AUSTRALIAN INSTITUTE of COMPANY DIRECTORS

14 March 2019

Committee Secretary
Senate Economics Legislation Committee
PO Box 6100
Parliament House
CANBERRA ACT 2600

via email: economics.sen@aph.gov.au

Dear Sir/Madam

Treasury Laws Amendment (Combatting Illegal Phoenixing) Bill 2019

Thank you for the opportunity to make a submission to the Senate Economics Legislation Committee on the Treasury Laws Amendment (Combatting Illegal Phoenixing) Bill 2019 (**Bill**).

The Australian Institute of Company Directors (**AICD**) has a membership of more than 43,000 including directors and senior leaders from business, government and the not-for-profit sectors. The mission of the AICD is to be the independent and trusted voice of governance, building the capability of a community of leaders for the benefit of society.

The AICD strongly supports the Parliament's aim of deterring and disrupting illegal phoenix activity. We acknowledge the significant harm that illegal phoenixing causes to creditors, employees and other stakeholders, along with the broader economy. It also undermines confidence in the corporate model, to the detriment of the vast majority of responsible businesses and directors.

Overall, our view remains (as expressed in prior consultations) that more proactive policing and enforcement of existing law – including breaches of directors' duties, where penalties have substantially increased[1] – is critical to combatting the scourge of illegal phoenixing.

Accordingly, we continue to encourage the prioritisation of enforcement of relevant laws, and adequate resourcing of ASIC to facilitate this, ahead of complex and potentially duplicative new provisions in legislation.

The AICD also supports administrative measures that will assist in the detection of illegal phoenix activity, including requirements for "director identification numbers" (**DINs**) and stronger identity verification processes for directors. If well-implemented and supported by effective information sharing across agencies and regulators, the DIN framework should enable all current and previous corporate activity and taxation compliance by prospective directors to be tracked and enforcement appropriately targeted. Identity verification requirements, and more visible enforcement action, would make use of so-called "dummy directors" or use of fraudulent identities much more difficult for those seeking to engage in illegal phoenix activity[2].

Importantly, the establishment of a well-implemented DIN framework with identity verification would also support limiting the general public disclosure of personal information of directors currently held on the Companies Register. The AICD has a number of concerns with the current

[1] Treasury Laws Amendment (Strengthening Corporate and Financial Sector Penalties) Bill 2018.
[2] See also submission by Professor Helen Anderson, Professor Ian Ramsay and Mr Jasper Hedges, Melbourne Law School, and Professor Michelle Welsh, Monash Business School, Monash University, 9 October 2017 at 10-11 (incorporated in Professor Helen Anderson's submission to this Committee).

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public availability of these details, relating to issues of privacy, cyber-security and personal safety. While we recognise that there would be cases where access to personal information could be justified, an effective DIN framework could accommodate application for public interest purposes. The introduction of DINs affords the government an opportunity to address this issue.

This submission focuses on providing feedback on the Bill and accompanying materials. We have focused our comments on limited areas of specific concern.

1. Executive Summary

In summary, the AICD:

- Is not convinced that a new legislative mechanism to recover property in circumstances where a company has sought to avoid creditors is necessary, given the existing provisions in the *Corporations Act 2001* (Cth) (**Corporations Act**). However, if the proposed amendment proceeds, it is critical that the definition of "creditor-defeating disposition" is appropriately targeted. We make some suggestions for further clarifying the operation of the definition in the Explanatory Memorandum (**EM**);
- Recommends that ASIC be required 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 it necessary to introduce a new civil penalty or criminal offence for illegal phoenixing, given that illegal phoenix behaviour will involve (at a minimum) a civil or criminal breach of directors' duties, for which substantial penalties apply;
- Supports the policy intent of limiting back-dating of director resignations, but offers some practical and administrative issues for further consideration;
- Supports preventing the abandonment of companies by directors, but considers that enforcement of existing laws, particularly directors' duties, will be more effective in addressing this serious issue than the proposed amendments in the Bill; and
- Does not support enabling the Australian Tax Office (**ATO**) to make directors personally liable for any outstanding GST liabilities through the director penalty regime.

2. Creditor-defeating dispositions

The AICD queries whether it is necessary to introduce a new legislative mechanism to recover property in circumstances where a company has sought to avoid creditors. The existing provisions available to liquidators and ASIC – in particular, the uncommercial and insolvent transactions provisions in ss 588FB and 588FC and the insolvent trading provisions in s 588G(1), as well as the directors' duties found in ss 180(1) to 184 of the Corporations Act – would seem to achieve this purpose. In our view, unnecessary duplication and complexity should be avoided wherever possible.

