- The *Treasury Laws Amendment (Combating Illegal Phoenixing) Act 2020* (Cth) has introduced a number of new provisions which aim to prevent illegal phoenixing activity.
- The aim of the legislation is to prevent creditors from being left behind to deal with a shell company without any assets to satisfy its debts.
- New provisions introduced into the *Corporations Act* aim to make directors more accountable by preventing directors from resigning where their resignation would mean that the company has no directors.

The *Treasury Laws Amendment (Combating Illegal Phoenixing) Act 2020* (Cth) (the '**Act**') came into force on 18 February 2020.

The purpose of the Act is to:

- combat illegal phoenix activity; and
- improve the accountability of resigning directors.

Three years since the Act came into force, we revisit the changes to see what impact they have had and provide an update on their effectiveness. The introduction of the Act coincided with the Covid-19 pandemic and the impact of these changes on illegal phoenix activity is yet to be fully tested. However, given current economic conditions, combined with the effects of the pandemic on businesses, we expect these reforms to become increasingly important. It remains to be seen whether the reforms will be impacted by the Parliamentary Joint Committee's inquiry into Australia's corporate insolvency law, which is due to provide its first report to the Senate on 30 May 2023.

Phoenix activity typically involves:

- the creation of a new company, with similar (if not identical) characteristics, assets and business operations;
- the transfer of assets from the original company at no value or substantial under value; and
- the original creditors having no assets to claim against.

The Act was primarily designed to prevent creditors from being left behind in the shell company without recourse to any assets.

The Act has made it an offence to engage in conduct described as a 'creditor defeating disposition', namely the disposition of company property that removes assets from creditors reach for less than its market value. The Act also targeted fleeing directors who left the company behind, by making it illegal for them to resign when there was no replacement director in place.

As if proving the point of the intervening events, to date, only two cases have considered the provisions of the Act. Further, it is not apparent whether ASIC has availed itself of its new powers (and the new civil penalty provision contained in section 588GAC of the *Corporations Act 2001* (Cth)) ('***Corporations Act***').

Section 588FDB and combating illegal phoenix activity

In *Intellicomms Pty Ltd (in liq)* [2022] VSC 228 (‘***Intellicomms***’), his Honour Gardiner AsJ referred to the Act’s explanatory memorandum’s discussion on phoenix activity as:

‘While the scale of illegal phoenix activity ranges from the opportunistic to the systemic, a common characteristic is the stripping and transfer of assets from a company to another entity. Such transactions are carried out by a company’s directors or other controlling minds with the intention of defeating the interests of the first company’s creditors in that company’s assets. Such transactions are also facilitated by others, including unscrupulous pre-insolvency advisers, accountants, lawyers or other business advisers, who advise companies on how to engage in illegal phoenix activity.

[The legislation] introduces new phoenixing offences to prohibit creditor-defeating dispositions of company property, penalise those who engage in or facilitate such dispositions, and allow liquidators and ASIC to recover such property’ (at [6]-[7]).

Intellicomms was a single director company. It sold its business undertaking to a company for $20,000. The new company had been incorporated 14 days prior to the appointment of the liquidators, and the sole director and shareholder of the new company was Intellicomm’s financial and payroll administrator (and sister of Intellicomms sole director). The sale was effected on the same day that a statutory demand, issued against Intellicomms by a creditor, was due to expire and minutes before a resolution was passed placing Intellicomms into voluntary liquidation. At the time it went into voluntary liquidation, the total debt owed to creditors was in excess of $3.2 million.

Interestingly, the defendants admitted that the sale had the effect of preventing the property from becoming available for the benefit of Intellicomms creditors in the winding up for the purpose of s 588FDB(1)(b) and that it was entered into when Intellicomms was insolvent for the purpose of s 588FE(6B)(b).

Gardiner AsJ noted:

‘I think these were appropriate concessions to make. The Sale Agreement has, to my mind, all the hallmarks of a classic phoenix transaction, i.e., it involves the transfer of the assets of an insolvent enterprise to an entity controlled by persons closely associated with it, leaving behind significant liabilities with no means to satisfy them’ (at [16]).

The dispute centred around whether the price paid under the sale agreement was less than the lesser of either the market value of the property or the best price that was reasonably obtainable for the property, having regard to the circumstances existing at that time. The defendants argued that the liquidators were required to lead sufficient evidence to enable the Court to determine the actual monetary value of the market value and/or the best price reasonably obtainable, which in each case was required to be higher than the consideration payable to Intellicomms for the assets (at [19]).

His Honour rejected that approach:

‘I do not agree with that submission. In my view, the Liquidators are required to establish that, on the balance of probabilities, the consideration payable under the Sale Agreement was less than both of the limbs contained in s 588FDB’ (at [235]).

