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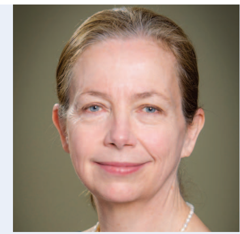

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comment and opinion

QUANTIFYING ILLEGAL PHOENIX ACTIVITY

A new report finds illegal phoenix activity is very hard to quantify.

Illegal phoenix activity has become a matter of increasing concern in recent years. Regulators such as ASIC and the ATO have stepped up their public statements and their detection and enforcement strategies. External administrators encounter illegal phoenix activity frequently and are sometimes accused of being complicit in it.[1]

In 2015, bodies such as the Productivity Commission[2] and the Senate Economic References Committee[3] looked at phoenix activity as part of their inquiries into broader matters. Many parties are interested in understanding the size of the problem, how much it costs the economy, and how well current enforcement mechanisms work. These are important questions because they influence the allocation of government resources and the process of law reform.

I am part of a team funded by the Australian Research Council looking at ways to regulate phoenix activity. The other members are Professors Ian Ramsay and Ann O'Connell and research fellow Hannah Withers of Melbourne Law School, and Associate Professor Michelle Welsh of Monash Business School. Our first report was *Defining and Profiling Phoenix Activity* and is available from our website.[4]

To answer the quantification questions, we undertook to gather together all the available data on the incidence and cost of illegal phoenix activity, as well as the enforcement of the various laws that can be utilised in combating it. As our newly released second research report *Quantifying Phoenix Activity: Incidence, Cost, Enforcement* shows, the answers to these questions cannot be reliably ascertained.

DIGGING INTO THE DATA

We began by obtaining as much publicly available data as we could find. This included a variety of published reports from ASIC, the ATO, the Fair Work Ombudsman (FWO) and the Commonwealth Director of Public Prosecutions, as well as information from their websites, media releases and evidence they have given to oversight bodies.

We searched databases such as Austlii for relevant judgments. We looked at reports as diverse as the 2003 Cole Royal Commission into the Building and Construction Industry and the 2012 PriceWaterhouseCoopers' (PWC) report prepared for the FWO. Our report either reproduces this information or collates it into a manageable form.

To fill the gaps in publicly available information, we then sought and obtained some data directly from the regulators. We thank the many parties who generously assisted us with our research.

PHOENIX ACTIVITY PER SE IS NOT ILLEGAL

Despite the large amounts of information we obtained, we cannot provide a definitive answer to the quantification questions. Moreover, we believe that accurate quantification is highly problematic for three reasons. The first is that phoenix activity per se is not illegal. It is permissible, and sometimes even desirable, for the controllers of a failed business to start again via a new company, buying the assets of the failed company for a fair value.

This sort of phoenix activity – perhaps automatically assumed to be 'suspicious' – can easily be captured through

1 ASIC, *Senate Inquiry into Insolvency in the Construction Industry Submission by the Australian Securities and Investments Commission* (April 2015), [97]. **2** Productivity Commission, *Business Set-up, Transfer and Closure*, Draft Report, 379. **3** Senate Economic References Committee, *Insolvency in the Australian Construction Industry*, Terms of Reference, (d). **4** http://law.unimelb.edu.au/cclsr/centre-activities/research/major-research-projects/regulating-fraudulent-phoenix-activity.

risk assessments. But because the external manifestations of illegal phoenix activity – one company closed down, a new one started by the same people, creditors not paid in full – are also present in legal phoenix activity, risk assessments looking at these external factors do not reflect the incidence or likelihood of illegal phoenix activity.

Regulator risk analysis can lead to widely different results. For example, we discovered that the ATO has a 'candidate and confirmed' phoenix population of 335,837 'unique entities' of which 72 percent are micro businesses.[5] On the other hand, ASIC used an external data service provider to identify companies to investigate, and it has 7,000 potential phoenix companies in its sights.[6] As a point of reference, we do know that in 2013-14, 9,822 companies entered some form of external administration.[7]

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DORMANT COMPANIES

The second issue confounding each aspect of the quantification of illegal phoenix activity is the paucity of information about dormant companies. It is possible that dormant companies are being utilised as havens for illegal phoenix activity since they escape the scrutiny of external administrators prior to being deregistered.

The very act of 'phoenixing' – stripping the assets out of the company and transferring them to another entity – makes the company a difficult engagement for liquidators who risk not being paid for their services. Creditors are then faced with the difficult choice of putting up additional funds to seek the company's liquidation or letting the matter go.

