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Combating the Phoenix Phenomenon: An Analysis of International Approaches

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Abstract

The phoenix syndrome involves company directors misusing the protection afforded by the corporate form to evade debt and fraudulently pocket taxes that should benefit the community. The literature suggests that despite the concerted efforts of tax and corporate authorities, the incidence of phoenixing is growing in the international community. The impacts are far reaching in the industries in which phoenix practices tend to pervade. Enforcement strategies are complicated by the difficulty in distinguishing between harmful and beneficial business reconstructions. Government policy setting must strike a delicate balance between encouraging entrepreneurial risk taking and stopping outright fraud. Despite the attendant difficulties, various international jurisdictions have attempted to combat phoenixing with an interesting array of legislative and compliance approaches. This paper attempts to reconcile a definition of harmful phoenixing and examines the reasoning behind the rise of the corporate form. It questions the efficacy of the doctrines of separate legal entity and limited liability in the context of the closely-held company scenario, so prevalent with phoenixing. Next, it reviews a selective sample of international jurisdictions to compare how contextual factors affect the strategies adopted to address the phoenix phenomenon. Finally, the paper presents a series of recommendations that may provide an effective response to the worst aspects of phoenixing whilst preserving the corporate form as an attractive mechanism for honest business ventures.

1. INTRODUCTION

Much of the economic growth experienced in the developed world over the past two hundred years can be attributed to the rise of the concept of incorporation.[1] The unique legal structure and the protections afforded investors and management under the corporate form have permitted the efficient accumulation of vast amounts of capital and the sophisticated management necessary to the success of high-risk, large-scale projects. World governments have fostered the rise of corporations in the knowledge that they have a predominantly positive effect in the community. Corporations provide mass employment, support and encourage entrepreneurial risk taking, create economic growth and increase national revenue.

However, in recent years there has been growing concern in the international community about the misuse of companies to avoid debts through the strategic exploitation of cyclical liquidations; a phenomenon commonly referred to as 'phoenixing'. It is no accident that the increasing prevalence of the phoenixing phenomenon in the latter stages of the twentieth century correlates closely with the

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[1] Orhnial, T. (1982), p.81

emergence of the small single-director, single-shareholder company. In 2003, the Cole Royal Commission[2] highlighted the existence of a serious problem with phoenixing in the Australian building and construction industry. However, the literature confirms that the phoenixing syndrome is not unique to Australia.

Individual international jurisdictions have tended to tackle the issues in isolation as they have surfaced, careful not to over prescribe in the legislation for fear of stifling entrepreneurship. The result has been diverse legislative and compliance approaches across the international spectrum which operate with varying degrees of success. Some commonalties are emerging however, which hint at the possibility of a best practice approach to the problem. Cross jurisdictional conversations are beginning to take place in an effort to compare approaches and arrive at a comprehensive solution.[3]

2. A Definition For Phoenixing

The term 'phoenixing' was coined to describe the arising of a new business out of the 'ashes' of an expired former business – an analogy with the phoenix bird of Egyptian mythology.[4] However, arriving at an exact definition for phoenixing is problematic.[5] Although the term 'phoenixing' is increasingly being used in the pejorative sense, its definition is nebulous and difficult to pin down. A study conducted by the International Association of Insolvency Regulators (IAIR) revealed that no jurisdiction within the association was able to provide a categorical definition for phoenixing, although all acknowledged the phoenixing phenomenon as a problem to a greater or lesser extent.[6]

The difficulty in nailing down the term resides partly in the fact that phoenixing, of itself, is not inherently unlawful. To illustrate, it is not an offence for a business to fail once, or even on multiple occasions. If a company becomes insolvent and enters into liquidation, it is not improper for the directors of the insolvent company to form a new company involved in similar business activities. In the course of that new enterprise, it is not illegal for the management of the new company, to purchase assets out of the liquidation proceedings of the previous company for use in the new company.[7] There are good reasons for this.

History is replete with stories of innovators who have suffered bankruptcy somewhere along the path to success. The list includes such notables as: Henry Ford - who perfected the production line concept and the full application of specialisation; Walt Disney - entertainment entrepreneur; Charles Goodyear - inventor of the vulcanised rubber tyre; and Henry Heinz – founder of the eponymous American food conglomerate.[8] Experience shows that, on the whole, society benefits when entrepreneurs are not hindered from pursuing new entrepreneurial visions merely because of a previous failed business venture. The acquisition of business nous is, after all, an iterative process, with each business failure informing future business endeavours.

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[2] See Final Report of the Cole Royal Commission into the Building and Construction Industry tabled to Parliament 20 August 2002
[3] Appleby (2004)
[4] Pinch, G. (2004), p.118
[5] Parliamentary Joint Committee on Corporations and Financial Services (2004), p.131
[6] Appleby (2004), p.72
[7] Parliamentary Joint Committee on Corporations and Financial Services (2004), p.131
[8] Margulies, L (2009)

Phoenixing however, is ultimately an abuse of the limited liability concept and any analysis of phoenixing must necessarily consider the purpose of the corporate form and the theory underpinning company law. The rise in predominance of the limited liability company emanated from the period of rapid industrialisation in the UK during the 1700s.[9] It was a time when substantial amounts of venture capital were needed to exploit emergent technologies and embark on large-scale capital projects. Limited liability was originally designed to protect individual investors and encourage investment funding for major ventures that would benefit society. The limited liability concept has been vital to the aggregation of the vast sums of money necessary to implement the many large-scale infrastructure projects which have benefited society and appreciably improved first world living standards over the past two centuries.

The abuse of the corporate form however, is well documented, especially in the last half of the 20th century. The Costigan Royal Commission's revelation of the exploitation of 'bottom of the harbour' schemes to strip company assets, divert profits, and avoid tax was considered sufficiently repugnant as to trigger retrospective laws to prosecute culpable directors.[10] 'Bottom of the harbour' schemes were unethical legalistic constructions involving the fraudulent manipulation of transactions using loopholes in the law. Phoenixing however, is not quite as clear cut. The range of phoenix activities extends, at one end of the continuum, from the conscientious restructuring of a company that has failed due to economic downturn or poor market conditions, to the other end, where recidivist phoenix operators perpetually cycle the productive assets of a business through an endless series of companies in a deliberate effort to avoid tax, trade creditors and other liabilities.

Before a jurisdiction can effectively address harmful phoenixing and its undesirable consequences, it must first gain an appreciation as to what constitutes honest business failure. Paradoxes quickly emerge in analysing the various responsibilities of directors. Most corporate governance systems across the international arena require directors to minimise the impact of insolvency by ceasing to trade as soon as it becomes clear that a business cannot be saved. However, an enterprise can be expected to find itself in a predicament of inadequate cash flow at many times throughout its lifetime. A primary role of management is to accept and balance risk, engage professional advice and develop strategies in an effort to overcome liquidity problems, rather than concede at the first hurdle. Dealing with problems is, after all, a critical function and core responsibility of management. It is only when a business becomes untenable that it is beholden on directors to act swiftly to limit the losses for creditors. But the line between crisis and failure is frequently far from distinct.

Part of the resolution to a liquidity crisis may be to enter into deeds of arrangement with creditors or even to reconstitute the business by purchasing from the insolvency practitioner, at arms-length and at market value, key assets of the failed company for use in a new company. This approach may produce the best long-term result for all stakeholders, including; employees, who benefit from continuous employment, the tax authorities, who reap ongoing revenue from a revitalised enterprise; and creditors, who may achieve an ongoing profitable relationship with the successor company.

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[9] Rickett & Grantham (1998)
[10] Hannan & Hughes (2009)

Whilst such a strategy may fall under various definitions of phoenixing activity, it is not the type of phoenix activity that is of concern to governments around the world.[11]

The Australian Securities and Investments Commission (ASIC) categorises the phoenixing phenomenon in terms of '*innocent phoenixing*', '*occupational hazard*' and '*careerist offenders*'.[12] *Innocent phoenixing* occurs when a business comes under financial stress due to poor (as opposed to deliberately fraudulent) management decisions, inadequate record keeping and poor cash flow and financial management techniques. In some industries, such as building and construction, phoenixing is considered an *occupational hazard* in that once the business has collapsed, the operator's skill set drives them back into the same industry, where they are at high risk of failing again. They are affectively locked in to the industry by their skill-set. However, it is *careerist offenders* that pose the most serious concern for tax administrators. These operators intentionally structure their businesses to engage in cyclical phoenix activity, exploiting loopholes in insolvency laws and fractures in communication between government agencies and the insolvency profession.[13]

The Cole Royal Commission accepted ASIC's definition of phoenixing as the situation where an incorporated entity: [14]

- fails or is unable to pay its debts; and/or
- acts in a manner which intentionally denies unsecured creditors equal access to the entity's assets to meet outstanding debts; and
- within 12 months, another business commences which may use some or all of the assets of the former business, and is controlled by parties related to either the management or directors of the previous business

The Australian Tax Office (ATO) qualifies this definition somewhat to include only that behaviour which poses a significant risk to the tax revenue and retirement income systems. For the ATO phoenixing is defined as '(t)he evasion of tax and superannuation guarantee liabilities through the deliberate, systematic and sometimes cyclic liquidation of related trading corporate entities'.[15]

Some jurisdictions prefer the term '*strategic bankruptcy*' to describe phoenixing.[16] In many ways, this term helps to outline an important distinction between the motivations and intents in the minds of business owners engaged in fraudulent phoenix activity and those who have simply fallen foul of egregious economic conditions or disastrous but innocent business decisions.

It is important to keep in mind that there are many positive policy reasons for a government to foster an environment in which a failing enterprise is able to wipe the slate clean and start again. Innocent phoenix activity can preserve jobs and reduce the burden on the transfer payment system. It can encourage entrepreneurship and

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[11] Appleby (2004)
[12] ASIC (2002)
[13] Ibid, p.4-5
[14] Cole (2003), pp.113-114
[15] ATO internal brief, "Strategically managing the risk posed by phoenix practices", p.4; Darmanin (2010), p.4
[16] Delaney (1992), Ch.6

rational risk taking and provide innovation, economic growth and new commodities for the community. Legitimate businesses do not always succeed on the first attempt. One UK source estimates that one in three businesses fails within their first three years of operation.[17] An innocent phoenix arrangement allows the profitable elements of a business to survive and start again, which provides some continuity for employees and suppliers. The critical factor is in deciding how to frame laws and policies to distinguish between harmful and beneficial phoenixing. For the purpose of this paper the use of the term "phoenixing", unless otherwise specifically stated, can be taken to refer to those business practices, which have a predominately undesirable effect on society.

3. Phoenixing And The Rationale For Limited Liability

The corporate form has two key facets; separate legal identity for the business and limited liability of the owners. Phoenixing allows the directors of closely held companies to take unfair advantage of these facets in tandem; firstly by isolating the directors' responsibility for their management decisions under the corporate veil and, secondly, by limiting their liability as investors to recompense the unpaid creditors of the business. The phoenix phenomenon is therefore fundamentally an abuse of the corporate form.

