15 November 2022

The Committee Secretary
Parliamentary Joint Committee on Corporations and Financial Services
PO Box 6100
Parliament House
CANBERRA ACT 2600

Dear Sir,

Submission to the Inquiry into Corporate Insolvency in Australia

I am a Chartered Accountant and registered company liquidator.

I wish to make the following submission.

Term of reference: The role of government agencies in the corporate insolvency system

Topic 1: The compulsory company deregistration procedure

1. **Background to compulsory company deregistrations**

In the 1980's Australia saw the rise and widespread use of tax schemes to avoid the payment of income tax. One of the most notorious schemes was the 'bottom the harbour schemes' under which the scheme promoters purchased companies from their shareholders and then changed the directors to dead people, so sending the companies to the bottom of the harbour.

The circumstances behind the schemes were that many companies had retained earnings or unappropriated profits on their balance sheets which would have been taxable to the shareholders upon the distribution of the profits to the shareholders by a liquidator if a liquidator was appointed to the company (this was prior to the dividend imputation system).Thus sending the companies to the bottom of the harbour avoided the liquidation of those companies and the resultant tax liabilities to the shareholders on profits that would have been distributed to them if the companies were liquidated.

However not long after the bottom of the harbour scandal was uncovered the Australian Securities and Investments Commission (ASIC) instituted a practice which, it would seem, makes it unnecessary for tax scheme promoters, tax avoiders and others to send companies to the bottom of the harbour. ASIC commenced a new procedure around this time (mid to late 1980's) by which it deregisters companies compulsorily if the companies fail to lodge their annual returns and documents with ASIC. The companies are compulsorily deregistered by ASIC without liquidation or investigation of their affairs.

Like tax schemes and similar bad corporate behaviour it didn't take long for the knowledge that there is a much easier way to get rid of a company without any scrutiny, by simply failing to lodge the company's annual documents with ASIC, to permeate parts of the Australian community.

Since that time a new scam has come to the fore in Australia, that of phoenix companies. Phoenix companies involve the transfer of a company's assets and/or business to a related party followed by the deregistration of the company to prevent any claims being made by creditors and others against the company. A common form of phoenix company is where all of the creditors of the company are paid except the Australian Taxation Office ('ATO') before the company's business or assets are

transferred to a related party. Under this scenario the business' suppliers are happy to continue to supply the business under the 'new owner' as if nothing had happened but taxation debts are not recovered.

In this scenario the deregistration of the company after it has been 'phoenixed' might be undertaken through the voluntary deregistration procedure (under s.601AA of the Corporations Act 2001) or by prompting the automatic, compulsory deregistration mentioned above (under s.601AB) by failing to lodge documents with ASIC. Although a requirement for a voluntary application for deregistration of a company is that the company has no liabilities and has assets worth less than $1,000 the only evidence that needs to be filed with an application is a declaration from a company director attesting that the company meets these requirements. Similarly the only limitation preventing compulsory deregistration for failure to lodge documents is that ASIC has no reason to believe that the company is carrying on business [s.601AB(1)(c)].

So there are virtually no controls over compulsory deregistrations and only a very weak control over voluntary deregistrations.

2. Consequences of the 'deregistration loophole' (i.e. automatic company deregistration)

2.1 Potential for tax avoidance and other criminal behaviour

It is not known whether compulsorily deregistered companies (under s.601AB) have unpaid tax and other liabilities or how many shareholders are instigating the compulsory deregistrations, by intentionally not lodging annual documents with ASIC. The reasons behind a desire to abuse the compulsory deregistration procedure could range from a desire to avoid disclosure of criminal activity by the company and/or its directors if the company was liquidated (including phoenixing) to avoiding creditors' claims, particularly tax debts, or to avoid the payment of liquidators' fees.

On average 50,633 companies are being compulsorily deregistered each year (see figures below). If this figure was consistent over the past 30 years, then 1,518,990 (i.e.1.5M) companies have been compulsorily deregistered over this period.

Of the solvent companies in the more than 1.5 million of deregistrations, it is not known how many companies had retained earnings and capital profits reserves, and insufficient franking credits to cover the tax that would have been payable by the companies' shareholders on the distributions made to them if the companies had been liquidated by way of a members' voluntary liquidation. A major complaint over the proliferation of tax schemes in Australia is that they made paying income tax optional for many Australians. The deregistration loophole may be having a similar effect for the shareholders of some solvent companies.

