



Professionals connect – case study

Risks of advising companies in or close to insolvency

Phoenix activity

Fraudulent phoenix activity involves avoiding the payment of tax liabilities, wages, superannuation and leave entitlements and other responsibilities, such as supplier accounts, through the deliberate liquidation of a company. The business in question then continues, free of liabilities, in the form of another corporate entity, controlled by the same person or group of individuals.¹

The Assistant Treasurer, Senator Nick Sherry, has announced a package of reform options is being considered by the federal government to address phoenix activity, including:

- > Expanding ASIC’s powers to disqualify directors;
- > Extending the promoter penalty regime to cover individuals promoting phoenix activity;
- > Anti-avoidance provisions to negate taxation benefits derived from phoenix activity;
- > Rendering directors personally liable for a liquidated company’s debts where a ‘new’ company adopts the same or similar name as the prior company;
- > Lifting of the corporate veil where a subsidiary is established with insufficient capital to meet its (reasonably) expected liabilities; and
- > Expanding the coverage of Director Penalty Notices to impose stricter penalties and cover a broader range of taxes including superannuation guarantees and other taxation liabilities.

ASIC v Somerville [2009] NSWSC 934

ASIC’s recent successful prosecution of solicitor Timothy Donald Somerville for facilitating clients’ illegal ‘phoenix’ or asset stripping activity presents a warning for professionals and advisors to take care when advising distressed clients and the extent to which they become involved in their clients’ affairs.

Background

Somerville was a partner of the firm Somerville & Co. He advised various clients that were either referred by accountants or sought advice directly. On no less than eight occasions, Somerville and his staff recommended and assisted in the implementation of a mechanism for clients to protect assets where their companies were – or were about to – become insolvent. The advice given was found to have the effect of taking assets out of the companies and out of the reach of creditors.

The mechanism

Each of the clients had generally similar circumstances. Creditors had taken various actions, ranging from issuing payment demands to winding up applications, and in some instances Section 222AOE notices had been served on directors by the ATO.

Somerville proposed the following mechanism purporting to protect the assets of companies that were insolvent or about to become insolvent:

Old Company Pty Ltd

- > Sells assets and business operations which the current director/s seek to protect from creditor claims.
- > Keeps outstanding creditors that can’t be paid through normal trading.
- > Receives ‘V’ class shares in NewCo and the right to dividends.

New Company Pty Ltd

- > Acquires assets and business operations which the director/s seek to protect from creditor claims.
- > Issues ‘V Class’ shares in consideration.
- > No dividend is paid in respect to the ‘V’ class shares.

The findings

The court found that Somerville had aided, abetted, counselled and, by carrying out the necessary work, procured the carrying out of the transaction. There was therefore a direct causal connection between his involvement and the breach, and the transactions would not have taken place without Somerville's involvement.

The facts that the Supreme Court of NSW considered in finding against Somerville were:

1. In each case, Somerville or his staff:

- > Advised of the position as a result of insolvency or likely insolvency and as to the only course open, namely, to enter into a sale of the business or assets agreement on the terms set out.
- > Prepared the relevant agreement and documentation.
- > Arranged the registration of the new company and prepared the necessary returns and resolutions for the New Company 'V' class shares. In the relevant transactions, they ensured that the sale agreements were executed and settled before winding up and that the winding up took place prior to the triggering of a personal liability in a director pursuant to a Section 222 notice issued by the Deputy Commissioner of Taxation.
- > Where it was necessary to have the Old Company wound up, made arrangements to do so.

2. In terms of Section 79 of the Corporations Act, Somerville advised on and recommended the transaction which breached the sections in question and he:

- > Prepared or obtained all documents necessary to carry out the transaction.
- > Arranged execution of the documents in all cases with knowledge of the relevant facts.

Somerville has been disqualified from managing a corporation for six years from 24 October 2009, and has failed in attempts at exoneration. Subject to further submissions, the court held Somerville should bear 60 per cent of the costs.

However, it does not end there. The liquidator of each company may pursue Somerville for breaches under the Corporations Act. He also faces disciplinary action by the Legal Practitioners Admission Board as a result of the findings.

Advice for professionals

While this case relates to a solicitor, it applies to ALL professionals offering advice to their clients. Care must be taken when advising on courses of action where a company is suffering financial stress or may become insolvent and must not promote the use of phoenix activity or 'sugar coat' a solution.

¹ Assistant Treasurer - Crackdown on Phoenix Activity, No. 090 Media Release of 13 November 2009.

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Offices throughout Australia.