Nevertheless, it is important to qualify from the outset that limited liability is not intrinsically inequitable in itself. The UK Insolvency Service highlights that a misconception exists amongst the general population in understanding company reconstructions. People intuitively feel that directors have a moral, if not legal, duty to discharge the debts of a failed company before undertaking a new venture.[18] However, this perception belies the underpinning rationale for the corporate form, which emanated in the industrial age during a period of rapid economic expansion.

Corporations under royal charter were a feature in English commerce from as early as the late sixteenth century. Although the concept of limited liability existed in theory at this early time, in reality it was illusory, with companies frequently calling on their members to meet outstanding debts.[19] Chartered corporations eventually began to wane principally due to the difficulties of obtaining a charter from the Crown and joint stock companies began to dominate the commercial world from about 1840.[20] Joint stock companies were in effect nothing more than vast partnerships with freely transferable shares, where members retained personal liability for company debts.

Limited liability as we know it today was formalised in 1855 with the enactment of the UK Limited Liability Act.[21] From a theoretical perspective, the case for limited liability was premised on the notion that, within a widely-held company, there was a separation of the ownership from the control of a business and this limited control justified a limited liability to accumulated debts.[22] Liberal economists countered this argument with the contention that limited liability was incompatible with free market behaviour and cautious investment and so limited liability resulted in economic

[17] See Insolvency Network at: http://www.insolvencynetwork.co.uk/page.php?id=56
[18] Appleby (2004), p31; Quainton (2008)
[19] Davies & Gower (2003), p.22
[20] Rickett & Grantham (1998); Sealy, cited in Feldman & Meisel (1996), p.22
[21] Mayson, S. French, D. & Ryan, C. (2007), p.55
[22] Orhnial, T. (1982), p.45

inefficiency.[23] An inherent tension exists between fostering the expedient gathering of large amounts of capital and assuring a well behaved marketplace. Too little regulation fosters volatility and corruption, while too much restrains innovation and flexibility.[24]

Early literature on the theoretical justification of the limited liability concept focused on the widely-held corporation and rarely considered the single-director, single-shareholder company. However, it has more recently been suggested that the extension of limited liability to the sole trader is justified on the grounds that the fixed 'special' assets of the business are said to represent the 'special capital' of the enterprise undertaken, rather than that of the individual.[25] Certainly, the 'separation of ownership and control' argument seems weak in the context of closely held companies, the predominant entity structure in phoenix operations.

Phoenixing represents a clear breach of a director's legal and ethical duty to act in the interests of all the investors (which includes the creditors) of the company. The resultant agency cost of the phoenixing director's breach of duty is ultimately borne by the creditors of the business. Nevertheless, it bears emphasising that the true nucleus of the phoenix problem is not so much located in theoretical flaws in the doctrines of limited liability and separate legal identity which underpin incorporation; rather, it resides in the transfer of assets from the failed company at undervalue.

4. Common Phoenixing Techniques

Phoenixing essentially involves a director hiding behind the corporate veil which separates their actions and responsibilities. The basic premise of using a company to avoid responsibility for debt is common to all phoenixing, but the exact manner in which that outcome is achieved can vary from industry to industry and from jurisdiction to jurisdiction. Even so, the following common characteristics of harmful phoenixing tend to be observable across the international experience:[26]

- the failed entity is formed with only a nominal share capital
- the failed entity is under capitalised
- the directors/managers/controllers of the failed and successor company are the same
- the failed entity is trading whilst insolvent
- assets of the failed company are depleted shortly before the cessation of business
- the failed company makes preferential payments to key creditors to assure supply to the successor company
- the failed entity was operated to evade prior liabilities
- the successor company operates in the same industry

[23] Ibid, p.46
[24] Appleby (2004), p.70
[25] Orhnial, T. (1982), p.44
[26] Appleby (2004), p.6

- the successor company trades with the same or similar name
- the successor company commences trading immediately prior to, or within 12 months of, the cessation of the failed entity
- assets of the failed company are transferred at below market value to the successor company
- many of the employees of the failed company are re-employed by the successor company

The technique of phoenixing may vary somewhat between jurisdictions to accommodate legislative or other contextual differences. Within the Australian context, the following principle phoenixing scenarios predominate.[27]

4.1 One after the Other Method

In this scenario a closely held company is formed. The company trades for a short period, typically between six months and two years. During that time, the company accumulates large debts, most commonly in relation to unremitted tax, workers compensation and superannuation contributions. The management stalls creditors for as long as possible. Liquid assets that in a normal trading situation would be applied to payment of creditors are syphoned off the business for the personal use of the directors and their associates. When the pressure from creditors becomes intolerable, the company goes into liquidation and another company, frequently with a very similar name, purchases the productive assets and takes over the operations of the failing company. Often the new company operates out of the same premises, with the same suppliers, employees and customers. To all outward appearances, it is difficult to detect that there has been any change in the business at all. The directors of both companies may be identical or they may be related persons or associates who act as a puppet management for the phoenixing directors. The new company is usually able to continue to cash cheques from the former company because of the similarity in trading names. Liquidators generally conduct very limited investigations into the conduct of the directors, because there are insufficient funds left in the company to fund such activity.[28]

4.2 Management Company Method

Another strategy of phoenix operators is to quarantine the productive assets of the business in a management company. This primary company is kept solvent. A second labour supply company employs the workers and conducts the principal business operations. The management company hires the equipment to the labour supply company at exorbitant rates, thus stripping any profits out of the labour supply company. The labour hire company does not remit PAYG or GST withholding, these provisional amounts additionally being stripped by the management company. Eventually, the labour hire company will be liquidated, with little to no capital reserves, and a new one will rise in its stead. The real assets of the business are isolated and protected under the corporate veil of the management company for use in

[27] Cole (2003), pp.116-117
[28] Ibid, p.115-118

successive labour hire companies. The workforce is simply re-employed by the new labour hire company.[29]

4.3 Labour Hire Method

This strategy utilises a management company, a sales company and a labour hire company. The sales company receives all the income from the activities of the overarching business. The management company owns all the productive assets of the enterprise and hires them to the sales company. The sales company also hires employees from the labour hire company, but only to the extent of the net wages paid to the employees and other worker entitlements. Little, if any, provision is made for PAYG withholdings and workers compensation premiums. Often the labour hire company is a façade, merely issuing payment summaries, while the sales company pays the workers directly. The labour hire company is eventually forced into liquidation by the ATO or the workers compensation authority. The core assets of the overall enterprise are preserved in the management company.[30]

4.4 Shadow Directors Method

The control of phoenix activity is further complicated because of the ease with which former directors can control a company through spouses, relatives and associates.[31] There is little to prevent a disqualified director from giving advice as an employee of a successor company. An effective strategy to address the phoenix phenomenon must acknowledge the use of shadow directorships to circumvent disqualifications and find a way to counter them.

5. THE SOCIO-ECONOMIC IMPLICATIONS

In developing a compliance strategy, it is important to understand the powerful socioeconomic drivers that underpin the phoenix phenomenon. Phoenixing helps to fund a lifestyle for directors that they otherwise could not afford. It provides the director a status of wealth that is extremely tempting. There appears to be varying degrees of acceptance of phoenixing amongst different ethnic, industry and socioeconomic cultures.[32] This may be due in part to a perception that the tax system is oppressive or unfair, or that phoenixing is essential to compete in an industry. Analyses of certain industries where phoenixing is prevalent indicates a general belief that phoenixing is ethical, or at least normal behaviour[33]. Generally, phoenix operators tend to be uncooperative with tax authorities and not particularly concerned with the consequences of being caught.[34] These data provide a reasonable heuristic of the relative ineffectiveness of present sanctions.

The insolvency process is designed to achieve a number of economic efficiency and equity policy objectives. Economic efficiency is achieved by promoting confidence in a credit system, where risks can be objectively quantified and high levels of trust exist that the insolvency process operates fairly and consistently.[35] Two efficiency aims

[29] Cole (2003), p.115-118
[30] Ibid
[31] Parliamentary Joint Committee on Corporations and Financial Services (2004), p.132
[32] ATO BISEP Analysis of Phoenix Practices
[33] Ibid
[34] Ibid
[35] Swain (2003), p.3

influence the development of policy on phoenixing. Firstly, there is pressure to deal with liquidations quickly and fairly to keep the transaction cost of bankruptcy and the cost of debt capital as low as possible. Importantly, the cost and availability of capital for all companies are directly influenced by what happens in the insolvency setting. Secondly, there is a social interest in expediting the transfer of the productive assets of the failed company to their new owners to mitigate the economic losses that come with the prolonged inactivity of these key assets.

Equity is achieved in the insolvency process by distributing the net assets of the failed business fairly, punishing fraudulent offenders and by reforming honest debtors by relieving them of financial liabilities and rehabilitating them. Inevitably, equity outcomes also help to support economic efficiency, because they provide a structure under which the corollary of business failure can be administered in a methodical and less wasteful manner.[36]

A business that is fundamentally sound is a significant piece of social capital. If its core structure of customers, suppliers, employees, assets, and tax contributions are broken up in insolvency, no doubt the individual elements will eventually be re-employed within the economy, but not without large transaction costs. So long as the going concern value of a business is greater than its liquidation value, it is more efficient to maintain an entity intact. In practical terms, this efficiency outcome is best effected by putting energetic new managers in place with a sound strategy for revitalising the business and consigning the mistakes of the past to those directors who made them.[37] These efficiency principles are evident in the insolvency legislation of a number of countries, including Canada and the United States, which promote business reorganisations where they are practicable. These reorganisations usually involve creditors trading debt for equity in order to keep an enterprise in tact.[38]

Quantifying the socio-economic costs of phoenixing is problematic, partly because of the vagueness of its definition and partly because of the subjective judgment required in distinguishing between innocent business reconstruction and fraudulent phoenixing. Not surprisingly, very few countries are able to provide any definitive metrics on the incidence of phoenixing or the costs associated with phoenix insolvencies.[39] A limited number of countries have attempted to extrapolate the cost of phoenix activities based on insolvency and tax authority statistics however, these estimates are vague to say the least.[40] Most large-scale phoenix activity in Australia occurs with closely held companies with turnovers of between $2 million and $10 million per annum.[41] Phoenixing by its nature is the almost exclusive domain of closely held companies. The ATO has estimated that each year approximately 12,500 companies in Australia are subject to a phoenix process, resulting in an annual loss of revenue amounting to somewhere between $500 million and $1 billion. Limited public resources mean that only a small percentage of these are targeted for compliance activity. The Parliamentary Joint Committee on Corporations and Financial Services advised in its 2004 annual report to Parliament that the risk to the Australian economy posed by

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[36] Ibid
[37] Ibid, p.4
[38] Bankruptcy and Insolvency Act (Canada) Part III; Bankruptcy Code (US) Chapter 11.
[39] Appleby (2004), pp.8, 25, 29, 31, 35, 37, 45, 49, 55, 66.
[40] Ibid, p.72
[41] ATO (2002)

Phoenix and insolvency related practices was estimated at between $1 billion and $2.4 billion per annum.[42]

In 1996, ASIC conducted research into the incidence of phoenixing in Australia.[43] Although now somewhat dated, the report provides an indication of the impact of phoenixing within this region. ASIC's research suggested that the overall loss to the Australian economy as a result of phoenix activities amounted to $1.3 billion, or just over a quarter of 1% of Australia's GDP. Almost one in five small to medium sized firms were affected by phoenix activities, yet only 20% of those affected had attempted to report it to authorities. Almost half of all phoenix activities in Australia occurred in the building and construction industry. This phenomenon was mirrored in the international experience.[44] Internationally, phoenixing is recognised as a growing problem that threatens to substantially erode revenue and undermine community and business confidence.

