



A Phoenix – A Flaming (Mythical) Bird, or a Flaming (Illegal) Mess...

Like the mythical bird, phoenix companies are reborn and rise out of the ashes of their insolvent predecessors. However, how they are reborn is important.

On 11 August 2016, the Australian Taxation Office (ATO) and the Australian Securities and Investments Commission (ASIC) made a very public statement when 120 officials raided the offices and homes of 13 professional advisors across Melbourne and the Gold Coast. It is alleged these advisors were promoting illegal phoenix activity to their clients.

Whether charges from these raids are laid or, ultimately, successful, it is clear that both the ATO and ASIC are taking illegal phoenix activity very seriously.

What is illegal phoenix activity?

According to ASIC, illegal phoenix activity involves the intentional transfer of assets from an indebted company to a new company to avoid paying creditors, tax or employee entitlements. The directors leave the debts with the old company, often placing that company into administration or liquidation, leaving limited or no assets to pay creditors. The new company then continues to trade a similar business, usually with the same directors, however directors who undertake illegal phoenix activities, normally, breach a number of:

- Specific duties under the Corporations Act 2001 (Act); and
- General common law duties that relate to their fiduciary obligations.

These breaches, usually, relate to deliberate arrangements to avoid liabilities and/or directors improperly using their position. Depending on the severity of the breaches, directors can be made financially liable, banned from acting as a company director and/or face criminal conviction.

Can phoenix activity be legal?

Not all phoenix activity is illegal. There are mechanisms available under the Act that can result in a business being restructured and saved – either under their existing form, or through a new corporate structure. However, the affairs of the existing company must be dealt with by an external administrator in a transparent manner. Furthermore, there cannot be any intention to defraud creditors, including the ATO.

Directors who have acted properly, but find themselves in a genuine corporate failure, should have nothing to fear.

What are the regulators doing?

It is estimated that illegal phoenix activity costs the Australian economy up to \$3.2 billion per year. As a result, a number of government initiatives have been launched to curb the practice.

The Inter-Agency Phoenix Forum (IAPF) comprises a number of government departments (including the ATO, ASIC, the Federal Police and the Australian Crime Commission) who all now share information that has previously been siloed within those departments. The IAPF members use this shared information with the goal of limiting illegal phoenix activity. ASIC undertakes its own surveillance investigations and funds liquidators to investigate phoenix activities, while the ATO can issue Director Penalty Notices (DPNs). DPNs can make company directors personally liable for unpaid PAYG withholding and SGC, in certain circumstances.

A warning to illegal phoenix advisors

Section 79 of the Act imposes liability on those “involved in” contraventions of the Act. In *ASIC v Somerville*, ASIC successfully argued Mr Somerville, the name partner of his own law firm, advised and recommended that the directors of 15 companies undertake phoenix activity. These companies were found to be either insolvent, or likely to become insolvent in the future. Mr Somerville was found guilty of breaching sections 181(2), 182(2) and 183(2) of the Act, which relate to directors’ duties; notwithstanding, he was not a director of the companies. As a result, he was banned from acting as a director of any company for six years.

Interestingly, the Court did not impose any financial liability on Mr Somerville despite it being available.

What directors and advisors need to know

Government and regulators are very sensitive to illegal phoenix activity and are taking steps to curtail the practice. The recent raid by the ATO and ASIC on alleged proponents of phoenix activity is not the first of its kind and unlikely to be the last.

At its core, the distinction between legal and illegal phoenix activity is the intention to transfer the assets from an insolvent company to a solvent one to avoid paying creditors. Directors and advisors need to be aware of this distinction, as the consequences of undertaking illegal phoenix activity can involve reputational damages, director banning orders, monetary liabilities and, at its extreme, a criminal conviction and jail.

Not all phoenix activity is illegal. If you are concerned about the solvency of any of your clients, please do not hesitate to contact FTI Consulting to ensure that they do not partake (even unintentionally) in any illegal phoenix activity.

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