Illegal phoenix activity within Australia: An analysis of the legal and ethical issues

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Abstract
Illegal phoenixing is a company practice that occurs when assets from an ‘old company’ are transferred to a ‘new company’ in order to avoid paying company debts owed to creditors, so that a company effectively ‘rises out of the ashes’ without meeting creditor repayment obligations imposed by law. This company practice costs the Australian economy up to $3.19 billion a year and is thus a major issue. In our paper we consulted the literature to determine specific legal and ethical issues relating to illegal phoenixing before researching the key approaches that have been employed to address illegal phoenixing in other countries. Through this research, we conclude that reforming aspects of the Australian Securities and Investments Commission (ASIC), analysing and adopting the approaches of Ireland and the U.K., in particular adopting ‘Similar Names’ legislation, has the potential to greatly reduce the prevalence of illegal phoenixing within Australia.

Keywords: Australian corporate law, phoenix activity, reform, legal issues, ethical issues
1. Introduction

The ability of a business to undergo restructure in accordance with the law is an essential feature of corporate governance within Australia. It is vital that the founders and directors of a company are able to choose the business structure most appropriate for conducting their business, with common structures including Public Company, Proprietary Company and Partnerships. However business restructure can be achieved in both legal and illegal ways. When the components of an ‘old company,’ most commonly its liquid assets, are transferred to a new company this behaviour is termed ‘phoenixing.’¹ Phoenix activity commonly occurs when a company faces financial difficulties, such as when facing the probability of being insolvent.² This paper explores ‘illegal phoenixing,’ which occurs when business restructure is undertaken to intentionally avoid paying company debts owed to creditors. This practice is of major concern and has been identified as both a prominent and emerging issue by legal scholars.³ Across all industries, illegal phoenixing costs the Australian economy up to $3.19 billion annually.⁴ Despite business restructure and ‘phoenixing behaviour’ arguably already being extensively regulated and illegal phoenixing arguably being indirectly prohibited in many areas of law (such as criminal law),⁵ there remains inadequate deterrence of illegal phoenix activity, which is a central legal issue. This paper argues that the current literature debating the practical prevention of illegal phoenix activity places too great an emphasis upon the pursuit for a unified definition of phoenixing.

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Instead, this paper argues that the main focus should be on deterring the specific illegal behaviours which can constitute illegal phoenixing, such as transferring assets from an old company to a new company not merely as a business decision made to honestly promote the growth of a company, but with the dishonest intention to avoid paying company debts owed to creditors. In addition, this paper explores the ethical issues that arise when balancing the interests of a potentially struggling company and creditors that the company is legally and morally obliged to repay. Furthermore, this paper proposes several recommendations for law reform which have the potential to aid in reducing the prevalence of illegal phoenixing in Australia.

2. Background

2.1 Distinguishing legal and illegal phoenixing and the misguided pursuit of a definition

‘Legal’ phoenixing, as defined by Matthew, is a necessary part of the corporate world, where companies have the ability to honestly restructure as a new entity with the good intention of remaining willing and able to satisfy all company debts. ‘Illegal’ phoenixing is the dishonest or fraudulent restructure of a company as a new entity that usually occurs with the intent to avoid creditor debt. This type of activity is not only illegal, but also arguably heavily breaches moral values such as honesty, trust and integrity, which are necessary to a certain extent in the corporate world as these values underpin the law that governs corporate behaviour and business relations.

8 Ibid.
Currently, there is no express legislative definition that clearly outlines and distinguishes ‘legal’ phoening from ‘illegal’ phoening. Hence, illegal phoening is not directly prohibited, which has been highlighted as a central legal issue. However an express definition may not in fact be useful as a wide range of actions can be considered illegal in the corporate sphere depending on the circumstances in which they are undertaken. For example, withholding information from shareholders and ASIC could arguably be deemed to be illegal conduct. This suggests the complexity of business activities and behaviours may render illegal phoening incapable of being afforded a clear and precise definition. Pursuing an all-encompassing definition of illegal phoening is arguably a misguided focus in the literature as it detracts from practical preventative strategies which may be alternatively pursued and employed to deter this activity. Enshrining certain factors that are recognised to constitute illegal phoening into a statutory definition may still exclude behaviour which ought to be illegal, thus still failing to act as a deterrent.

3. Legal issues

3.1 Inadequate deterrence

The central legal issue raised by illegal phoening is that there is a clear lack of deterrence. This lack of deterrence occurs despite illegal phoening conduct arguably being captured and prohibited under various sections of the Corporations Act 2001 (Cth) (‘the Act’). For instance, under s 181, directors must exercise their powers in good faith and for proper

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purpose\textsuperscript{14} and intentionally seeking to avoid paying creditors arguably fails to meet these requirements. Where a company is nearly insolvent or is insolvent, directors moving the old company’s assets to a new company depletes the availability of assets of the old company, thus denying creditors the right to these assets if and when the old company enters into liquidation. Hence, illegal phoenixing arguably breaches s 181 of the Act, and other areas of the Act may also be investigated.