Although phoenixing can potentially affect all creditors, generally it is the tax authorities that bear the greatest financial cost of the phoenixing phenomenon. Tax authorities are involuntary creditors in that they cannot choose to disengage with high-risk companies like other creditors can.[45] The non-payment of group tax, payroll tax and consumption tax can be significant. In Australia, the loss of revenue due to phoenixing has been conservatively estimated to be $500 million to $1 billion per annum.[46] Other jurisdictions report similar significant revenue losses.[47] This tax gap is at least in part borne by the population of individual taxpayers, whose proportionate tax burden is increased due to the shortfall from the corporate tax regime.[48]

Compounding the revenue shortfall problem, directors of Australian phoenix companies often ascribe to themselves large amounts of nominal withholding tax from the failing company. As with all the other outstanding tax liabilities, the withholding amount is never remitted to the tax administration. However, the phoenix operator is aware that the administration historically honours the tax credit that this withholding represents to preserve the integrity of the tax-transfer system. As a result, the director is permitted an additional benefit of the tax credit as a result of the phoenixing activity. This process is known as "double dipping".[49]

Insolvent trading inevitably results in a financial loss for the unsecured trade creditors of the failed companies that have been unethically stripped of assets.[50] These losses can have follow-on or 'downstream' effects on the cash-flows of creditors, who may in turn become insolvent as a result of the primary event. Often, phoenix operators will pay their key suppliers to keep them on side and maintain supply.[51] This is especially true where there are few reliable suppliers in the industry.

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[42] The Parliamentary Joint Committee on Corporations and Financial Services (2004)
[43] ASIC Research Paper, Phoenix Companies and insolvent trading cited in Martin (2007), p.3
[44] Appleby (2004), Ch 15
[45] Jones ((2010), p.10
[46] ATO (2006), p.6
[47] See various agency responses in Appleby (2004)
[48] Office of the Revenue Commissioners (2002), p.1
[49] ATO BISEP Analysis of Phoenix Practices
[50] Cole (2003), p.131
[51] Appleby (2004), p.62

Trade creditors possess the ability to diversify bad debt risk across a large number of client companies.[52] It has been argued that creditors are in no position to complain that insolvency has caused them loss because they have contracted to bear that risk and should have built compensation into the cost of credit.[53] Creditors charge a fee for the goods and services they provide. Factored into that fee is an element that represents the risk that they bear in extending trade credit. The greater the risk, the greater is the premium to compensate for that risk. However, this contention is specious in that it fails to acknowledge that these unnecessary costs are ultimately absorbed by down-stream customers in the supply chain, not just the phoenix operator.

Employees are also exposed to greater risk than trade creditors because they tend to invest all of their human capital in a single business. While some highly skilled employees may be able to bargain for increased remuneration to offset the risk of financial instability, in reality few employees enjoy such a favourable position and the employees who are most likely to need protection are also the ones least likely to be able to negotiate additional compensation.[54] Employees face losing basic entitlements including remuneration and leave accumulations as a result of phoenixing, however because they enjoy the status of a preferred creditor they often receive unpaid wages in the liquidation process.[55] Superannuation payments, on the other hand, frequently remain unpaid.[56] Surveys conducted in Australia during the late 1990s found that nearly 28% of employers were non-compliant with their Superannuation Guarantee obligations with 1% of employers wholly failing to pay any superannuation contributions for their eligible employees. Between 2002 and 2008, the average shortfall increased six fold, from $300 to over $1800 per employee.[57]

Because the transition between the failed and successor companies is often seamless, it is possible for an employee to work in the same factory, with the same machinery, for the same management, in ostensibly the same business, over the course of the employee's working life, with no immediate realisation that the business has been perpetually phoenixed. Each time the company may have been wound up, the assets sold to a new shell company and unpaid superannuation contribution liability wiped clean. The business doors close one day and open the next under the veil of the new company. Essentially, the employee appears to be in continuous employment. However, the employee's superannuation benefit will be significantly reduced as a result.[58] This adversely affects standards of living of retirees and places added pressure on an already straining publicly funded pension system.[59] Where the phoenix transition is not seamless, employees suffer discontinuity of employment. This is especially detrimental in industries where phoenixing is prevalent, as employees are continuously forced to move from one employer to another.

One significant implication of phoenixing that has received much discussion in the literature is the unethical competitive advantage afforded to phoenix operators. Since

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[52] Anderson, (2008), p.476
[53] Wishart (1991), p.336
[54] Anderson, (2008), p.476
[55] Corporations Act 2001, s.556
[56] ACTU et al (2009)
[57] Ibid, p.2
[58] ACTU et al (2009), p.3 extrapolation of ATO data found that more than $900 million in superannuation entitlements was outstanding as at 2008
[59] Australia's Future Tax System: Retirement Income Consultation Paper, p. 11

they strategically avoid paying taxes, a phoenix operator can factor the non-payment of tax into their pricing decisions. A phoenix company enjoys considerably lower labour costs than its honest competitors do because they under-remit PAYG withholding tax. They also benefit from reduced labour on-costs from underpaying superannuation contributions and workers compensation insurance. Similarly, a phoenix operator who plans to under-remit consumption tax does not have to factor it into their price to the client. GST/VAT may appear on the bill; however, the phoenix operator is conscious that this tax will not be paid and so, in reality, to the extent that it is collected and under-remitted, it represents contribution margin rather than actual tax. Thus, phoenix companies enjoy an unfair competitive advantage resulting from this artificial cost leadership.

A phoenix operator can opt to price their output at the going market rate and pocket the unremitted tax element as economic profit, or alternatively they can pass part or all of these savings on to their customers and exercise their competitive advantage. If they choose the latter option, this is likely to have a compounding effect on revenue. All other things being equal, the unfair competitive advantage will result in phoenix operators attracting a larger market share than they otherwise deserve. The tax base is increasingly eroded as a greater share of the market is effectively conducted outside the tax system. Further to this, as phoenixing becomes more and more prolific in an industry, companies that would otherwise act honestly may be effectively forced into adopting phoenixing, simply to compete on a level playing field. Unchecked, the phoenixing phenomenon can eventually become entrenched in an industry.[60]

Goodwill is a business asset that can represent a significant economic value. Phoenix operators are particularly adept at holding on to the goodwill that is stored in the failing company. This is can be accomplished by holding valuable contracts in a separate contracting entity, but it is often achieved by simply ensuring that the name of the new company is only subtly different from that of the failed company. The new company often retains the contracts and custom of the previous business because customers are convinced that they are still dealing with the original company from which the successor company emerged.

In actuality, this situation represents a sub-par value transfer of the goodwill in the liquidation process. By rights, the full value of the goodwill should be harnessed by the liquidator for the benefit of the creditors. In jurisdictions where a company is free to appoint its own liquidator, there is a risk of collusion between the director and the insolvency professional.[61] Although at law the liquidator has a fiduciary duty to the creditors, the power of the director to appoint the liquidator creates a potential risk of conflict of interest. This issue is widely acknowledged and various jurisdictions have implemented legislative measures to prevent it.[62]

6. A COMPARISON OF INTERNATIONAL APPROACHES

6.1 Australia

Phoenixing is not defined in Australian law, despite it being a major focus of various enforcement agencies since the late 1990s. The Corporations Act details the general

[60] Cole (2003), p.161
[61] Taylor (2006)
[62] Insolvency Act (UK) 1986, s.216; Companies Act (NZ) 1993, s.386

duties of directors and other officers of a corporation and includes both criminal and civil penalty provisions for breaches of these duties. Authorities rely on these provisions to counter phoenix practices.[63] The level of community concern over phoenixing has been building in recent years. The ATO is experiencing increasing levels of phoenix activity which is adversely affecting revenue collections across the full ambit of tax regimes it administers.[64] A number of government and industry enquiries have outlined the serious detrimental impact that phoenixing poses to the community.[65] The ATO estimates that phoenixing results in an annual loss to Australia's revenue in the region of $600 million.[66]

The Labor federal government outlined a number of commitments during its recent election campaign to crack down on the rising incidence of fraudulent phoenixing. These measures included restricting the re-use of business names under legislation similar to that of the UK and New Zealand, extending the promoter penalty regime to include phoenixing schemes, extending the director penalty regime to include unpaid superannuation, income tax and indirect tax withholdings and strengthening ASIC's powers to place companies into liquidation.[67]

The ATO has audited over 1600 businesses suspected of engaging in phoenixing since 1998, when it began to specifically target the problem.[68] Audits focus on labour intensive industries and on compliance with income tax withholding, GST and Superannuation Guarantee obligations.[69] The return on investment, at first glance, appears substantial. Every dollar spent on phoenix compliance during 2001-2002, uncovered eight dollars in additional assessed revenue.[70] However, the collectability of much of this tax is questionable.[71] The ATO favours an early intervention approach which seeks to identify and track existing phoenix operators. Phoenix behaviour is identified by analysing data to identify tax agents who are hubs of phoenix behaviour. Early contact discourages directors from becoming serial offenders.[72]

As phoenix activity often involves non-compliance issues beyond the jurisdiction of tax authorities (such as non-lodgment of company returns and licences), the ATO exchanges intelligence and works in partnership with other government agencies, particularly ASIC. Phoenixing tends to thrive in a climate of fractured legislation and disconnection between the government agencies responsible for identifying and prosecuting phoenixing related offences. In 2007, ASIC and the ATO signed a memorandum of understanding designed to consolidate and strengthen the working relationship between the two agencies to promote public confidence in the financial system.[73]

More recently the ATO has concluded that a general failure across the international spectrum to define the real phoenix mischief has delayed broader resolution of the

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[63] Martin, A (2007), *Directors' Duties and Phoenix Companies*, 3 April 2007, p.4
[64] Discussion with G. Darmanin, Phoenix Risk Manager, ATO, 22 July 2008
[65] See Cole Royal Commission Report
[66] Darmanin (2010), p.5; Australian Government (2009), p.5
[67] Gillard et al (2010)
[68] Darmanin (2010), p.3
[69] ATO (2007)
[70] Cole(2003), p.140
[71] Darmanin (2010), p.3
[72] ATO (2007)
[73] ASIC/ATO Combined Media Release, (2007)

phoenixing problem. Accordingly, the ATO has attempted to distinguish and characterise *fraudulent* phoenix behaviour. Qualifying the types of behaviour that are considered fraudulent, illegal and abusive immediately excludes other less harmful, even positive, forms of business reconstruction. Moreover, it enables authorities to respond promptly to the worst aspects of phoenixing rather than causing them to remain distracted and bogged down in philosophical and legalistic debate.[74]

The ATO uses a variety of strategies to identify phoenix activity. Data matching examines the tax payment and insolvency patterns of directors and their entities. Intelligence from internal business lines is fed into the phoenix compliance area as is information provided by the community, including insolvency practitioners and trade creditors. Public reports of corporate insolvencies are also monitored within the ATO. Industry profiling permits the targeting of limited compliance resources on areas of highest risk, particularly labour-intensive trades in the building and construction industry.[75]

Since 2002, ASIC has required insolvency practitioners to indicate if they suspect phoenix activity by the directors of any failed company. In the late 1990s, ASIC implemented Operation Westgate to directly combat phoenixing. Westgate was a strategic intelligence-based approach, which involved using lead-time indictors of insolvency from sources including credit reference agencies and exercising ASIC's powers of inspection to target phoenix operations. Companies of dubious solvency were monitored closely and those that were clearly insolvent were given a very short time to appoint an administrator.[76] Despite some clear successes Westgate was short lived, lasting only 12 months. During the last decade, ASIC's focus on small business has been distracted by a number of large corporate collapses, including HIH, One.Tel and Ansett. ASIC's current strategy favours maintaining a flexible and responsive enforcement team over the division of its resources by category of misconduct.[77] ASIC acknowledges that it is untenable to investigate all reported cases of phoenixing, due to resource constraints and other factors.[78]

An ASIC administered Assetless Administration Fund (AAF) finances liquidator investigations where offences are suspected in companies that have insufficient residual assets to fund a proper investigation. The AAF addresses the phoenixing tactic of stripping funds to prevent investigations that might result in prosecution of phoenix directors for breach of the Corporations Law.