Of the remaining companies in the more than 1 million of deregistrations over the past 25 years, it is not known how many of these companies had creditors, including the ATO, at the time of deregistration. The companies that had creditors, including tax debts, should have been wound up, with a liquidator appointed to them.

The recent introduction of director identification numbers as proposed in the Australian Law Reform Commission's Discussion Paper 87 'Corporate Criminal Responsibility' of 2019 is a step to combat phoenix companies. However this step appears to be directed to identifying and closing down the activity of regular phoenixers of companies than in combatting the 'one-off' misuse of the company deregistration procedures.

2.2 The effects on Australia's insolvency system

It has been said that ASIC's view is that it is up to the creditors of these companies to instigate measures to wind-up the companies to prevent the automatic deregistration of them. Such a statement, if true, appears to be self-serving justification for the process. The creditors of these companies are not individually informed about the impending automatic deregistration of the companies for failing to lodge documents, no steps are taken by ASIC to identify the creditors and no meetings to gain creditors' views are called before the companies are deregistered. So the ability of creditors to take timely steps to appoint a liquidator to prevent the automatic deregistration of these companies if they are insolvent is very limited.

The defining feature of insolvency is that there is not enough money left to be able to pay the claims against the company in full. The task of a country's insolvency system is to resolve creditors' claims against insolvent companies and their assets in a fair and even-handed manner. A multitude of claims are resolved each year under Australia's insolvency system by means of company liquidations, voluntary administrations, controllerships and schemes of arrangement. As Australia's insolvency regulator it is ASIC's task to oversee and ensure the effectiveness of this process of resolving claims against insolvent companies.

The action of the regulator of insolvency, in implementing a policy of automatic deregistration, is subverting the due and proper processes applicable to the administration of insolvent companies. The claims of creditors of these companies are not being resolved. Thus the policy of automatic company deregistration is corrupting the integrity of Australia's insolvency system by not allowing normal and proper insolvency procedures to be applied to these companies.

If the reason for undertaking automatic, compulsory deregistrations of companies is that ASIC is under-funded and under-resourced to properly regulate them and if necessary place them into the hands of an insolvency practitioner, then similarities to the Queensland forensic laboratory scandal are apparent. ASIC uses the term 'abandoned companies' but this label is a misnomer because it is suspected that all types of companies are being automatically deregistered, both solvent and insolvent. Most companies in Australia are not required to file their financial statements with ASIC, so the financial position of the companies being compulsorily deregistered is unknown.

Another aspect that should be of concern to the regulator is no investigations are being undertaken as to whether these companies would have been able to pay their unsecured creditors more than 50 cents in the dollar or whether their officers and employees had committed any offences under the law of the Commonwealth or a State or Territory, as would have been statutorily required if the companies had been wound up (CA s.533). Thus ASIC is unable to fulfill its statutory roles for these companies, to seek banning orders for directors of companies that have paid less than 50 cents in the dollar to unsecured creditors in 2 or more cases and to prosecute offences.

2.3 The effect on the financial viability of corporate insolvency practitioners

One of the terms of reference of this inquiry is examining the financial viability of corporate insolvency practitioners. Another consequence of the deregistration loophole is that insolvency practitioners are missing out on appointments that they may otherwise have been given.

It is sometimes claimed that the companies being automatically deregistered are only small and assetless companies and thus there would be no assets in these companies available to pay the costs of liquidation. However there is no information available about the composition of the companies that are being automatically deregistered. They could be large companies that may have had numerous, high value assets that have been converted to related party loans (and the shareholders don't wish to pay the tax on liquidators' distributions) or companies that have had their assets stripped

or ‘phoenixed’ and thus the assets are potentially recoverable by a liquidator. The availability of litigation funding to an insolvency practitioner, which is now very common, means that asset recovery actions may be funded by other parties if a liquidator or administrator was appointed to such companies.