Notwithstanding our view, if the government decides to proceed with the proposal, it is critical that the definition of "creditor defeating disposition" (**CDD**) is not so wide as to risk making legitimate business transactions voidable.

The current definition in the Bill requires that the consideration payable to the company for the relevant disposition be less than the market value of the property or the best price that was reasonably obtainable for the property, having regard to the circumstances existing at the time.

We note that the EM states that the "best price reasonably obtainable test" recognises that there will be legitimate situations where a company may need to realise assets at less than market value (particularly where companies are in legitimate financial difficulties and have

urgent cash flow needs). In these cases, the EM states, the circumstances of the disposition, and the reasonableness of the steps the company took or should have taken to realise the value of the asset, will be relevant to determining whether the disposition is a creditor-defeating disposition.

The AICD strongly supports a focus on the steps that were taken (or should have been taken), as this approach reflects the commercial reality that companies in financial stress may have a legitimate need to transact, but might not be able to extract full market value for a particular asset. Given the criticality of the definition, we suggest that additional guidance on the "reasonable steps test" be provided in the EM. It currently provides the example of a company that sells property through a reasonable process such as a public auction designed to obtain the best price available.

It is important to emphasise that what is a "reasonable process" needs to be considered carefully, on a case by case basis (in accordance with directors' existing duties to act with care and diligence, and in good faith in the best interests of the company and for a proper purpose). Indeed, not all assets lend themselves to an auction process (for example, in the case of assets that require considerable due diligence to understand and value), nor will time always allow it. Examples of other reasonable steps may include engaging appropriate advisors to help determine the best approach for disposing of assets in the circumstances; ensuring an appropriate valuation is undertaken; identifying and addressing, or advertising to, the correct market; advertising for an adequate amount of time in the circumstances; and appointing an appropriate agent with knowledge of the market in which the asset is to be sold.

3. ASIC order regarding voidable transactions

The AICD supports the objective of ensuring that ASIC has power to take effective action against illegal phoenix activity. However, we are concerned about the drafting of the proposed administrative recovery power set out in section 588FGAA.

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 (analogous to a power to acquire property compulsorily). The AICD believes that it is critical that there are sufficient checks and balances in place to ensure that the power is used appropriately.

Accordingly, the AICD recommends that ASIC be required to seek a Court order to unwind the effect of a voidable CDD. This order could be obtained *ex parte* to avoid delay or unnecessary costs.

Court oversight has a number of benefits including:

- it ensures a degree of independent oversight over the use of this significant new power;
- 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 operation of s 588FGAA(4) of the Bill which requires ASIC to make an assessment of what a court might do. We consider it preferable, and simpler, to provide the court with the task of considering the relevant factors in ss 588FG.

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

4. Officers' duty to prevent creditor-defeating disposition

As previously noted, the AICD condemns illegal phoenix activity and strongly supports the Parliament's commitment to address it.

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 directors' duties, and may also constitute conduct intended to defraud the company or its creditors under s 596 of the Corporations Act, or fraud under criminal statutes (see for instance s 192E of the Crimes Act 1900 (NSW)).

For these reasons, the AICD does not consider it necessary to introduce a new criminal offence or civil penalty provision. In our view, adequate resourcing and prioritising of enforcement action against those involved in illegal phoenix activity will be a more effective response than a new offence, including because it will more effectively achieve general and specific deterrence. In this regard, the AICD has supported significant increases in civil and criminal penalties applicable to corporate misconduct under separate legislation.

However, if such the amendment proceeds, it is essential that directors can avail themselves of appropriate defences to ensure there are appropriate checks and balances in place to protect directors acting lawfully and engaging in legitimate restructuring activities. In particular, 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; and
- suggests, in relation to the "reasonable expectation of solvency" defence in s 588(H)(2) that applies to the civil penalty contravention, that the EM be amended to reflect that expectation of solvency means "a higher degree of certainty than 'mere hope or possibility' or 'suspecting'. The defence requires an actual expectation that the company was and would continue to be solvent, and the grounds for so expecting are reasonable" (*Tourprint International Pty Ltd v Bott* (1999) 32 ACSR 201 per Austin J at 215) (the EM currently states that "an expectation of solvency must be supported by facts that point to a high degree of certainty").