We found it impossible to accurately calculate the exact number of dormant companies that are deregistered by ASIC each year. The last time that ASIC published this figure was in 2007-2008,[8] when 23,565 such companies were deregistered. No ASIC deregistration figures are available for the years 2008 to 2011. After that time, ASIC's annual report lists a total deregistration figure, which will also include those companies deregistered voluntarily by their controllers, as well as companies which are deregistered following external administration.

According to ASIC's annual reports, the total numbers of companies deregistered in 2011-12, 2012-13, and 2013-14 were 97,198,[9] 105,627,[10] and 109,147[11] respectively. In those same three years, the total numbers of companies entering some form of external administration (but not necessarily deregistered that same year) were 10,757, 10,746, and 9,822[12] respectively.

It is readily apparent that deregistered companies outnumber companies in external administration by roughly 10 to one. There are no available statistics to show the numbers of voluntary deregistrations of solvent companies.

NO SPECIFIC 'PHOENIX OFFENCE'

The third reason that quantification relating to illegal phoenix activity is so difficult is that there is no specific 'phoenix offence'. Any enforcement activity relates to other laws which also capture non-phoenix behaviour, and generally speaking, regulators have not kept data about which enforcement actions relate to illegal phoenix activity.

The unavoidable fact remains that what makes phoenix activity illegal, such as a breach of directors' duty related to an undervalued transfer of assets, is not easily discernible. This is where data collated by external administrators and reported to ASIC can be so valuable. ASIC rightly points out that '[e]xternal administrators are the front-line investigators of insolvent corporations.'[13] Their work contributes towards '(a) maintaining the integrity of the marketplace; and (b) promoting investor and consumer confidence.'[14]

Unfortunately, there is no scope on the present Regulatory Guide 16 documentation for external administrators to expressly report their suspicions about illegal phoenix activity. Adding a tick-box to this effect, as well as scope for comments, would greatly assist the task of quantifying the incidence of illegal phoenix activity and estimating its cost.

5 Quantification report, Table 15, based on directly supplied data. **6** ASIC, *Senate Inquiry into Insolvency in the Construction Industry Submission by the Australian Securities and Investments Commission* (April 2015), 31. **7** ASIC, *Insolvency Statistics – Series 1: Table 1.3 Companies entering external administration, January 1999-November 2014* (January 2015). **8** ASIC, *Annual Report 2007-08* (1 August 2008), 57. **9** ASIC, *Annual Report 2011-12* (10 October 2012), 40. **10** ASIC, *Annual Report 2012-2013* (10 October 2013), 47. **11** ASIC, *Annual Report 2013-2014* (10 October 2014), 52. **12** ASIC, *Insolvency Statistics – Series 1: Companies entering external administration, January 1999–November 2014* (January 2015). **13** ASIC, *Regulatory Guide 16 External administrators: Reporting and lodging July 2008*, RG16.4. **14** Ibid, RG16.5.

Ensuring that insolvency practitioners have adequate funding for their investigations and free access to information held on ASIC's databases would also significantly improve the quality and usefulness of this reporting. In 2013-14, external administrators reported 18,195 suspected instances of breach of the *Corporations Act*, via 9,459 reports. Misconduct of some sort was suspected in 76.3 percent of their reports.

ASIC ACTION

We were interested in discovering how many of these reported instances of misconduct had involved phoenix activity and had been the subject of action by ASIC. We searched the Austlii databases for all the cases which mentioned one of the *Corporations Act* disqualification provisions. This was done for the period 1 January 2004 to 31 December 2014. There were no actions under ss 206D or s 206E that related to phoenix activity and only one under s 206C – the well-known case of *ASIC v Somerville*.[15]

We were more successful examining ASIC's media releases for the period 1 January 2004 to 31 December 2014 relating to s 206F disqualifications, which ASIC can do in-house as administrative enforcement. This section deals with those involved in two or more corporations within the past seven years where a liquidator's report about unpaid debts has been lodged and ASIC is satisfied the disqualification is justified.

In some of the media releases, ASIC spoke of disqualifying directors under s 206F because of breaches of directors' duties in the context of phoenix activity. However, this expression was used by ASIC informally, and it should be remembered that these are not proven directors' duties cases under the civil penalty or criminal provisions.[16]

During the period 1 January 2004 to 30 June 2014, 32 media releases reported that 51 directors were disqualified in circumstances involving phoenix activity. There were 165 companies involved in these 51 disqualifications. The media releases provided information on the duration of the disqualification for 50 of the 51 directors. Our report shows that ASIC prefers to disqualify for periods towards the maximum of five years allowed.[17]

LOSSES TO CREDITORS

Even with these 'clear' instances of phoenix activity, we had difficulty quantifying the actual losses to creditors. Only nine of 32 media releases mentioning phoenix activity gave the amounts involved. This ranged from a top of $23 million for a group of six companies and four disqualified directors, down to $530,000 for a group of three companies and one disqualified director. When we averaged out the amount of losses reported by these nine media releases, it came to a figure of $1.75 million per company.