Under Australian corporate law, a person is automatically disqualified from taking part in the management of a corporation if they are convicted of certain offences including breaches of directors' duties.[79] A person who is automatically disqualified may seek leave from the court to manage a corporation. The court may disqualify a person from managing corporations if the person has contravened a civil penalty provision, including those in relation to breaches of directors' duties;[80] if the person

[74] Discussion with Grant Darmanin, Phoenix Risk Manager, ATO, 22 October 2010
[75] Ibid
[76] Cole (2003), p.144
[77] Ibid, p.145
[78] Ibid, p.146
[79] Corporations Act 2001, s.206B
[80] Ibid, s.206C

has been at least partly responsible for the failure of two or more corporations within seven years[81] or has repeatedly contravened the Act.[82]

ASIC is empowered (although not required) by the law to disqualify a person from managing corporations if the person has managed two or more failed corporations within a seven year period and providing the liquidator has reported to ASIC on those failed companies.[83] The director must be given an opportunity to show cause why a disqualification should not be imposed. The Cole Royal Commission recommended this power be amended to apply after just one company failure.

Australia's Corporations Law imposes a duty on directors to prevent insolvent trading and provide for both civil and criminal penalties if the director breaches this provision.[84] In conjunction with civil penalty provisions, the director can be held personally liable for the debt incurred whilst trading in insolvency and ordered to pay compensation to the company. The court may order a director to be personally responsible for the debts of a company if they managed a company while disqualified.[85] These provisions, if applied, lift the corporate veil on phoenix companies by holding directors personally accountable for the debts left in the failed entity.

Despite its apparent far reaching powers, the Corporations Law has proved ineffectual in its application against phoenix activities. Prosecutions have proven time consuming and resource intensive, relative to their outcomes. The Commissioner of Taxation has recently called for a tougher penalty regime for phoenixing in the light of evidence that the phenomenon is growing.[86] A lack of prosecutions in relation to phoenix activity and lenient sentences from Australian courts was contributing to the problem.[87] Since 2000, only 12 directors have been prosecuted under the phoenix-related provisions.[88] The ATO has lately ramped up its efforts in pursuing phoenix activity with at least six new cases in the hands of the Commonwealth Director of Public Prosecutions (DPP).[89] One recent case against a phoenix promoter held a solicitor culpable for advice and assistance given to a number of clients in relation to facilitating phoenixing.[90] Despite a refocusing of efforts, the Commissioner commented that phoenix cases struggled to gain priority amongst the high case loads of serious crimes already before the DPP.[91] Given the ATO and ASIC's continued pursuit of legislative change it can be inferred that the existing legislative and administrative regimes do not provide adequate disincentive to deter directors from phoenixing.

[81] Ibid, s.206D
[82] Ibid, s.206E
[83] Ibid, s.206F
[84] Ibid, s.588G
[85] Corporations Act 2001, s.588Z
[86] Salna (2009)
[87] See DCT Mark Konza's comments at Biannual Hearing with Commissioner of Taxation before the Joint Committee of Public Accounts and Audit, Parliament of Australia, Canberra, 23 October 2009
[88] Darmanin (2010), p.7
[89] Ibid
[90] See ASIC v Sommerville and Ors [2009] NSWSC 934
[91] Ibid

6.2 Canada

Phoenixing is a recognised concern for Canadian authorities, chiefly in relation to small company bankruptcies.[92] Again, there is no formal definition of phoenix activity in Canadian law.

In the 1990s, strong consideration was given to addressing the phoenix problem by prohibiting the sale of the assets of a bankrupt company to its directors; a strategy known as 'asset rollovers'. Although this proposal aroused some interest amongst stakeholder groups, the prohibition was never implemented. Public consultations on various insolvency reform issues confirmed a consensus view that asset rollovers should not be prohibited, the rationale being that they often generate the best returns for creditors and produce the most efficient reallocation of assets.[93]

Phoenix activity in Canada is challenged through the use of civil and criminal remedies in the court system. Canada's approach to phoenixing closely parallels that of the US. If there is a formal insolvency, the trustee may pursue assets through fraudulent conveyance actions against the directors. Trustees are also empowered at a federal level to challenge arrangements which result in certain creditors receiving preferential treatment, including payment of outstanding liabilities in exchange for a promise to continue to supply the new company. Such remedies are also available outside of a formal insolvency through the use of provincial fraudulent conveyance and preferences legislation.[94]

Canadian law provides criminal sanctions for the fraudulent activities of directors, however it is difficult to determine the extent to which such sanctions are imposed in the context of phoenixing. In the normal course, if the Office of the Superintendent of Bankruptcy receives a complaint in relation to phoenix activity, a referral is made to the Royal Canadian Mounted Police for investigation. However, no reliable data is available regarding the frequency or effectiveness of such investigations.[95]

The liability of directors and officers of the company is not necessarily extinguished when a company ceases trading. Canadian law specifically assigns personal liability to directors for source deductions and GST, although directors may avoid personal liability if they can establish that they exercised a reasonable degree of care.[96]

Canadian company law does very little to protect creditors from repeated reckless behaviour and wrongful conduct of phoenix directors. There is currently no disqualification scheme in place and no public register of directors of failed companies exists. Although the concept of a register has been discussed, the idea is not widely supported.[97] Girgis (2009) urges incorporation of a disqualification scheme into the federal insolvency provisions, commenting that the director disqualification scheme in the UK has had more success in protecting creditors than any existing Canadian measures.[98]

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[92] Appleby (2004)
[93] Appleby (2004), p.29
[94] Girgis (2009)
[95] Appleby (2004), p.30
[96] Bomhof (2009), p.5
[97] Ibid, p.30
[98] Girgis (2009)

6.3 Ireland

The Office of the Director of Corporate Enforcement (ODCE) is responsible for developing legislative measures to counter phoenixing activity in Ireland. The Irish tax authority, Revenue, is generally the primary creditor of phoenix companies. Revenue manages this growing tax risk by monitoring a list of some 400 companies that exhibit certain common characteristics of the phoenix syndrome. However, the monitored segment is believed to represent only a small fraction of the annual incidences of phoenixing in Ireland.[99]

For two decades Ireland has been vigorously pursuing economic growth through corporate investment. A liberal corporate regime is designed to attract foreign direct investment and encourage individuals to take advantage of corporate entities to engage in business ventures.[100] At 12.5%, Ireland's corporate tax rate is amongst the lowest in the world. Company formation costs are low at around €500. In the ten year period up until 2005, Ireland's strategy enabled it to attract five times as much foreign direct investment as Australia.[101] This substantial influx of capital has enabled Ireland to achieve economic growth way in excess of the rest of the EU. Unfortunately, the policies that promoted growth in corporate investment have also realised an increase in the abuse of the privilege of limited liability. One report from Revenue estimated a tax gap of €140 million due to phoenixing.[102]

The ODCE believes that a rise in phoenixing is partly attributed to a recent decline in the stigma associated with insolvency.[103] Ireland employs a bond provision to help prevent offshore abuse of corporations. Under section 43(3) of the Companies (Amendment) (No.2) Act 1999, companies that have no Irish resident directors are required to lodge a bond of around €25,000. Serial phoenix offenders tend to be residents however, so this response arguably has limited effect on the phoenixing syndrome. A person is eligible to be appointed a director providing they are not an undischarged bankrupt or otherwise prohibited or restricted by the Companies Act.[104] Like other jurisdictions, the lack of any specific qualifications or standards to become a director has been highlighted as a possible contributing factor in the growth of phoenixing.[105]

While theoretically there is no automatic inhibition of a person acting as a director as a result of insolvency, Ireland's insolvency law prescribes that a liquidator must report to ODCE on the conduct of the director within six months of being appointed. The liquidator is subsequently required to instigate High Court proceedings for the restriction of all company directors *unless* the ODCE grants relief from making this application.[106] The director must satisfy the court that they acted responsibly and honestly in their conduct of the company or face restriction under section 150 of the Companies Act.[107] A restricted director cannot be a director of a company unless that

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[99] Appleby (2004), p.37
[100] Ibid, p.38
[101] Gruen (2006), p.12
[102] Appleby (2004), p.38
[103] Ibid, p.38
[104] Companies Act (1990), s.150
[105] Appleby (2004)
[106] Company Law Enforcement Act (Ireland) 2001, s.56
[107] Companies Act 1990 (Ireland), s.150

company is capitalised to approximately €63,500 for a private company and €317,500 for a public company.

Authorities around the world are frequently frustrated by the resources expended, and the difficulties involved, in building cases against phoenix operators in order to have courts impose restrictions and interrupt the cycle of phoenixing. Ireland's unique approach reverses the burden of proof and frees up compliance resources. Honest directors who wish to pursue future ventures under a corporate structure are entitled to prove their case before a judge. Serial phoenix operators are thwarted because of the capitalisation rules that ensure substantial equity that creditors can access in a future liquidation.

The Companies Act provides an automatic five-year director disqualification where a person (director or otherwise) is convicted on an indictable offence in relation to a company or involving fraud or dishonesty.[108]

Phoenix activity in Ireland is primarily detected and reported by creditors.[109] However, as with other jurisdictions, phoenix companies tend to arrange to discharge their key trade creditors prior to falling under administration. Trade creditors in Ireland seem prepared to continue to deal with phoenix companies if their losses have not been substantial. Legal action against fraudulent preferential payments is available, however ODCE believes the prevailing feeling amongst creditors to be that there is little point in pursuing such action.