The defendants relied upon a series of ever diminishing valuations obtained prior to Intellicomms going into liquidation on 8 September 2021, including:

- a valuation of $12,470,564 in June 2020 (prepared in February 2021), for the purposes of valuing the company for a prospective investor;
- a valuation at a range between $117,456 and $683,559 in June 2021 (prepared in July 2021);
- a valuation of $101,476 representing the net present value of the goodwill of Intellicomms at 30 June 2021 (prepared in August 2021); and
- a valuation of $57,000 representing the net present value of Intellicomms as a result of the ‘loss or potential loss of significant contracts’ as at 30 June 2021 (prepared in September 2021).

Against this, shortly after the liquidation, a creditor of Intellicomms (the creditor who served the statutory demand) expressed an interest in acquiring the business. Upon finding out about the sale, they funded the liquidator in the proceedings.

Ultimately, his Honour concluded that:

‘Over a relatively short period of time, Ms Haynes commissioned several valuations of Intellicomms. With each succeeding valuation, she provided those conducting the valuation with inputs which reflected an increasingly pessimistic outlook for the company, with the direct effect of decreasing the valuation. I am satisfied that Ms Haynes did so in order that she could arrive at a valuation which would minimise the consideration payable by TF, an entity which was established shortly before the execution of the Sale Agreement and the liquidation as a NewCo vehicle, arranging so that her sister as TF’s director and shareholder would give the appearance of Ms Haynes being once removed from TF’ (at [229]).

Based upon those conclusions, his Honour found that the sale agreement was a creditor defeating disposition which was voidable under section 588FE(6B) of the *Corporations Act*.

Because of the defendant’s concessions, the Court was not required to consider in detail the ‘creditor defeating disposition’. Nevertheless, the case stands for a number of important propositions, including the support for the valuation methodology adopted by the liquidators, and the risks associated with the pre-sale of assets immediately followed by the appointment of a liquidator.

Section 203AB: Improving the accountability of directors

As part of the reforms, section 203AB was introduced into the *Corporations Act*. Its aim is to make phoenixing more difficult, by prohibiting directors from resigning unless another director has been appointed. Given the unlikely prospect that anyone would take on a role as a director of the original company (with no assets but plenty of creditors) the purpose is to stop directors from being able to run away from phoenixed companies.

Section 203AB came into effect on 8 February 2021 and was recently considered in *Hutton, in the matter of Big Village Australia Pty Ltd (Administrators Appointed)* [2023] FCA 48 (‘***Big Village Australia***’*)*.

In *Big Village Australia,* the joint and several administrators of Big Village Australia Pty Ltd, Mathew Russell Hutton and Robert Bruce Smith, sought orders (under section 447A of the Act) to clarify the validity of their appointment on two specific points:

1. First, the last remaining director who purported to appoint the administrators (Ms Kracht) was ordinarily a resident in the United States which is in breach of s 201A(1) of the *Corporations Act*. Section 201A(1) states that a proprietary company must have at least one director and that director must reside in Australia. The administrators sought clarity as to whether the breach of s 201A(1) would invalidate their appointment as voluntary administrators; and
2. Secondly, Ms Kracht had purported to resign as a director, leaving the company without a director. Later, when the director realised that her resignation was ineffective because of section 203AB of the Act, she then took steps to appoint the administrators (at [4]).

Anderson J noted there were conflicting views about the effectiveness of a resolution in circumstances like these, but:

‘The better view appears to be that the fact a company has breached s 201A(1) does not affect the ability of the company to function (subject to the provisions of its constitution), and therefore does not affect its ability to appoint an administrator under s 436A of the Act’ (at [18]).

Consequently, his Honour made orders pursuant to section 447A of the Act confirming the administrators’ appointment. In reaching that conclusion, Anderson J emphasised that the recently introduced anti-phoenix provision (s 203AB) clearly prevented Ms Kracht’s resignation from taking effect despite her attempt to resign, and despite the company’s constitution allowing for it (at [27]).

Implications

The Act has introduced additional measures to improve the accountability of culpable directors and advisors, and to deter companies from disposing a company’s assets to avoid the company’s obligations to its creditors.

The Act imposed a number of new criminal offences and civil penalties on directors, officers and professional advisors who engage in illegal phoenix activity to avoid tax and other liabilities. We are not aware of any civil or criminal prosecutions of directors and/or their advisors since the Act came into force (including any prosecution against the sole director and advisor). Given the disruption of the Covid-19 pandemic, it is too soon to assess whether it will work as a deterrent.

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