We believe this figure should be treated with extreme caution. Due to its limited resources and in accordance with its stated approach to enforcement,[18] ASIC only tackles cases justified by the extent of the loss and the benefits of pursuing the misconduct relative to the expense. It is likely therefore that there are many cases of illegal phoenix activity coming to its attention for which no action is taken because the amount at stake is relatively small.

It is also possible that ASIC only publishes the greatest amounts lost. The average lost per instance of illegal phoenix activity is therefore likely to be considerably less than $1.75 million per company, but we have no way of estimating what that lesser figure might be.

We found the same difficulties when trying to put an upper limit on the amount of losses that could be attributable to illegal phoenix activity. The annual estimate of $3.2 billion calculated by PWC for the FWO in 2012[19] is cited frequently. This figure may be accurate or it may over-or under-estimate the cost of illegal phoenix activity.

We sought to test this figure by looking at ASIC's annual collation of external administrator (EXAD) reports as to the shortfall between estimated assets and estimated liabilities in relation to all companies in external administration.[20] Again, we found insufficient data to calculate a meaningful figure.

In 2013-14, for example, 1,306 companies failed with asset deficiencies of between $0 and $50,000. This makes for a loss range of $0 to $6.53 million. The next reported category – $50,000 to $250,000 – had 3,065 companies for a loss range of $153.25 million to $766.25 million. The highest category has no upper limit at all.

15 *ASIC v Somerville* [2008] NSWSC 788; *ASIC v Somerville & Ors* [2009] NSWSC 934; *ASIC v Somerville & Ors (No 2)* [2009] NSWSC 998; *ASIC v Somerville* [2009] NSWSC 1149. **16** *Corporations Act* ss 180-183 and s 184 respectively. **17** Quantification report, Table 26. **18** ASIC, Information Sheet 151, *ASIC's Approach to Enforcement*, 2. **19** PWC and FWO, *Phoenix Activity – Sizing the Problem and Matching Solutions* (June 2012), 15. **20** *REP 412 Insolvency statistics: External administrators' reports (July 2013 to June 2014)*, Table 25. **21** PWC report, 15.

GEERS AND FEG

Using data from GEERS and FEG to quantify the cost of phoenix activity was of little help. In its report to the FWO, PWC had factored GEERS payments into its estimates of the cost of phoenix activity[21] but we were sceptical about the usefulness of this data for a number of reasons.

First, GEERS and FEG cover both incorporated and unincorporated businesses. Second, the fact that employees have been paid (and therefore do not rely on a government scheme) does not mean that illegal phoenix activity has not taken place. While the total paid by these schemes since 2000 tops $1.5 billion, the employees of only about 16,000 insolvent businesses received advances.

Companies whose employees relied on GEERS and FEG may have few or no assets, but that is not the same thing as saying these companies were phoenixed. Finally, GEERS and FEG are only available to employees of companies in liquidation, so the data does not capture dormant companies or companies in voluntary administration.

We requested information from the ATO about the use of the director penalty notice (DPN) provisions, and particularly the 2012 'lockdown' provisions that do not allow directors to escape personal liability via external administration if the company has not both reported and paid their PAYG(W) taxes or superannuation. This data had not been released publicly before.

The ATO provided us with statistics relating to both standard and lockdown DPNs for the years 2010-11 until 2014-15, across four sectors – large, SME, micro and not-for-profit – and for both PAYG(W) and superannuation. For example, in 2014-15, there were 1,474 lockdown DPNs and 2,004 standard DPNs relating to unremitted PAYG(W). Unfortunately, the data does not capture how many of the DPNs were issued to directors suspected of illegal phoenix activity.

This is understandable given that the DPN mechanism is available to the ATO whether or not there has been any improper behaviour by directors, other than the non-payment of those company obligations.

QUANTIFICATION IS IMPORTANT

Our searches went beyond the statistics mentioned above and we urge those interested in the quantification of illegal phoenix activity to read our report. We do believe that quantification of the incidence and cost of phoenix activity and of the enforcement of laws tackling phoenix activity is important.

To improve the quality of the data, we urge regulators and liquidators to record their suspicions when they are receiving information from external administrators and members of the public, when investigating alleged phoenix operators, and when enforcing the laws under their control.

However, we do not believe that quantification should be an end in itself. The problem of illegal phoenix activity is clearly a significant one that justifies considerable government attention and resources. Let's make sure that all interested parties continue to seek solutions even in the absence of accurate numerical benchmarks to assess their progress.

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