There is no mandatory requirement for insolvent companies to undergo liquidation in Irish company law. Until the introduction of the ODCE, there was a distinct lack of resources available to investigate corporate failures and the risk of phoenixing being detected and prosecuted was insignificant. The ODCE is entitled under the Companies Act, to conduct its own investigations and seek sanctions against phoenix activity by applying insolvency and winding up provisions relating to:

- criminal and civil liability for fraudulent trading (s297)
- civil liability for fraudulent preference (s286)
- civil liability for director malfeasance (s298)
- criminal liability for transfer of assets with intent to defraud creditors (s295)

However, obtaining proof of fraud is extremely difficult and as a result, there have been few instances of personal liability being imposed on directors of phoenix companies in Ireland. Revenue has instigated a number of initiatives to counter phoenixing in problem industries. For instance, public bar licence renewals require a tax clearance certificate, which will not issue if there is an outstanding tax obligation.[110]

Revenue's approach to the phoenix problem is proactive. Strategy is integrated across organisational departments and utilises cross functional and external intelligence.

[108] Ibid, s.160
[109] Appleby (2004), p.40
[110] Taxes Consolidation Act (Ireland) 1997, s.1064

Phoenix activity is identified at the earliest possible stage. Rapid follow-up action is instigated to prevent the build up of tax arrears, fraudulent and reckless trading is aggressively pursued in the courts, and a rigorous monitoring program of identified high-risk directors is implemented.[111] A 'commonality check' uses data matching techniques to compare companies with current tax arrears with companies that have been liquidated to detect the presence of common directors.[112]

6.4 New Zealand

New Zealand's corporate regulatory system recognises the national need to encourage entrepreneurship. The incorporation processes is inexpensive and simple, which enables the swift establishment of new companies in the event of the failure of an antecedent company.[113] New Zealand poses few restrictions on the incorporation of new companies. There is no minimum capital requirement and few limitations on who may become a director.[114] There are no mandatory qualifications or training requirements for a company director.[115] A company can be established over the Internet, across borders, for a fee of $NZ160. The comparative ease of incorporating in New Zealand [116] is beginning to cause concern for other jurisdictions, who are detecting an increase in use of New Zealand registered labour supply companies[117] to facilitate phoenixing in Australia.[118]

The Official Assignee acknowledges a lack of definitive data on the extent of the phoenixing phenomenon in New Zealand. [119] Anecdotal evidence suggests that suppliers and Inland Revenue (IR) are the parties most significantly affected.[120] While there is still some stigma associated with business failure, creditors tend to be pragmatic about dealing with new entities despite previous mismanagement or bad faith interactions.[121]

Detection of phoenixing in New Zealand up until the late 1990s largely depended on referrals from disaffected creditors. This approach proved ineffectual as creditors were generally apathetic, believing that reporting phoenixing would not result in any benefit to them. The prominent corporate failure of New Zealand Stevedoring Ltd in the late 1990s helped to garner the attention of law makers on the phoenixing phenomenon. In 1999, the Ministry of Economic Development announced that the issue of phoenix companies would be targeted in a review of the insolvency law. The Minister of Commerce released a Cabinet Paper in late 2003 which acknowledged that phoenix arrangements were not always counter to stakeholder interests.[122] The paper recommended the introduction of restrictions on directors re-using the trading names

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[111] Extract from the Office of the Chief Inspector of Taxes, Tax Briefing, Issue 24, revised January 2002.
[112] Irwin (2004)
[113] Appleby (2004), p.56
[114] See Companies Amendment Act (NZ) 2006, s. 368
[115] Appleby (2004), p.56
[116] compared with the Australian registration process, which requires submission of certified copies of relevant validating documentation and costs at least $AU4,000
[117] See discussion under heading *Labour hire method* on p.8
[118] ATO (2010), p.3
[119] Appleby (2004), p.57
[120] Ibid
[121] Ibid
[122] Office of the Minister of Commerce (2003), para 3

of insolvent companies, along the lines of the United Kingdom *Insolvency Act 1986.*[123] A contemporary report on the effectiveness of UK Company Law had concluded that incidence of phoenixing had been reduced by the changes introduced in 1986.[124] The Cabinet Paper accepted that the proposed provisions could not create a widespread restriction on the re-use of the name of insolvent companies; neither would they eliminate the abuse of phoenix companies.[125] Regardless, the decision was taken to implement the provisions in New Zealand corporate law.

New Zealand law prohibits a person from being a director of a phoenix company within a certain period of being a director of a failed company, unless that director has been granted leave of the court.[126] The prohibition is not calculated to prevent the re-use of a company or business name as such, simply the recycling of a company name by a director of the failed company. It does not attempt to restrict transactions by delinquent directors with new companies which have no relationship with the failed company. However, the sale of any asset, including goodwill, by a director at undervalue to another company, with which that director is associated, if done in bad faith will contravene the Act.[127] The offence is not circumvented by adopting a non-corporate form for the new business. The prohibition extends to involvement in any business that has an identical or similar name to a failed company.[128] This prevents the exploitation of any goodwill of the failed company that is attached to its name.

If a director has been involved in one or more failed companies, the Act empowers the Registrar of Companies to disqualify that person from acting as a director, if the Registrar is satisfied that there has been mismanagement on the part of the director.[129] Where there have been two or more failures in a five year period, the onus of proof is on the director to demonstrate that there has been no mismanagement.[130] Failed directors are not only prohibited from being an active director but also from being directly or indirectly involved in the formation, promotion or management of a subsequent phoenix company.[131] This legislative approach attempts to stymie the often used tactic of shadow directorships.

The legislation provides a mechanism for directors to capitalise on any goodwill in the failed company name, if the new company qualifies as a *successor company* and is named in a successor company notice.[132] A *successor company* is a company that acquires the whole or a substantial proportion of the business of the failed company, provided that the acquisition is arranged by a liquidator or receiver or under a deed of company arrangement.

It is an offence for any director to do anything that causes material loss with intent to defraud any creditor.[133] This targets intentional acts by directors to defraud creditors and so should not capture directors engaging in legitimate company reconstructions.

[123] Ibid, para 44
[124] Ibid, para 49
[125] Ibid, paras 48-52
[126] Laughton (2007); Companies Act (NZ) 1993 s. 386A
[127] Companies Act (NZ) 1993 s.380(2)
[128] Ibid, s.386(1)(c)
[129] Ibid, s.385
[130] Appleby (2004), p.58
[131] Companies Amendment Act (NZ) 2006, s.386A(1)
[132] Companies Amendment Act (NZ) 2006, s.386D(2)
[133] Companies Amendment Act (NZ) 2006, s.380

While the proposal to create a new criminal provision was widely supported in submissions to the Insolvency Law Review, concerns have been raised about the potential for prosecution successes given the required standard of proof of intent on the part of the director. The provision of a criminal penalty of up to five years imprisonment and a fine of up to $200,000 serves as a significant deterrent.[134]

In 1999 the Official Assignee and the Registrar of Companies established a joint National Enforcement Unit which carries out prosecutions under the Companies Act and prepares reports on candidates for director disqualifications.[135] To date there has been only one successful prosecution directly related to managing a phoenix company, which resulted in a 5 year disqualification and a $500 fine.[136] Enforcement has been hampered by the high cost of running legal proceedings, low levels of action from enforcement bodies and uncertainty amongst creditors that legal action will succeed.[137]

6.5 United Kingdom

The compliance approach in the UK recognises that not all business regeneration is unhealthy. Phoenixing is viewed as an abuse of the privilege of limited liability and sanctions focus only on those who abuse the corporate form, leaving innocent failed directors free to learn from their mistakes and persevere.[138] Responsibility for administering UK insolvency laws and carrying out investigations rests with regional Insolvency Services.[139] Much of the recent change in UK insolvency legislation has centred on rescuing viable companies and encouraging victims of honest failure to try again. Although acknowledged as a problem in England and Wales, the Insolvency Service of Northern Ireland has downplayed the impact of phoenixing within their jurisdiction.[140]

The focus of UK compliance enforcement action has been on detecting director misconduct in the transferring of assets, including goodwill, of the failed company. Like many regions, the UK places a heavy reliance on insolvency practitioners to identify director malfeasance during the investigation phase of the liquidation.[141] Liquidators have a statutory duty to report any apparent criminal offences by the directors of companies in liquidation.[142]

Under UK law, the courts can disqualify unfit directors for periods of between two and fifteen years, however precedent shows that substantial evidence is required to achieve disqualifications.[143] Companies House maintains a *Register of Disqualified Persons*. Anyone who acts as a director while disqualified is held personally liable for all company's debts and is additionally liable to a penalty of up to two years

[134] Keeper (2008)
[135] Appleby (2004), p.59
[136] See Donovan case discussed at http://www.business.govt.nz/companies/about-us/enforcement/conviction-results/1-july-2009-30-june-2010
[137] Appleby (2004), p.57
[138] Ibid, p.31
[139] The UK has three insolvency regions – combined England and Wales, Northern Ireland and Scotland
[140] Appleby (2004), p.61, 65
[141] Ibid, p.32
[142] Insolvency Act (UK) 1986, s.218(4); Insolvency Act (UK) 2000, s.10
[143] Company Director Disqualification Act (UK) 1986, s.18

imprisonment.[144] Approximately one quarter of all director disqualifications in the UK is related to phoenix activity.[145]

While the insolvency legislation contains claw-back provisions to recover misappropriated assets, all too frequently there are insufficient residual company funds to enable the liquidator to undertake the necessary legal action. The UK government makes no specific provision of public funds to permit investigations of phoenixing in assetless companies.[146] However, the Financial Services Authority, which has a wide range of rule-making, investigatory and enforcement powers to promote fair markets and business capability and effectiveness, has indicated its preparedness to intervene and invest resources to deal with complaints against phoenix activity where a company has left insufficient provisions to enable a thorough investigation.[147]

Another key feature of the UK's compliance strategy is to prevent the undervalue transfer of goodwill to the new company. UK legislation makes it a criminal offence for any director of an insolvent company to reuse the company's name, or a similar name, within five years of the insolvency unless the director first obtains the leave of the court.[148] The ban extends to anyone who has been a director of the insolvent company in the twelve month period before the date of liquidation. A director in breach of this legislation becomes personally liable for the debts of the former company and risks imprisonment and/or a fine.[149]

This legislation was specifically introduced to address the rising incidence of phoenixing in the UK. Its purpose is to prevent the undervalue transfer of goodwill to the new company. However, the "anti-phoenix" provisions of the Insolvency Act are widely drafted, leaving broad scope for judicial interpretation. Recent case law has revealed that the effect of the legislation goes beyond the phoenixing situation and creates a strict liability regime where non-compliance occurs. The courts confirmed that there is no requirement for creditors to have been disadvantaged in relation to the act of using the name. It is sufficient for the act to have occurred.[150] In Ricketts v Ad Valorem Factors Ltd [2003] a successor company was trading under a similar name to that of the failed company. The central issue under consideration was whether the successor company's name was a prohibited name for the purposes of the act. In this case there was no under-value transfer of assets between the failed company and the successor company. There was no evidence that the companies were used to incur debts and avoid liabilities, nor was there any evidence that creditors of the failed company had been misled by the similarity of the two names. Notwithstanding this, the court found that the director was in breach and, accordingly, was personally liable for all the debts of the successor company.[151]

[144] Quainton (2008); The Insolvency Service (2004), p.3
[145] Appleby (2004), p.61
[146] Ibid, p.65
[147] Lord (2005)
[148] Insolvency Act (UK) 1986, ss.216-217 *'Restriction on Re-use of Company Names'*; also Insolvency Order (Northern Ireland) 1989 – Article 18
[149] Appleby (2004), p.32
[150] Kean, F. & McLauchlan, R. (2009)
[151] Ricketts v Ad Valorem Factors Ltd [2003] EWCA Civ 1706; [2004] 1 All E.R. 894

At an administrative level, HMRC readily acknowledges that phoenix companies pose a higher than normal risk to revenue. To mitigate this risk procedures are employed to flag 'successor' (phoenix) companies, in circumstances where the liquidated company has avoided a revenue debt of £10,000 or more and the successor company is engaged in the same industry.[152] The flag promotes the full use of available intelligence to highlight issues at a very early stage and manage compliance of the phoenix company. The flag ensures a PAYE scheme is initiated for the new company. It also ensures an escalated tax debt recovery process is implemented. The PAYE regulations provide for HRMC on the basis of previous payment history to insist on payment of an unremitted PAYE withholding within seven days.[153] These measures proactively monitor the activity of high-risk 'successor' companies and prevent a subsequent excessive buildup of unremitted tax before HMRC initiates insolvency proceedings.

