

IAIR



The International Association of
Insolvency Regulators

THE REGULATION OF PHOENIX COMPANIES

**The collective responses of a survey
of the members of the IAIR
relating to the incidence and control of
the Phoenix Syndrome**

INTRODUCTION

Following the Annual Conference of the International Association of Insolvency Regulators (IAIR) in March 2003, it was decided that the Association should undertake a comparative study of phoenix companies which is a persistent problem for many of its members. The initial purpose of the research was to provide substantive material on the problem for discussion at the Association's 2004 Annual Conference. This would, it was envisaged, enable the Association to agree definitive guidance for members on the most effective measures for dealing with the problem.

In July 2003, Mr Terry Gallagher, the Chairman of IAIR, asked me to lead the research exercise, and I was delighted to accept this honour. This study was undertaken over a number of months in late 2003 in consultation with IAIR members. A framework for the study was initially agreed (copy at Appendix 1), and IAIR members were subsequently asked to contribute information and experience in dealing with the phoenix syndrome. Consequently, it will be apparent from the individual country replies (Chapter 2 et seq.) that contributions have been made in a defined format.

In all, a total of thirteen IAIR members and observers replied with valuable material which has been incorporated into this Report. These were:

- the Australian Securities and Investments Commission,
- Insolvency and Trustee Service, Australia,
- the BVI Financial Services Commission (British Virgin Islands),
- the Superintendent of Bankruptcy (Canada),
- the Insolvency Service (England and Wales),
- the Office of the Bankruptcy Ombudsman (Finland),
- the Office of the Director of Corporate Enforcement (Ireland),
- the Viscount's Department (Jersey),
- Mr Bharat Upreti, Pioneer Law Associates (Nepal),
- Institutio Federal de Especialistas de Concursos Mercantiles (Federal Insolvency Specialists Institute), Mexico,
- the Official Assignee for New Zealand,
- the Insolvency Service of Northern Ireland and
- the Administrative Office of the United States Court.

As convenor, I wish to record formally my appreciation of all those who contributed to this study. I also wish to pay tribute to the considerable support and advice given to me by my colleague, Mr Adrian Brennan, in the completion of this exercise. I should also acknowledge the wonders of electronic communication which, despite its occasional frustrations, proved to be an indispensable instrument in facilitating prompt communication and feedback from IAIR colleagues all over the world.

At the IAIR's 2004 Conference, the value of this research was endorsed, and it was decided to undertake further similar work in the future. Members also agreed to publish the Report. This final Report takes on board additional contributions made subsequent to the 2004 Conference.

I anticipate that this Report will prove beneficial in assisting IAIR members and observers in developing solutions and strategies to curtail in the future the insidious effects of the phoenix syndrome and assist in improving the integrity of the business environment in their respective jurisdictions.

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29 October 2004

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Chapter 1

AN INTRODUCTION TO PHOENIX COMPANIES

The phoenix is a legendary bird which is reputed to have died by fire and to have subsequently been re-born from its own ashes. However in an insolvency context, the modern dictionary also recognises the term as meaning the following:

“tendency for a bankrupt business to start up again under a new identity”.

However, this statement fails to distinguish between the honest and responsible business failure which may result in a new or reconstituted business being established and the unscrupulous business practices which achieve the same result.

Before moving on to describe those practices, let us first consider what we mean by ‘honest and responsible business failure’. Typically, the directors of the insolvent company will have acted promptly to cease trading after it has become clear that the business cannot be saved. They will have done so, in order for instance to limit the potential financial losses of creditors, etc. They may have also engaged professional advice to help them save the company in advance of their decision, and they may arrange for voluntary administration or the orderly liquidation of the company.

It may be that one or more of the directors of the insolvent company will subsequently succeed in rehabilitating the business with the agreement of its creditors or in purchasing from the insolvency practitioner at market value some assets of the failed entity and that they will then proceed to incorporate the same or a related business using those assets. While this is a phoenix company under the above dictionary definition, it is not the type of phoenix which is of primary concern here.

At the same time, it must be recognised that:

- competitive market conditions do not always exist;
- insolvency practitioners do not always discharge their duties properly and

- deficiencies in insolvency procedures may be exploited for unscrupulous purposes.