A comparison of the number of annual companies being deregistered to companies entering insolvency administration (including controllerships) for the first time (i.e. ASIC Series 1 data) for the 5 financial years up to FY2021 is as follows:

Year	Voluntary deregistrations	Compulsory deregistrations	Total deregistrations	External insolvency administrations including controllerships
2016/17	71,059	45,841	116,900	8,031
2017/18	74,902	50,147	125,049	7,747
2018/19	80.546	51,839	132,385	8,105
2019/20	85,061	52,973	138,034	7,362
2020/21	80,735	52,365	133,100	4,235
Average per annum	78,461	50,633	129,094	7,096

Sources:

1. ARITA Journal vol. 34 #02 /2022 ‘Is ASIC deregistering more ‘abandoned companies’? What the data shows.’ by Thea Eszenyi, Senior Executive Leader, ASIC.

2. ASIC Series 1 statistical data on external insolvency administrations.

This comparison shows that on average 18 times more companies are being deregistered each year than are entering external insolvency administration. Of those, 7 times more companies are being compulsorily deregistered by ASIC each year than are entering external administration and having insolvency practitioners appointed to them.

Financially, if only 15% of the companies that are being compulsorily deregistered each year had sufficient assets or claims that justified placing them into liquidation or voluntary administration (i.e.7,595 companies) then assuming an average fee of only $15,000 per company (which is overly conservative) the total of the insolvency practitioners’ fees for administering these companies would be $113,925,000. Thus it is conceivable that at least $114 million of potential fees are being taken out of the insolvency profession each year by the compulsory deregistration policy. The figure could be much higher. This figure does not include the additional fees that are possibly being taken out of the insolvency system by abuse of the voluntary deregistration procedure, by phoenixers and other criminals.

The practice of compulsory deregistration of companies under CA s.601AB(1), s.601AB(1A) and s.601AB(1B) should cease immediately. Such companies would then be returned to the insolvency system, if insolvent, for proper administration of their affairs by means of liquidation or administration. Furthermore, the voluntary deregistration procedure needs to be overhauled to introduce investigation of those companies’ affairs before deregistration.

Topic 2: The small business restructuring reforms and safe harbour law

Both the small business restructuring reform and safe harbour law have requirements that only allow companies which have paid all employee entitlements and lodged all tax documents to be eligible for these restructuring procedures [CA Reg.5.3B.24 and s.588GA(4)].This raises the question of why are the other Australian companies which don’t come within these eligibility requirements being

discriminated against so that they are unable to be restructured under these laws? Thus the new laws actively penalise a large number of Australian companies that may need to be restructured.

The eligibility criteria appear to be administrative procedures implemented for the benefit of the government authorities, GEERS (to reduce the payment of employee claims for insolvent companies) and the Australian Taxation Office (the lodgment of tax documents).

The eligibility criteria create a dual system of insolvency and restructuring in Australia, one for the companies that have paid all employee entitlements and lodged all tax documents, which are able to obtain the benefit of these restructuring laws, and the remainder of the companies which are ineligible to be restructured using these laws. This adversely affects the employees, creditors and other stakeholders of the remainder of the companies if, as a result of being ineligible to be restructured under these laws, companies fail with a resultant loss of jobs and failure to pay creditors in full.

In my experience, directors and management of most companies seek to pay their employee entitlements in full and lodge relevant tax documents within time however the effects of financial distress are often unforeseen and can easily overwhelm a business and its management. Thus the claim that such discriminatory laws will achieve a change in management's behavior are unrealistic.

In the interests of a fairer system which would allow all Australian companies to participate, the eligibility criteria of the business restructuring reforms and safe harbour law should be amended to delete the requirements that companies need to have paid their employee entitlements in full and have lodged all tax documents.

Topic 3: An oversight body is needed to maintain the integrity of Australia's insolvency system

Government agencies have too much control over the insolvency system in Australia which is having a detrimental impact on the integrity of the insolvency system. I have outlined two examples above.

A solution to the problem of government intervention causing bias in the system is to set up an oversight body to oversee the system of corporate insolvency in Australia in order to maintain the integrity of the system. An insolvency oversight body with considerable powers and control given to the insolvency profession, would ensure that new insolvency laws and procedures are consistent with the overall intent and principles of Australia's insolvency system.

Yours faithfully,

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