The Higgs Review in 2003 examined the role and effectiveness of non-executive directors in the UK. One of its key recommendations was the development of a code of conduct for non-executive directors to outline their responsibilities and increase their effectiveness.[154] The establishment of a code of conduct for directors of closely held companies might go some way towards combating phoenixing by articulating the behaviours expected of directors of insolvent companies.

6.6 United States

The Global Financial Crisis had a marked impact on the level of insolvency in the US. Business Reorganisations under Chapter 11 of the insolvency code more than doubled during the first half of 2009.[155] Chapter 7 Business Liquidations increased by more than 50% in the same period with some 20,375 filings.[156]

The US does not define phoenixing in its statutes.[157] However, the United States Trustee Manual provides a description of 'parallel entities' that closely aligns with phoenixing.[158] The activities that facilitate phoenixing are prosecuted under a variety of civil and criminal legal actions. The law imposes a fiduciary duty on the officers of an insolvent company to act in the interests of the company's creditors. Under the federal bankruptcy system, the officers of a company are obliged to disclose under oath any transactions that may expose phoenix activity.[159] The trustees of the liquidation are empowered to conduct enquiries and examinations to detect and rectify phoenix transactions.[160]

The US criminal code contains wide-ranging provisions to deal with the criminal conduct of directors under a bankruptcy process.[161] Notwithstanding this, referrals to

[152] HMRC, Insolvency Manual, INS1121 – Insolvency and Insolvency Practitioners
[153] Income Tax (Pay as You Earn) Regulations (UK) 2003, s.78
[154] Financial Reporting Council, Good practice suggestions from the Higgs Report, June 2006
[155] Chapter 11 filings for first two quarters of 2009 numbered 7,396 compared to just 3,470 during the same period of 2008
[156] See American Bankruptcy Institute website at: http://www.abiworld.org/AM/Template.cfm?Section=Home&TEMPLATE=/CM/ContentDisplay.cfm&CONTENTID=58407
[157] Appleby (2004), p.68
[158] US Trustees Manual, s5-10.3.1.3 *Parallel Entities*
[159] See http://www.uscourts.gov/bankform/form7.pdf
[160] Federal Rule of Bankruptcy Procedure 2004
[161] US Code - Title 18, Part 1, Chapter 9, *Bankruptcy*, ss.150-158

the US Attorney by the US Trustee program are rare and prosecutions rarer still.[162] The Administrative Department of the US Court suggests that this may be due to the availability of other criminal and civil legal avenues to redress phoenixing activity in the US legal system, but it also acknowledges that resource constraints on regulators hamper compliance action against phoenix operators. For this reason, most remedies are instituted by the liquidator and are therefore ultimately financed by the creditors. No public funding exists in the US to carry out investigations on assetless liquidations, which permits an unknown number of phoenix operators to slip through the compliance net.[163]

The collapse of major corporates such as Enron and WorldCom during the first decade of 2000 created uproar in the US and resulted in sweeping reforms to corporate governance in the form of the Sarbanes-Oxley Act. Although the Act was not specifically targeted at phoenixing, it is inevitable that a tightening of corporate practices is likely to have a positive impact on the phenomenon.[164]

The US Bankruptcy Code permits the reorganisation of businesses in financial trouble, as an option to resorting to liquidation. Under a Chapter 11 reorganisation, the existing management remains in control of the business as a debtor in possession, although they are subject to the oversight of the court. The court is able to grant partial or full relief from many of the company's liabilities. If the business has negative equity, the owners' rights and interests in the business are ended and the creditors assume ownership of the reorganised company. Chapter 11 intrinsically recognises that often the value of a business is greater if sold in tact as a going concern rather than broken down into its composite assets. The reorganised company can be retained, in which case creditors swap their debt for equity in the reorganisation. Alternatively, the revamped company can be sold as a going concern with the net proceeds of the sale distributed pro rata to the creditors.[165]

Critics assert that Chapter 11 fails on economic efficiency grounds. The leniency it affords promotes incompetent management. Companies operating under Chapter 11 trade under the protection of the court, which distorts the market and disadvantages competitive businesses. Yet another criticism focuses on the potential increase in the cost of capital resultant from the forestalling of creditors' rights.[166] Notwithstanding these criticisms, providing an avenue for creditors to take control and reorganise a failing business for their own advantage has enormous potential to preserve value for creditors and prevent phoenix operators from syphoning off key assets to their own advantage, particularly the goodwill of the business, which often evaporates in the insolvency process.

7. Evaluating The Solutions

No single solution is likely to bring about an end of the phoenixing syndrome. The problem is extremely complex and requires careful consideration of competing agenda. It is of profound importance that the solution should not undermine genuine entrepreneurial spirit and commitment to the principles of incorporation. A holistic

[162] Appleby (2004), p.69
[163] Ibid, p.69
[164] Sarbanes-Oxley Act (2002)
[165] Swanson et al (2008), Ch.3
[166] Haidar (2009)

approach is required which clearly enunciates the issues, coordinates compliance efforts, reduces opportunity, eradicates phoenixing benefits, enhances lead-time detection and mitigates any residual negative effects of phoenixing.

7.1 Legal definition, legislative change and agency responsibilities

It is clear from the international experience that the development of anti-phoenixing measures is heavily influenced and constrained by concerns about stifling entrepreneurship. The term "phoenixing" is seldom mentioned across the spectrum of international taxation and corporations' legislation. Definitions are rarer still.[167] The legislation dealing with the phoenixing phenomenon tends to be disjoint, split between tax authorities and corporation watchdogs, which makes detection and enforcement problematic.

Defining phoenixing at law is an essential precursor to combating the syndrome. A legal definition might reasonably include indicia of both acceptable and unacceptable business reconstructions to reaffirm the validity of genuine reorganisations. However, legislative design needs to follow a coherent principles approach rather than a black letter drafting style. Clear articulation of the legislative intent in the drafting of the law will reduce complexity and prevent the development and exploitation of technical loopholes by enabling judicial decisions to adapt to changing circumstances.[168] Equally, legislation must provide certainty for those directors of failed companies who wish to engage in legitimate business reconstructions. In particular, the legislation should recognise illicit phoenixing as a criminal offence of fraud on the creditors of a company and provide a penalty regime on par with fraud offences of comparable magnitude.

It is important that individual government agency responsibilities in relation to the monitoring and prosecution of phoenixing be clearly articulated in the legislation and the interfaces between agencies outlined in memoranda of understanding. Where appropriate, jurisdictions should look at implementing an inter-agency/cross-functional phoenix task force to synergise agency technical capabilities, intelligence resources and enforcement powers. This is likely to result in more efficient and effective application of resources.

7.2 Protecting legitimate reconstructions

The literature demonstrates a universal recognition that the legitimate reconstruction of ailing businesses often maximizes stakeholder outcomes. The difficulty lies in determining when a reconstruction is in the public interest and when it is a mere sham to facilitate fraud.[169] Legitimate reconstructions should be supported. Bogus reconstructions should be quashed. The government should consider the benefits that would result from a formal legal process for reviewing and sanctioning bona fide company reconstructions. Such a mechanism could be expected to include legislation, policy and guidelines and a formal independent review panel to examine and approve corporate reconstructions. The mechanism would assure the probity of insolvency transactions and provide certainty to directors wishing to engage in honest business rehabilitation. Ideally, the process should be administered by appropriately skilled

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[167] Appleby (2004)

[168] Pinder (2005), p. 77

[169] See Jones (2010) for a full discussion on the reconciliation of commercial and public interests

management specialists, rather than judges, who may not have the business expertise necessary to distinguish between a legitimate and fraudulent reconstruction.

7.3 Detection and response

The compliance approach adopted to combat phoenixing must be comprehensive - strategic and tactical, proactive and reactive. From a top-down perspective the strategy must target known high-risk industries, regions and individuals. Processes must support early detection and rapid reaction. Where possible, compliance responses, such as the early issue of director penalty notices, should be automated to tighten the compliance net and reduce the burden on limited resources. At the same time, from the bottom-up, lead-time data needs to be collected and synthesised into intelligence, which in turn will inform the strategy as to emerging risks.

Importantly, compliance strategies should adhere to regional compliance models and support the political objectives of encouraging legitimate entrepreneurial risk taking under the protection of corporate limited liability. Processes and systems must support and encourage those directors generally willing to comply and strong enforcement action taken against the worst serial phoenix offenders.[170]

Phoenix compliance teams need to make the best use of the full ambit of available intelligence. To the end government agencies need to foster partnerships with other government and non-government organisations, such as credit reference associations and industry associations. This approach offers the opportunity of real-time intelligence and the development of prospective indicia of emergent phoenixing risks. Information from these sources will prove invaluable for data matching and profiling of phoenix operators. Several jurisdictions have shown benefits from monitoring acknowledged indicators of phoenix preparation.[171] The strategic sharing of data related to non-lodgment and unpaid tax liabilities between tax and corporate enforcement authorities would help trigger compliance activity across both spheres. The adoption of a tax clearance certificate, such as that employed in Ireland, could be made a condition of continued annual company registration. However, this policy may be less effective than a simple program of expeditious debt enforcement action from within the tax authority. Currently, a raft of Australian legislative restrictions thwarts interagency communication, hindering the detection and prosecution of phoenixing offences. There is a need to revisit secrecy and exchange of information laws with a view to removing this blocker to effective enforcement against phoenixing.[172]

Tax and corporate authorities need to cooperate to ensure that robust automated data matching occurs against the restricted/disqualification register to ensure that disqualified directors cannot register a company. Suspected phoenix operators must be identified at an early stage and flagged on tax administration systems.[173] The flag should trigger a high-risk response to non-lodgment and/or unpaid tax liabilities by way of high-level monitoring, early intervention and escalated debt recovery. The production of directors' penalty notices, holding the director personally liable if tax

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[170] See ATO Compliance Model at http://www.ato.gov.au/corporate/content.asp?doc=/content/5704.htm
[171] the UK's flags identified successor companies
[172] Cole (2003), p.165
[173] HMRC, Insolvency Manual, INS1121 – Insolvency and Insolvency Practitioners

debt is not cleared within a prescribed period, should be automated and issued at an early stage where phoenixing is suspected and/or flagged.

