



Phoenix danger: directors beware!

Last week, 65 year-old Sydney man, James Soong, was sentenced to three years jail after being prosecuted for conducting a phoenix scheme. It was a clear demonstration of the Government's intention to crack down on phoenix activity, the often brazen asset stripping that sees one company collapse owing huge debts to creditors while another – almost the same except for its name – emerges from the ashes to carry on unencumbered with debt.

Phoenix schemes generally involve the transferring of operating assets from a troubled company to a new one with similar ownership or directorship for little or no consideration. Commonly in the past, creditors have been left in the lurch while the perpetrators have moved on without penalty.

It is estimated that phoenix schemes in Australia avoid \$600 million a year in tax and that the activity costs the economy up to \$2.4 billion a year. Of the 10,264 company failures in the 2009 financial year, 43% involved directors of previously wound-up companies.

To date, the fines imposed by the Courts on delinquent directors have not acted as a deterrent. The Australian Taxation Office has only prosecuted 12 company directors for fraudulent phoenix activity since 1998. While the ATO has raised more than \$700 million in tax and penalties from the finalisation of more than 1,500 phoenix audits over the past 12 years, it has clearly signalled that this is going to be a new focus.

New funding in the 2009 Federal Budget is specifically earmarked for undertaking additional phoenix casework over the next four years. This money is being used to identify and monitor people who have been involved in phoenix arrangements in order to prevent them continuing to breach Australia's tax and superannuation laws.

This crackdown on phoenix activity is changing the Australian business landscape. In this issue of SME Insights we examine phoenix activity and the dangers it creates for company directors. Do you know what your responsibilities are?

Government cracks down on phoenix activities

In June, tax reforms contained in the Tax Laws Amendment (Transfer of Provisions) Bill 2010 were passed by the Senate. This legislation gives the ATO powers to demand security deposits from businesses to secure their tax obligations in relation to existing or future liabilities.

In line with the new reforms, and as a demonstration of how seriously the government is taking the phoenix issue, the penalties for phoenix activity have been increased 500%, with the new fines hitting \$11,000 for individuals and \$55,000 for companies.





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Directors' duties – avoiding the link between phoenix activity and insolvent trading

Company directors have clear and significant statutory duties outlined in the Corporations Act. They must exercise their roles with care and diligence, in good faith and in the best interests of the company. Breaches of directors' duties are considered extremely serious and directors can face both civil and criminal consequences under the Corporations Act.

The Corporations Act states that directors must not continue to operate a business and incur debts if they suspect the company may be insolvent or may become insolvent. If a company incurs debts while it is insolvent, directors could be held personally liable for those debts.

In a phoenix situation, when directors transfer assets from a troubled company to a new company, it is likely that the troubled company has been trading whilst insolvent for some time. Accordingly, not only have the directors breached their duties by engaging in phoenix activity, they will also have traded whilst insolvent and will be exposed personally to orders for compensation for the debts they have incurred whilst trading the troubled company.

For further discussion on directors' duties and how to determine signs of insolvency, please refer to our previous newsletter, [SME Insights – May](#).

The fact that James Soong found himself behind bars as a result of phoenix activity is a clear indication of the Government's new stance and a warning to company directors and managers about the importance of adhering to the law.

It is not an isolated case. In September 2009, in *ASIC v Somerville*, the New South Wales Supreme Court found eight directors of unrelated companies had engaged in phoenix activity and their legal adviser was involved. In that case, the Court disqualified Sydney solicitor, Timothy Donald Somerville, from managing corporations for six years. The Court also disqualified the directors from managing corporations for two years.

Conclusion

It is important for directors to be aware that phoenix activity is NOT a business restructuring tool. They also need to be aware of their responsibilities when managing a corporation and the implications of knowingly trading a company whilst insolvent and engaging in phoenix activity. In the current business environment, those tempted to flout the law face significant financial penalties and jail time.

If there is any question over the solvency issue or whether certain actions may imply phoenix trading, it is crucial that company directors seek professional advice. An advisor will be able to provide you with greater clarity regarding the situation you find yourself in and will guide you away from anything that could be regarded as phoenix activity.





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- Consider restructuring options.

Regards,

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