3.2 Difficulties in enforcement

Creditors do not automatically have standing to bring actions against directors but must rely on liquidators of the old company or apply to the Court.\textsuperscript{15} This is problematic as creditors are arguably the most adversely affected by illegal phoenixing and so should arguably have a direct right to launch proceedings.

Enforcement may also be prevented due to liquidator bias to certain creditors,\textsuperscript{16} which is of concern as this occurrence in itself breaches the requirement that liquidators must treat creditors ‘fairly and in accordance with their legal rights.’\textsuperscript{17}

Further, liquidators have limited funds to launch legal proceedings. Despite the Assetless Administration Fund assisting liquidators report on failed companies with few or no assets,\textsuperscript{18} this avenue is somewhat limited due to stringent requirements of evidence.\textsuperscript{19}

\textsuperscript{14} Ibid s 181.
\textsuperscript{15} Ibid, ss 588R, 588T.
\textsuperscript{16} Australian Securities and Investments Commission (ASIC) v Franklin (liquidator), Re Walton Constructions Pty Ltd [2014] FCAFC 85.
Further, liquidators must make initial enquiries at their own expense, providing further evidence of the difficulty in enforcing penalties applied to companies who have chosen to undertake illegal phoening.

### 3.2.1 Penalties: hindrances to imposition

Firstly, directors can avoid the application of disqualification penalties by registering phoenix companies in a family member’s name, thus failing to meet the criteria required for disqualification.\(^{20}\) A strategy to address this may be to enable ASIC to investigate a company’s solvency status before it is wound up, which may prevent the company being wound up if it is unable to pay its debts, thus providing a better remedy for creditors.

Moreover, evidence suggests ASIC is unable to pursue most allegations of director misconduct due to being overly burdened. In the construction industry, almost 250 criminal offences, and more than 3000 allegations of civil misconduct were referred to ASIC over a 12 month period.\(^{21}\) However only around 69 director disqualifications are ordered by ASIC each year,\(^{22}\) which may be due to the lengthy process involved of ASIC investigating both criminal and civil matters. Further, although there are court ordered penalties for a breach of director’s duties including a possible $220,000 fine and imprisonment,\(^{23}\) critics allege that ASIC chooses to employ its own disqualification powers to implement a shorter ban instead.

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\(^{21}\) Economics References Committee, The Senate, *'I just want to be paid': Insolvency in the Australian construction industry* (2015).

\(^{22}\) Economics References Committee, The Senate, *'I just want to be paid': Insolvency in the Australian construction industry* (2015), xxii.

of applying to the courts,\(^24\) which may be due to this preference resulting in reduced costs to ASIC. Shorter bans and more lenient penalties may compound factors contributing to a lack of deterrence. In ordering more lenient penalties, ASIC is arguably partially responsible for the failed deterrence of illegal phoenixing. Thus ASIC should arguably be compelled by the Australian Government to refer a greater number of cases to court if certain pre-determined criteria are met or if specific legal questions arise.

### 3.2.2 Advisers avoiding extended application of s 79

Advisors, including lawyers, are often consulted before a company engages in illegal phoenixing.\(^25\) In *ASIC v Somerville* (‘*Somerville*’),\(^26\) Windeyer AJ held a lawyer may be held liable under ss 181(2), 182(2) and 183(2) due to his extensive involvement in illegal company activity,\(^27\) as these provisions extend the application of s 79.\(^28\) The drafting of s 180 however may demonstrate it does not extend the application of s 79. This suggests a greater consensus and understanding on the relationship between case law and specific provisions of the Act must be reached in relation to corporate behaviour and illegal phoenixing.

