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PHOENIX COMPANIES AND SOLICITORS' DUTIES

Introduction

In 2008 the Australian Securities and Investments Commission (**ASIC**) commenced proceedings against eight unrelated company directors and their common solicitor in relation to their involvement in alleged '*phoenix'* trading. On 8 September 2009 the Supreme Court of New South Wales handed down the judgment of *ASIC v Somerville & Ors*,[1] and held that the directors had breached their duties under the *Corporations Act* 2001 (Cth) (**Act**). The solicitor was also found to have breached the Act by aiding and abetting the directors' contraventions.

The decision is significant as this is the first time that ASIC has successfully initiated an action against a solicitor for the facilitation of illegal phoenix activities.

Phoenix trading

Phoenix trading is a form of asset stripping by which directors remove assets from an insolvent or near insolvent company, and transfer them to a new company with the same or similar directorship. The old company will usually enter into liquidation or administration, with the result that no assets are left to pay its creditors. At the same time, business continues to operate under the new company without the burden of the old liabilities.

Summary of facts

In *ASIC v Somerville & Ors* eight directors of non-related companies sought advice from the same solicitor in relation to their financially distressed companies. In each case, the solicitor advised that the following course of action be taken – that the old company should cease to trade, a new company be formed, and assets be transferred from the old company to the new company. In return, the old company received shares issued by the new company as a consideration for the transfer of assets.

At a superficial level the transaction appeared to be legitimate as consideration was given for the assets and creditors of the old company were to be paid out of the dividends of the issued shares. However, the declaration of dividends of the issued shares was purely discretionary. In fact, no dividends were ever declared on the issued shares and the court found that the consideration was merely fictional and illusory. In each instance the old company was eventually placed into liquidation, leaving creditors without redress. The new company retained the employees, premises and equipment of the old company free of the old liabilities and continued the operation of business with a favourable balance sheet.

Judgment against the directors

The court found that the transactions were asset-stripping activities with the intention of keeping assets out of reach of creditors. Each of the eight directors was found to have breached his duties under sections 181-183 of the Act.

Section 181 subsection (1) stipulates that a director has a duty to act in good faith and for a proper purpose. Such duty is extended to creditors of the company if it is insolvent or nearing insolvency.[2] In *ASIC v Somerville & Ors*, the issue of virtually worthless shares was considered by the court as an indication that the directors had no genuine intention to discharge their liabilities to the creditors. Further, the transfer of assets to the new companies was always arranged just prior to a winding up application by the creditors. This supported the conclusion that the directors had disregarded the interests of creditors, and therefore breached their duty under section 181(1).

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[1] [2009] NSWSC 934.

[2] See also *Sycotex Pty Ltd v Baseler & Ors* (1994) 13 ACSR 766 at 785.

Similarly, the directors were found to have breached subsection (1) of section 182 – the duty not to use their position improperly to gain an advantage for themselves or someone else, or to cause detriment to the company. The court found that the directors gained an advantage for themselves as they continued to operate the businesses with the benefit of the transferred assets. Further, they benefited '*someone else*', namely the new companies, and caused detriment to the old companies by removing their assets and substituting them with fictional shares.

Finally, the same conclusion was reached for the breach of subsection (1) of section 183 – the duty not to improperly use information obtained in their position to gain an advantage for themselves or someone else, or to cause detriment to the company. The court found that the directors, knowing the financial distress of the companies, transferred the assets to give an advantage to themselves and the new companies, all at the expense of the old companies and their creditors.

Judgment against the solicitor

ASIC claimed that the solicitor was liable under subsection (2) of each of sections 181-183, which provides that 'a person who is involved in a contravention of subsection (1) contravenes this subsection'. Section 79 of the Act defines who is considered to be involved in a contravention. Relevantly, it provides that a person who has 'aided, abetted, counselled or procured the contravention' is involved in a contravention.