7.4 Directors' liability for non-remission of collected tax

At a legislative level, there is a credible argument that directors' should be held personally liable for non-remission of taxes as per the Canadian approach.[174] The basis of this view is that GST collections and tax withholdings are not liabilities in the same manner as trade creditors are. These moneys are collected in good faith from customers and employees who have the expectation that they will be remitted to the government as tax. The non-remission of these funds, either because they have been allocated for business or for personal use, is effectively a misappropriation of funds for which the director arguably should be held personally accountable.

The international experience reveals that tax administrations are overwhelmingly the foremost victim of phoenixing. Holding directors personally accountable for the taxes that they collect would eliminate a substantial benefit of phoenixing and thus should significantly reduce the extent of the phenomenon. It must be acknowledged however, that this measure would also no doubt act as a significant disincentive to entrepreneurs who currently enjoy the option of utilising tax withholdings to overcome periodic cash flow problems or as initial capital funding of the business. Further analysis is required before the efficacy of such a policy can be accurately assessed.

7.5 Double-dipping of withholding taxes

Legislation should include a provision to ensure that PAYG withholding credits are denied to directors to the extent that they are not remitted. This prevents 'double dipping' of phoenixing directors who misuse the PAYG withholding system to dishonestly allot themselves large income tax credits. Similarly, GST credits should be denied between companies in business groups where a former company has phoenixed to prevent abuse of the GST system. Grouping provisions should look through the corporate veil into the successor company for misappropriated assets where phoenixing is proven.

7.6 Investigation of assetless companies

Publicly funded investigations have proved effective in overcoming the issue of phoenix directors stripping company funds to prevent detection of their malfeasance. Conceptually, a liquidator is expected not to engage in a course of action if it is unlikely to produce a worthwhile benefit for the creditors.[175] Moreover, liquidators, being commercial operators, are reluctant to conduct any activity, such as an investigation or legal action, for which they are unlikely to be paid. The Assetless Administration Fund, implemented in Australia, has permitted director misconduct to be identified where it might otherwise have remained undetected. The overarching strategy to combat phoenixing must provide funding to permit investigations into suspected director misconduct especially when asset stripping has occurred. In many jurisdictions this means public funding of liquidator investigations.

[174] Bomhof (2009), p.5
[175] Economic References Committee (2010), p.100

Alternatively, the responsibility for investigating director misconduct could be allocated to a specialist government agency with appropriate investigative and forensic accounting capabilities and the power to prosecute misconduct. Interestingly, the UK has established the Companies Investigation Branch (CIB), which has wide investigatory powers and the statutory authority to request the court to wind-up rogue companies in the public interest without having to establish insolvency or breach of the law.[176] Having a dedicated corporate investigative department to look into director misconduct enables the robust and vigorous pursuit of phoenixing operators and also mitigates the risk of collusion between liquidator and director that exists under the current investigation scheme.

The self-sufficiency and longevity of any investigations program, whether performed by liquidators through the Assetless Administration Fund or by a new government agency, could be underwritten by imposition of a levy on corporate registration fees and by channelling the proceeds of directors' fines back into investigations.

7.7 Strengthening the penalty regime

Overall, it is readily apparent that the current penalty regime needs strengthening. The penalties administered by the courts in recent phoenixing cases seem incongruous with the nature of the offence, which is in reality a fraud. The absence of a strong deterrent effect is undoubtedly contributing to the growth of the phenomenon.[177] Low conviction rates and light penalties reinforce the belief amongst directors that phoenixing is a low-risk activity with big rewards.[178] The clear articulation in the legislation that phoenixing is a fraud, with penalty provisions that correspond with the seriousness of the offence, is therefore essential to provide a disincentive for directors considering participating in phoenixing.

7.8 Improving the qualifications of directors

Low qualification requirements for directors are a common feature of the phoenix problem across jurisdictions. Some countries have gone some way towards tackling this problem. The UK has issued a set of guidelines that outline the full ambit of director responsibilities, especially in relation to duties to act in good faith and with due diligence. The establishment of guidelines which outline what is permissible and what is fraudulent in corporate reconstructions would be a further step in the right direction.

An International Association of Insolvency Regulators survey shows that few countries mandate any formal training for directors[179]. Phoenixing is usually characterised by a deficiency in the formal processes, records and systems that are typically found in a successful company administered by competent management. Most professional bodies, including medicine, law and accountancy, readily accept the necessity of ongoing professional development to maintain competencies and protect the integrity and legitimacy of the profession. The implementation of compulsory short courses would help to outline the responsibilities and duties of directors and explain the consequences for breaches of the Corporations Law. The development

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[176] See CIB website at: http://www.insolvency.gov.uk/cib/

[177] Salna, K. 'ATO anger over rising phoenix', *The Age*, 24 October 2009

[178] Ibid

[179] Appleby (2004)

and implementation of a mandatory qualification for people wanting to use the corporate form to run their businesses could also help to lift the skill levels and competence of directorship, promote an ethical approach to management and institute more robust corporate governance.

7.9 Arms-length asset transfers

A recurring theme in this paper is that the crux of the phoenixing problem is the undervalue transfer of assets from the failed company to the successor company. Because of the economic imperatives of insolvency, which include achieving the fastest possible reallocation of economic resources, given the highly specialised nature of assets under liquidation and the fact that the break-up of the assets during sale usually diminishes their overall value, liquidators will often have little alternative but to dispose of the business assets to the successor company.[180] An absolute prohibition on transfer of tangible assets to the original directors is almost universally seen as undesirable policy because it restricts the opportunity of achieving the highest price. However, stalking horse bids have been successfully employed in some jurisdictions to help ensure an arms length transfer price is achieved for creditors.[181]

The restriction of the re-use of business names of insolvent companies is a common feature in the insolvency regimes of some jurisdictions. Although various critics point to the fact that such legislation does not effectively prevent phoenixing,[182] it has been a valuable legal device to prevent the undervalue transfer of goodwill to directors of phoenix companies. The implementation of similar legislation to that adopted in the UK and New Zealand must be considered as a measure to ensure that creditors receive the full residual value of the insolvent company.[183] Restricting the re-use of business names has the added benefit of making the liquidation of phoenix companies more transparent to customers, creditors and employees and alerts stakeholders to heightened risk. A change in business name hints at discontinuity and draws the attention of stakeholders. The retention of the phoenix operator's customer bases and supply chains becomes more problematic. As a result, phoenixing becomes much less attractive as a first option for debt avoidance.

Pre-packing is becoming a common feature in insolvency, particularly in the UK.[184] Pre-packing is a business reconstruction process not dissimilar to phoenixing but with the repugnant features removed. The viable core of a failing business is saved, priced at market value, and transferred to a successor company. The proceeds of the sale of the business, which represent fair value of all valuable assets including goodwill, are transferred to the creditors. The new business is legislatively bound to take on the employee entitlement liabilities for the failed company, thus preserving employment. The pre-pack does not circumvent director investigations and disqualification

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[180] Ibid, p.63
[181] Groklaw website, '*SCO Has a Bid; Would Like More*' at: http://www.groklaw.net/article.php?story=20071023172159177
[182] Office of the Minister of Commerce (2003), paras 48-52
[183] Insolvency Act (UK), s.216;
[184] Cooper Mathews Website, *Phoenixing or Pre-packing*, at http://coopermathews.com/phoenixing.html

reporting to authorities. Pre-packing preserves the value of the goodwill of the failed company that would otherwise be eroded in a formal liquidation process.[185]

Whatever disposition strategy is adopted it must ensure the integrity of transactions involving both tangible and intangible assets. The liquidation process must balance the desire for fast redeployment of economic assets (and the swift remedy of liabilities) with obtaining the highest possible value return for creditors.

7.10 Automated restriction and disqualification regime

It is generally acknowledged that an effective restriction and disqualification regime plays an important role in reducing the incidence of phoenixing.[186] Under current Australian law, ASIC and the courts have specific powers to prevent inappropriate people from acting as directors. However, the process is slow and costly with the onus of proof resting on the enforcement agency. Few directors are disqualified and, when they are, the periods of disqualification are inconsequential. Recalcitrant directors can readily operate with low risk of detection through shadow directorships, with family and associates ostensibly at the helm of their businesses.

The implementation of a two-tiered regime providing for restrictions as well as disqualifications of directors helps to balance the competing policies of tackling phoenixing whilst encouraging enterprise using the corporate form. The restricted category permits a high-risk person to act as a director of a successor company under certain strict conditions that help mitigate the risk of future phoenix activity, such as the lodgment of a substantial bond.

The Irish system automates the restriction/disqualification process and shifts the onus of proof from the enforcement agency onto the failed directors, who are required to show cause why they should not be restricted or disqualified and proving that they acted with due diligence and in good faith. This approach frees up significant enforcement agency resources and provides a guaranteed review of the actions of directors who wish to continue their entrepreneurial endeavours using the corporate form. Automating the disqualification process is a sound strategic approach and furthermore reduces the risk of passive or even complicit liquidators failing to report on rogue directors.

7.11 Minimum capitalisation

The establishment of a minimum capitalisation requirement for restricted directors reduces the likelihood of that director phoenixing a successor company. The Irish system requires a closely-held private company with a restricted director to have minimum liquid assets of around $100,000 AUD. This provides a healthy buffer for creditors to call on should a company begin to commit acts of insolvency, such as failing to pay liabilities as and when they fall due. Australia's present bond provisions are inadequate and not sufficiently targeted to address phoenixing; however they could be expanded to expedite payment of phoenix related tax liabilities.[187]

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[185] See Carter Clark website, Pre-pack Administration, at http://www.carterclark.co.uk/index.php?section=39&page=2237

[186] Appleby (2004), p.62; Girgis (2009)

[187] See Bond Provision, Income Tax Assessment Act 1936 s.213

7.12 Reliance on creditors to initiate action

Most enforcement systems around the world place an unrealistic expectation on creditors to identify and report incidences of phoenix. While creditors are certainly in an ideal position to recognise a phoenixing situation, there are serious doubts as to whether this strategy is effective in detecting phoenixing. Directors often diffuse this risk by conferring preferential payments to placate angry creditors. Many creditors simply accept phoenixing as a business risk, building the cost into their pricing. Generally, creditors perceive little benefit in reporting a phoenix activity.[188] Pursuing an insolvent company independently and driving it into administration incurs significant legal costs for the creditor whilst leaving them on an even footing with all other creditors. Creditors who fund actions against phoenix companies should be granted priority at law. Inevitably the policy of relying on creditors to report phoenixing is flawed and detection by enforcement agencies must become more proactive and intelligence based.