Where any such conditions exist, undesirable phoenix activity may be facilitated.

Typically, the phoenix company in its odious form is established in the following circumstances and has many of the following characteristics:

- the failed entity was undercapitalised, normally having a minimum issued share capital;
- it is insolvent;
- there was a depletion of assets shortly before the cessation of its business;
- the failed entity was operated to evade some or all of its prior liabilities;
- the phoenix company is formed with a nominal share capital;
- it operates in the same or a related business area to that of the failed entity;
- it commences operations immediately prior to the cessation of the trade of the failed entity or within a short period (no more than 12 months) of the failed entity ceasing to trade;
- its directors/managers/controllers (or a number of them) also operated the previous business;
- many employees of the former business proceed to work for the phoenix company;
- the assets (including intangibles such as goodwill) of the failed entity are transferred by the directors at a below market value to the phoenix company, either before or after the entity ceased trading;
- there are preferential payments, i.e., commitments relating to the payment of outstanding liabilities are made by the directors to a number of the creditors of the insolvent company prior to it ceasing to trade, in order that they will continue to supply the newly incorporated business;

- substantial liabilities (e.g., tax due to State authorities), which are dispensable insofar as the newly incorporated business is concerned, are left behind in the insolvent company which has limited assets to meet these liabilities.

In some insolvency situations, unscrupulous directors may deliberately deplete a company's assets, so as to result in insufficient assets being left to justify the appointment by a creditor of an insolvency practitioner to the insolvent company. This practice, sometimes known as the 'scorched earth syndrome', may exist in phoenix situations.

Many administrations face difficulties in detecting and addressing undesirable phoenix situations. Authorities will often depend on State agencies, creditors or other interests to alert them to phoenix-type conditions, and investigation involves time and expense before suitable cases are selected for enforcement action. The parties involved in the phoenix situation may have exploited these information gaps and delays on more than one occasion before they are ultimately identified and sanctioned.

Unless effective counter-measures are in place to curb such abuses, the result of phoenix practices is that:

- directors bear no personal liability or are not otherwise made accountable for the failed business;
- creditors (including in particular the State's tax authorities) suffer the financial consequences of the failure, and some of these traders may themselves fail in consequence;
- competition in the business area is distorted, because the phoenix company enjoys lower-than-market costs and therefore has the potential to achieve an unfair competitive advantage in the marketplace.

Chapter 2

Australia

(Australian Securities & Investments Commission)

A. How big a problem is the phoenix company and what is its impact in your jurisdiction?

There is no specific provision under the Corporations Act or any other legislation that directly prohibits phoenix activity, whether fraudulent or otherwise. There are a number of ways of attacking phoenix activity and phoenix operators, using offence provisions or recovery mechanisms under the Corporations Act or the Income Tax Assessment Act, but these provisions and mechanisms can be – and are – used for other purposes. Hence, it is very difficult to gather reliable published data on the incidence of phoenix activity in Australia.

The following information is available:

Registered Companies

There are approximately 1.25 million companies registered in Australia.

Victorian Law Reform Committee

From 1993 – 1995, the Victorian Law Reform Committee looked at measures that could be undertaken to curb the incidence of phoenix activity. The committee did not provide any specific information on the extent of the phoenix problem in its published reports (available at the website address provided) although the committee did consider that phoenix activity represented a sizeable problem.

ASIC Research

ASIC undertook a research project into phoenix activities and insolvent trading in 1996. The research was commissioned to improve ASIC's understanding of the regulatory and enforcement issues relating to these two topics. The particular focus of the research was the impact on small to

medium enterprises (SMEs). As part of the study, a telephone survey was conducted. The following results were obtained:

- 18% of respondents claimed to have been affected by a phoenix type activity;
- 45% of phoenix activity experienced was in the building/construction industry;
- 80% of respondents who had experienced a phoenix type activity did not report that experience to the authorities;
- respondents who had experienced phoenix activities had done so an average of 2.6 times over the life of their business.

The 1996 study is not available on the ASIC website.