5. Resignation of directors – when resignation takes effect

<u>Limiting backdating of director resignations</u>

The AICD has previously supported proposed changes to the Corporations Act that would limit the backdating of director resignations by providing that any late lodgements of resignation to ASIC (i.e. those received after 28 days of the date of the director's resignation) would instead be taken to apply from the date the notice was received by ASIC. Under the proposed amendments, either the director or the company could apply to ASIC or the court to backdate a resignation to the relevant effective date, and in doing so must satisfy ASIC or the Court that the director did (in fact) resign on the purported date. The rebuttable presumption provided to the Court and ASIC (as appropriate) goes some way to striking a balance between compliance and flexibility to deal with unusual circumstances.

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The intent is to limit the scope for those seeking to misrepresent resignation dates in order to limit their accountability for illegal phoenix activity. The AICD strongly supports this objective.

Of course, all companies and their directors and officers should comply with their obligations under the law, including the obligation to report director resignations to ASIC within statutory timeframes. We note and support the penalties that currently apply for breaches.

Having reviewed the proposal further, however, the AICD is concerned that there could be practical and administrative challenges that warrant further consideration.

As the Governance Institute noted in its submission on the Exposure Draft[3], drawing on the experience of its company secretary members, the new provision would capture circumstances where administrative errors or officer illness (as some examples) lead to late lodgement of director resignations with no malicious intent or link to illegal phoenix activity. In such cases companies or directors would need to apply to ASIC or the Court to reconcile ASIC registers with corporate records and reality. This could be costly and complex for companies and officers and potentially for the regulator and the Court, depending on the volume of late lodgements and applications to reconcile dates received.

We encourage consideration of options to reduce these risks. This might include ASIC having a streamlined process that differentiates higher-risk lodgements for review. Alternatively, more targeted approaches (enabling liquidators who suspect that illegal phoenix activity has occurred to apply to ASIC to set aside backdated resignations) may have merit.

As a drafting suggestion on the current Bill, we note if the Court makes an order to backdate the effective date of a director's resignation, the applicant must provide a copy of the order to ASIC within two business days. Non-compliance is a strict liability offence subject to 120 penalty units. Given the significant penalty that attaches to non-compliance, and recognising that it is a strict liability offence, the AICD suggests that the period be extended to five days.

<u>Abandoning a company</u>

The AICD acknowledges the challenges relating to abandonment of companies by directors engaged in illegal phoenix activity. This is a serious issue that needs to be addressed. However, we are concerned that the new provision may not achieve the Bill'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 legal liability.

The changes also do not address directors abandoning a company without resigning (albeit directors clearly would remain legally liable), a concern highlighted by Professor Helen Anderson, Professor Ian Ramsay and Mr Jasper Hedges, Melbourne Law School, and Professor Michelle Welsh, Monash University, in a September 2017 submission to Treasury[4].

In addition, we are concerned that that this change could perversely incentivise directors of troubled companies to resign early to ensure that they do not become the sole director on the board, and therefore be precluded from resigning. This could drain a company of directors at a time when they are most needed to guide the company through difficult circumstances.

[3] Submission by Governance Institute of Australia to Treasury on reforms to combat illegal phoenix activity, https://static.treasury.gov.au/uploads/sites/1/2019/02/t313204-Governance-Institute.pdf, 27 September 2018.

[4] Submission by Professor Helen Anderson, Professor Ian Ramsay and Mr Jasper Hedges, Melbourne Law School, and Professor Michelle Welsh, Monash Business School, Monash University, 9 October 2017 at 10-11 (incorporated in Professor Helen Anderson's submission to this Committee).

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For these reasons, the AICD considers the best option to address the issue of abandonment is stronger 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, to expand personal liability for all directors rather than targeting those criminals and companies engaged in misconduct.

The Bill would effectively impose a new and significant risk of personal liability on every director in Australia, including directors of not-for-profits, small business owners and entrepreneurs. This would run counter to the policy objective of targeting the limited cohort of individuals who abuse the corporate form to avoid paying their GST liabilities.

Instead, the AICD recommends more targeted solutions. The policy intent could be better be achieved by a special taskforce to pursue directors who liquidate a company while taking GST credits elsewhere for breach of their directors' duties, for example.

As a related matter, the AICD has a long-held concern with the defences under the director penalty regime contained in s 269-35 in Schedule 1 of the Taxation Administration Act 1953 (Cth) (TAA). Pursuant to s 269-35(1) 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 even when the relevant tax liabilities accrued.

Before any change is made to the director penalty notice regime, the AICD recommends this defence be amended. 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.

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 [redacted]

Yours sincerely

[redacted]

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