7.13 Probity of the Insolvency Profession

The efficacy of the insolvency regime is fundamentally reliant on the skills and ethical standards of the insolvency profession. The Insolvency Practitioners' Association of Australia (IPAA) sets out core values and ethical standards in an effort to maintain the legitimacy of the profession and preserve its autonomy.[189] However, the IPA has no formal powers to investigate complaints against practitioners and membership is voluntary.[190] The recent Australian Senate Inquiry into Liquidators and Administrators concluded that self regulation of the profession is failing.[191]

There is a widespread belief that the insolvency profession in Australia is riddled with problems.[192] Surprisingly, Australia has virtually no publicly available data on insolvency. In contrast, other regimes around the world collect a variety of data to measure the effectiveness of their insolvency processes. For instance several countries monitor liquidator fees as a ratio of value returned to creditors, as a metric of the efficacy of the insolvency profession.[193] Australia's abject failure to collect similar data needs to be addressed to enable comparisons of our insolvency industry against international benchmarks.[194]

The supervision of Australia's insolvency profession has been roundly criticised in a recent Senate Inquiry into the profession. Disciplinary proceedings in relation to liquidator misconduct in Australia are rare especially in relation to the number of complaints made.[195] Between July 2006 and December 2009, ASIC received 1647 complaints against insolvency practitioners. With less than 600 insolvency practitioners registered in Australia, this represents an average of nearly three

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[188] Appleby (2004)

[189] See Code of Professional Practice at: http://www.ipaa.com.au/user/docs/codes/Code%20of%20Professional%20Practice%20%20-%20FINAL.pdf

[190] Approximately 15% of insolvency professionals are not affiliated with IPAA

[191] See Senate Enquiry into Liquidators and Administrators, chapters 5 & 6

[192] See submissions to the Senate Enquiry into Liquidators and Administrators at: http://www.aph.gov.au/Senate/committee/economics_ctte/liquidators_09/submissions.htm

[193] Economic References Committee (2010), pp.121-122

[194] Ibid

[195] Ibid, p.50

complaints for every practitioner.[196] The Cole Royal Commission raised concerns regarding the complicity of liquidators in advancing and promoting phoenixing schemes.[197] In recent years, the Companies Auditors and Liquidator's Disciplinary Board (CALDB) has reported a limited number of instances where liquidators were proved to have ignored conflict of interest rules.[198] Of thirteen disciplinary cases proven against liquidators since the inception of CALDB, only two have resulted in suspensions of more than two years.[199]

Insolvency firms have been accused of 'touting' for business[200] and promoting phoenixing as a legitimate business practice; a common-place tactic to disencumber debt, rather than a process of the last resort.[201] Insolvency is a lucrative profession. The larger Australian insolvency firms each take more than $4 million per year in fees, providing partner earnings which are significantly greater than those of comparable leading corporate law firms.[202] The remuneration system for insolvencies has been subject to abuse from unscrupulous practitioners unduly prolonging liquidation proceedings to the detriment of creditors.[203] In theory, questionable insolvency fees may be subject to the review of a court or a professional body. In practice however, there is a considerable financial burden on any creditor initiating such a review, especially in situations where other creditors are unwilling to share the cost of the review. The implementation of a prescribed insolvency fee schedule and a robust practice note will help prevent abuses of the fee system. The remuneration scheme should prescribe an automatic independent review of liquidators' fees outside of practice note parameters with the costs of such a review to be borne by the liquidator if they are found to be excessive.[204]

The integrity of the insolvency profession has been called into question with instances of liquidator complicity in phoenix activity across the international scene.[205] In Ireland, evidence has been tendered of liquidators deliberately depressing the value of company assets prior to their sale to phoenix companies.[206] Incidences of liquidator misconduct, including fraudulent billing and collusion in permitting false creditor claims to be lodged against companies under liquidation, have emerged in the Australian context in recent years.[207] A UK television documentary highlighted questionable practices and regulatory inaction in the insolvency industry in that jurisdiction.[208] The programme used covert filming to reveal that insolvency practitioners were readily offering questionable services and collaborating with

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[196] Ferguson (2010)
[197] Cole (2003), p.117
[198] See ASIC v Walker (06/VIC07) and ASIC v McVeigh (10/VIC08) on the CALDB website at: http://www.caldb.gov.au/CALDB/CALDBWeb.nsf/byheadline/Decisions?opendocument
[199] Economic References Committee (2010), p.50
[200] Parliamentary Joint Committee On Corporations And Financial Services, Improving Australia's Corporate Insolvency Laws, Issues Paper, May 2003, p.9
[201] UK TV Channel 4 'Dispatches' programme, broadcast 19th June 1996
[202] Economic References Committee (2010), p.100
[203] Gromec-Broc & Perry (2004), p.74; Economics References Committee (2010), pp.52, 100
[204] See Legal Fees Review Panel website at: http://www.lawlink.nsw.gov.au/lawlink/olsc/ll_olsc.nsf/pages/OLSC_lfrp
[205] Appleby (2004), p.41
[206] Ibid
[207] ASIC, *Liquidator (Stuart Ariff) Banned for Life*, Media Release 09-150AD, 18 August 2009
[208] UK TV Channel 4 'Dispatches' programme, broadcast 19th June 1996

directors to cover up fraud and facilitate phoenixing activity.[209] The UK Insolvency Service recently highlighted a lack of disclosure and transparency by the insolvency profession in the administration of pre-packs, with more than one-third of liquidators failing to meet basic guidelines protecting creditor interests.[210] A New Zealand Insolvency Law Reform discussion paper highlighted concerns about the supervision of the insolvency profession, and concluded up to 40% of New Zealand's insolvency practitioners might not meet adequate standards.[211]

The Corporations Law seeks to assure the independence of insolvency practitioners by a system which includes mandatory registration, qualification and skilling requirements, detailed legal responsibilities and established criteria for independence.[212] Insolvency professionals are prohibited from issuing inducements to members or creditors to obtain appointments.[213] However, because the vast majority of directors entering into voluntary administration elect to exercise their entitlement to appoint administrators of their own choosing, the independence of these relationships is called into question.

The ATO expressed concern that public confidence in the voluntary administration process may be undermined by a perceived absence of impartiality and advocated the implementation of a roster system for the appointment of administrators on a random basis.[214] The employment of a roster greatly mitigates the risk of conflicts of interest and the appointment of 'tame' liquidators by phoenixing directors and negates any direct benefit to any individual insolvency firm from promoting phoenixing. Such an approach however, requires overcoming a number of significant difficulties, including matching work allocations to insolvency firm capacities and competencies.

The failure of the insolvency regulatory system is reflected in the fact that the profession, the bulwark against phoenixing in most insolvency regimes, has comprehensively failed to arrest the phoenixing phenomenon. Moreover, there is strong evidence that liquidator misconduct is actually contributing to the problem.[215] There is strong stakeholder consensus that greater scrutiny of the insolvency profession is necessary.[216] Regulatory approaches driven by creditor complaints such as the one currently employed in Australia are ineffectual and lead to a weakening of community confidence, not just in the insolvency profession but the insolvency process also.[217] Creditors are generally not well-positioned to identify when misconduct is occurring due to a limited understanding of legislation, professional guidelines and the inner workings of individual insolvency processes.[218] When complaints are forthcoming, they are frequently poorly managed by regulatory bodies.[219] A proactive regulatory approach invloving profiling the industry, such as

[209] Cousins et al (2009), p.58
[210] McCulloch (2009)
[211] Business New Zealand (2004), p.3; Vance (2010)
[212] Corporations Act 2001, ss.448C, 532
[213] Corporations Act 2001, s.595
[214] Parliamentary Joint Committee On Corporations And Financial Services, *Improving Australia's Corporate Insolvency Laws*, Issues Paper, May 2003, Submission 14, p 3.
[215] Appleby (2004); Cousins et al (2009), p.58; UK TV Channel 4 'Dispatches' programme, broadcast 19th June 1996
[216] Economic References Committee (2010), pp.130-133, 147-149
[217] See Senate Enquiry into Liquidators and Administrators, chapters 5 & 6
[218] Ibid, p.66-68
[219] Ibid, p.70

that adopted in the UK, greatly improves the likelihood of identifying incompetence, misbehavior and complicity amongst liquidators in respect of phoenixing.[220] Regardless of the approach adopted, comprehensive monitoring of the insolvency industry is required to ensure liquidators are fulfilling their responsibilities in preventing the under-value transfer of assets which characterises and underpins all phoenixing activity.

The establishment of specialised insolvency regulatory authorities, distinct from the corporate regulatory authorities, which are frequently overstretched,[221] will enhance supervision of the insolvency profession and reduce the risks of under-value transfer of assets, excessive liquidator fees and liquidator collusion in phoenixing. The insolvency regulatory authority should have statutory powers to manage industry licensing, set ethical standards, policy and guidelines and monitor compliance across the profession. It would investigate complaints of misconduct, fix remuneration scales and review liquidators' fees. It could also review and sanction reconstructions to assure their integrity and provide certainty for successor businesses.

In Australia, the Institute of Chartered Accountants has recommended ASIC implement an inspection program similar to that which it operates over the auditing profession to assure the independence and probity of the insolvency profession.[222] Insolvency and Trustee Service Australia (ITSA) has proffered its own annual inspection program, used to monitor bankruptcy trustees, as a benchmark to be adopted by ASIC to monitor liquidators.[223]

The creation of an independent ombudsman with wide powers to investigate complaints is necessary to provide a high-level mechanism for the prompt, independent review of any contentious actions by insolvency practitioners during a liquidation process. An Insolvency Ombudsman's scope should, of course, extend to any activities by liquidators that facilitate phoenixing.

In many of the regions studied, tax authorities have the ability at law to install their own liquidators if they are the majority creditor. This is significant in that it opens up the possibility of establishing competitive partnering arrangements with panels of insolvency firms who would be more likely to act in the genuine interest of the creditors under a predetermined, cost-effective fee agreement. Tax administrations might also consider taking steps to develop an internal competency in liquidating suspected phoenix companies, to control the probity of the administration process, prevent the erosion of tax revenue from exorbitant insolvency fees, investigate breaches of directors' duties and enforce phoenix related legislation, policies and penalties. Where the insolvency process permits creditors to form 'committees of inspection', as it does in the Australian context, tax administrations should consider exercising this prerogative to take a leading hand in monitoring and advising the liquidator in the administration of insolvencies.[224] The cost of engaging more closely in the insolvency process will be offset by increases in tax revenue which would otherwise be absorbed by insolvency fees.

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[220] Ibid, p.67
[221] Ibid, p.147
[222] ICAA (2010), p.4
[223] Ferguson (2010)
[224] Corporations Act 2001, s.548

8. CONCLUSION

Phoenixing remains a significant global problem for taxation authorities and corporate watchdogs. With a few exceptions here and there, jurisdictions have attempted to tackle the phenomenon in isolation, shaping strategies that fit their unique legal frameworks and regional factors. Although there have been some recent attempts to network and share experiences,[225] jurisdictions have not yet grasped the opportunity to synthesise and benchmark approaches across the wider international spectrum in order to develop an international best practice approach to combating phoenixing.

Ultimately, political and institutional dimensions are going to influence the choices taken by policy makers. The recent global financial crisis has heightened community fears that honest businessmen, suffering at the hands of worsening economic conditions, will be unfairly caught up in a tightening compliance net. Consequently, pragmatic governments may well be resigned to tolerating the present level of socio-economic costs associated with phoenixing in order to foster enterprise, encourage growth and prevent alienating the wider business community.

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