The court found that the solicitor was liable under section 79 on the grounds that, with the full knowledge of all relevant facts, he:

- advised and recommended the transactions which breached sections 181(1), 182(1) and 183(1);
- prepared and obtained all documentation essential for carrying out the transactions, including the agreements for the sale of the businesses and assets;
- organised execution of all documentation;
- arranged the registration for the new companies, and prepared the necessary returns and resolutions for the fictional shares; and
- arranged for the appointment of a liquidator for the old companies.

Finding a direct causal link between the solicitor's involvement and the breaches, the court stated '... when advice is given by a solicitor to carry out an improper activity and the solicitor does all the work involved in carrying it out apart from signing documents, it seems to me that there can be no question as to liability'. As a consequence, the solicitor was found to have aided and abetted the contraventions of sections 181-183 of the Act.

In summary, declarations of breaches of sections 181-183 were made against each of the eight directors. The same declaration was also made against the solicitor pursuant to section 79 of the Act. As a result of these declarations, several injunctive and disqualification orders were made against the defendants. Specifically, the eight directors and the solicitor were disqualified from managing corporations for two and six years respectively, commencing from 24 October 2009. The solicitor is also facing a potential costs order, which may result in him bearing a substantial part of the costs of the proceedings.[3]

Observations

The decision in *ASIC v Somerville & Ors* serves as a cautious alert to legal advisers who provide advice to directors in insolvency situations. Legal advisers should ensure that their advice and assistance do not cause their clients to breach the directors' duties provisions of the Act. Otherwise, they run the risk of breaching those provisions themselves through aiding and abetting their clients' contraventions.

In respect to phoenix trading, we are likely to see an increase in ASIC prosecutions for the following reasons:

- *ASIC v Somerville & Ors* is a landmark authority by which ASIC has, for the first time, successfully taken action against an external adviser for his facilitation in phoenix

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[3] See *ASIC v Somerville & Ors (No. 2)* [2009] NSWSC 998 at paragraphs [37] – [39].

activities. This decision will potentially serve as a precedent for all future ASIC prosecutions involving similar factual circumstances;

- historically, the remuneration of liquidators has been funded from the assets of the company in liquidation. In cases where a company was left with few or no assets, liquidators were less likely to perform in-depth investigations into breaches of directors' duties. Recognising this problem, the Assetless Administration Fund (**AA Fund**) was established by the Federal government and is administered by ASIC. The fund, totalling $23million, has been operational since 2006 and provides financial remuneration to liquidators, encouraging them to carry out proper investigations into the failure of assetless companies. A specific focus of the AA Fund is to monitor illegal phoenix activities by directors;[4] and
- with the present economic downturn, there is an increased risk of corporate insolvency, and, as a result, an increased risk of directors seeking to avoid the consequences of insolvency. Prior to the decision in *ASIC v Somerville*, ASIC issued an alert to all directors and their advisers, warning that it is keeping a close eye on their actions during the global financial crisis. ASIC's Executive Director of Enforcement issued the following statement on 27 May 2008:

> 'Phoenix activity is a significant issue and ASIC has broadened its focus in relation to misconduct to include not only company directors but also others who are involved in, or help facilitate, such transactions.'[5]

Finally, although *ASIC v Somerville & Ors* is concerned with a solicitor, there is nothing in the judgment or the Act which prevents the legal principles from being extended to other advisers, including financial advisers and insolvency practitioners. All in all, advisers who give advice and assistance to clients to carry out improper activities, even when the transactions are disguised in superficial legitimacy, may end up finding themselves exposed to the risks of ASIC proceedings.

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[4] For more information on the AA Fund, see the following ASIC online press release: http://www.asic.gov.au/asic/asic.nsf/byheadline/Assetless+Administration+Fund?openDocument

[5] See the full ASIC online press release: http://www.fido.asic.gov.au/asic/asic.nsf/byheadline/08-110+ASIC+launches+action+against+alleged+phoenix+activity?OpenDocument&Click=