It is noted that *Somerville* was a novel case. Windeyer AJ acknowledged in obiter dicta that simply giving illegal advice does not necessarily breach s 79,\(^29\) as a causal link to breach must be established.\(^30\) His Honour did not define the threshold needed to be held

\[^{24}\] Ibid.
\[^{26}\] (2007) 77 NSWLR 110.
\[^{28}\] *The Corporations Act 2001* s 79.
\[^{29}\] Ibid 126 [48].
liable,\textsuperscript{31} so this area of law is unclear. Mr Somerville’s high degree of involvement in the illegal company activity was rare for an adviser,\textsuperscript{32} suggesting lawyers less involved may avoid the extended application. Advisors can also avoid s 79 by outsourcing work to a third party.\textsuperscript{33} Notably, Mr Somerville was only disqualified as a director for 6 years as negative publicity was considered both deterrence and punishment.\textsuperscript{34}

4. Ethical issues:

Illegal phoenixing offends moral expectations of honesty, integrity and trust. These moral expectations are reflected in the law which governs Australian corporate activity and business relations: in statute, at Common Law, and in Equity. For example, in equity, there exists a body of law which prevents unconscionable behaviour between parties, such as fiduciary duties and estoppel. Unconscionability generally refers to behaviour that is dishonest, fraudulent, and unfair, and this behaviour attracts harsh penalties. Therefore, Australian corporate law is arguably concerned with the ethics behind unjust corporate behaviour.

4.1. Phoenixing: always unethical?

Arguably, phoenixing is always unethical\textsuperscript{35} as the new business competing with the failed business has a ‘deliberately crafted competitive edge,’\textsuperscript{36} which is the unfair ability to survive without paying the debts of the ‘old company.’ Further, the significant detriment

\textsuperscript{31} Ibid.  
\textsuperscript{33} Ibid.  
\textsuperscript{34} Somerville [36].  
experienced by creditors caused by pursuing this competitive edge is unethical. The Fair
Work Ombudsman has estimated the total cost of phoenix activity to employees, business
and government revenue combined is between $1.78 billion - $3.19 billion.\textsuperscript{37} This harm is
amplified by the emotional stress experienced by business contractors.\textsuperscript{38}

Illegal phoenixing may be analysed with reference to the ethics of philosopher
Immanuel Kant. A Kantian approach to ethics provides one’s actions will be unethical unless
that action could be universalised without being self-defeating, in that the universalisation
of an action could be realistically achieved without the ‘breakdown’ of society.\textsuperscript{39} Illegal
phoenixing can clearly not be universalised because if every business were to act in this way,
the combined effect of their actions would cripple the Australian economy as no creditors
would ever be paid. Therefore, according to Kantian ethics, illegal phoenixing is morally
reprehensible, as universalising illegal phoenixing would likely be severely detrimental in the
corporate landscape.

\textbf{4.2 Balancing interests}

However, the argument that phoenixing is unethical cannot be made without considering
the necessity of business restructuring.\textsuperscript{40} Business failures and protecting a company by

\begin{footnotesize}
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acting in one’s own best interests is a natural part of competing in a capitalist market,\(^{41}\) where ‘entrepreneurs, investors and creditors all voluntary assume risks.’\(^{42}\) However, this argument fails in relation to tax authorities, who are most commonly harmed by illegal phoenixing, are non-voluntary creditors and therefore have no choice in assuming risk.\(^{43}\)

Thus, difficulties are raised in identifying the extent to which a company may act in its best own best interests, and the point at which it is ethically obliged to consider its broader societal impacts and its Corporate Social Responsibility.\(^{44}\) To what extent can harmful externalities of corporate activity be justified based on upholding the commercial viability of a company? This question is difficult to answer, but is highly relevant to corporate law and governance.

### 4.3 Law and ethics: intrinsically tied

In *Al-Kateb*\(^{45}\) McHugh J pronounced judgment in favour of ‘tragic’ consequences.\(^{46}\) Kirby J, in dissent, persuasively held “‘Tragic’ outcomes are best repaired before they become a settled rule…”\(^{47}\) A strong analogy can be drawn to this position as more effective measures to deter illegal phoenixing must be implemented to prevent this practice becoming accepted within Australia.

\(^{41}\) Ibid 119.
\(^{42}\) Ibid 118.
4.4 Legal hierarchy:

Lawyers are required to act in the client’s best interest due a vertical fiduciary relationship. However, lawyers’ higher duty to the Law and the Courts can be less clear as there is a strong drive to assist the client. Despite being bound by a professional standard of integrity, lawyers may be tempted, such as in the American case of Enron, to advise clients to act technically ‘within’ the law whilst arguably acting in a way which offends the expectations of the general public and business sector generally.

Thus, facilitating ‘illegal’ phoenixing is arguably inconsistent with the integrity demanded of lawyers which is expected as the Australian legal system is underpinned by justice and fairness. Lawyers ought to consider the impact of their behaviour on company employees, tax revenue and creditors when advising clients, despite the added complexity that lawyers are in fact acting on behalf of the company (which is a separate legal entity).

5. Law reform

Enforcement should take priority over defining illegal Phoenixing. We propose four primary measures.

5.1 ASIC

Several recommendations targeting illegal phoenixing have been made, including ASIC conducting more reviews into the industry and having an optional box to tick on ASIC forms if a company is suspected of phoenixing. However, these measures are arguably insufficient as they may further overly burden ASIC and still fail to remove incentives.

5.1.1 Overhaul of asset administration scheme

A possible reform to ASIC’s Assetless Administration Scheme is removing the requirement for liquidators to conduct the initial investigation at their own expense.\textsuperscript{51} Whilst ASIC is Australia’s sole corporate regulator, by contrast, the UK has several regulatory bodies.\textsuperscript{52} Adopting this approach in Australia, a separate body could fund initial liquidator investigations. Sufficient financial assistance could empower liquidators to be more effective gatekeepers and investigators,\textsuperscript{53} thus resulting in a reduction of illegal phoenixing.

5.2 Holding advisers to account

Section 79\textsuperscript{54} can catch people advising in favour of illegal phoenixing,\textsuperscript{55} however this section may be easy to circumvent. Holding advisers to account is highly likely deter illegal phoenixing because the directors and board members responsible for a company’s behaviour usually cannot illegally phoenix or conduct any illegal activity without legal or financial advice: ‘...without lawyers, few corporate scandals would exist and fewer still would succeed long enough to cause any significant damage.’\textsuperscript{56}

The proposed national disciplinary framework\textsuperscript{57} prescribing proper legal professional conduct defines unsatisfactory professional conduct\textsuperscript{58} and professional misconduct.\textsuperscript{59} States

\textsuperscript{52} Ibid.
\textsuperscript{53} Ibid.
\textsuperscript{54} Corporations Act 2001 s 79.
\textsuperscript{55} Somerville.
\textsuperscript{57} Standing Committee of Attorneys-General, Legal profession – model laws project Model Bill (Model Provisions) 2006.
\textsuperscript{58} Ibid, cl 4.2.1.
\textsuperscript{59} Ibid, cl 4.2.2.
have amended their legal profession legislation to model this framework, however there is currently no Commonwealth legislation, which is a further issue.

Currently these provisions do not catch offences of ‘a dishonest or infamous nature’ committed by legal practitioners like in the original, unamended Legal Practitioners Act 1981 (SA). ‘Dishonest or infamous’ conduct could be incorporated into the definition of ‘professional misconduct’ in addition to the existing ‘fit and proper person’ requirement. This would catch lawyers of ill character, but also specifically target and deter fraudulent conduct related to illegal phoenixing activity. However, this involves considering intention in determining what is ‘honest’ behaviour which is difficult to establish and arguably should not be applied to the corporate setting as demonstrated in this paper. This will only work if the National Framework is legally formalised and the relevant central regulatory bodies are created.

5.3 Ireland’s approach

The Republic of Ireland uses both restriction and prevention orders to make directors and officers accountable. The insolvency law requires liquidators to report on directors within six months of commencing liquidation. They must launch proceedings in the High Court which restricts the company’s directors under the Companies Act 2014, unless they can prove to the Court they ‘acted responsibly and honestly in their conduct.’ Restricted directors may

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61 Legal Practitioners Act 1981 (SA) s 5.
62 Standing Committee of Attorneys-General, Legal profession – model laws project Model Bill (Model Provisions) 2006 cl 4.2.2.
64 Companies Act 2014 (Ireland) s 150.
only direct a company if it has sufficient capital (£63 500 for private companies and £317 500 for public companies). This approach has potential to work in Australia because it ‘reverses the burden of proof’ onto directors which relieves the resources of liquidators and creditors, and catches repeat phoenixers with the capitalisation requirement. This reform would work well in conjunction with 4.12.

5.4 Approach of the United Kingdom

Despite some Phoenixing-specific legislation being adopted in Australia, the U.K. has adopted ‘Similar Names Legislation,’ which prevents a company being registered if another company with a similar name has recently become insolvent. However Australia has rejected similarly proposed Bill. Adopting such a Bill may further deter illegal phoenixing as a ‘phoenix’ company may be unable to draw on the reputation of the new company.

6. Conclusion

From the analysis of legal and ethical issues arising from the prevalence of illegal phoenixing within Australia, we conclude providing an express legislative definition of phoenixing is not as useful as improving the enforcement of current provisions. The reforms outlined in this paper would together reduce the incentive to phoenix and thus reduce the significant financial and emotional burden placed on creditors and employees. This suggested law reform focuses on the practicality of enforcement, but perhaps a further step is to find new

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67 Ibid.
68 Corporations Amendment (Phoenixing and Other Measures) Act 2012.
ways to ‘pierce the corporate veil’ to hold directors to account as opposed to pursuing the company which is a separate legal entity which enjoys a distinct status. Although this is beyond the scope of our paper, this further investigation is a worthy future research pursuit.
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