Cole Royal Commission

In late 2001, the Federal Government established a Royal Commission to review conduct and practices in the building and construction industry in Australia. Known as the Cole Royal Commission (Cole), it reported in March 2003. The Government received a secret volume, but the rest of the report was publicly released and is available on the Cole website. The Government has tabled a response to the Cole recommendations.

Phoenix companies warranted a separate chapter in the Cole Report.

The building and construction industry in 2001- 02 directly accounted for 5.5% of GDP and 7.5% of employment.

In a submission to Cole, the Australian Taxation Office (ATO) referred to its concerns about the loss of revenue through phoenix activity and the formation of a specialist team to address the problem. Since 1998, the ATO team has finalised 400 cases, 85 per cent of which relate to the building and construction industry. A further 150 cases are underway. Revenue of \$140m has been raised of which \$110m relates to cases in the building and construction industry.

Complaints to ASIC

ASIC provided figures to Cole based on the number of complaints received in the 2001/2002 financial year. Only 1.6% of complaints received were categorised as phoenix related. These

figures should not be misconstrued. ASIC must categorise its complaints for assessment and usually this is in accordance with the nature of the alleged offence. Activity that is 'phoenix' in character may be categorised instead as insolvent trading, a fraudulent asset transfer or director disqualification.

ASIC Enforcement Action

ASIC also provided Cole with non-identifying details of cases that ASIC had pursued against known phoenix operators.

Information from insolvency practitioners

Since 2002, ASIC has instructed insolvency practitioners to indicate whether they suspect phoenix activity by the directors of any failed company where a statutory report is filed with ASIC.

The type of phoenix activity in the building and construction industry

The ATO gave evidence to Cole that phoenix activity most commonly occurred in building sub-industries which have large workforces of semi or unskilled labour and where labour costs are a significant part of the running costs of the business. According to the ATO, most large-scale phoenix activity occurs with enterprises that have turnovers of between \$2 million and \$10 million and involves non-payment of taxation and other employee related imposts to government agencies.

The main union representing the interests of building workers provided detailed information on three phoenix company scenarios.

In the first scenario, the phoenix operator sets up a series of companies with similar names and transfers the assets (mainly receivables) to subsequent companies leaving liabilities (mainly tax debts) in previous companies that have been jettisoned. The scenario relies on minimal investigation being conducted by a liquidator due to lack of funds.

In the second scenario, the business affairs are split between a management company (holding the assets) and a labour supply company (holding the liabilities). A succession of labour supply companies is then phoenixed leaving a trail of debt.

In the third scenario, there are three companies in the scheme – a management company (holding the assets), a sales company (receiving the revenue) and a labour supply company (with the employee claims and tax debts). The labour supply company is provided with funds only sufficient to pay the employee claims but not tax debts and is then liquidated. A new labour supply company can be set up with each new project.

B. What legal/regulatory/other conditions assist the formation of phoenix companies in your jurisdiction?

Cole outlined particular characteristics which make the building and construction industry vulnerable to phoenix activity. Typically, subcontractors are small companies with virtually no assets and little business acumen or administrative support. It is a competitive industry where there is competition to undercut rivals (perhaps by not paying debts to taxation authorities and employees). They then engage in phoenix activity as a survival mechanism.

Incorporating a company and starting a business

Businesses are required to apply for an Australian Business Number (ABN) from the Australian Taxation Office if they are a company or a business with an annual turnover of at least \$50,000. The ABN system was introduced when the Government imposed a consumption tax in 2000.

Details of how to incorporate a company are provided on the ASIC website. The procedure is straightforward. There are no requirements for directors to have business or financial skills.

If a company is to trade in a name other than the company name, it must separately register for a business name.

Recent amendments to the Corporations Act simplified the system for ongoing requirements for companies. As of 1 July 2003, directors will receive an annual statement upon the anniversary date of incorporation. They check the details in this statement (principal place of business, officeholders etc.) and pay an annual fee. Payment of the fee is taken as evidence that: (a) all details on the statement are correct and (b) the directors have passed a solvency resolution (that the company

can pay debts as and when they fall due). Directors are under an obligation to inform ASIC if this resolution cannot be passed.

Bankrupts are not entitled to act as directors or take part in the management of a company. All bankrupts are informed of this requirement and asked to resign current directorships.

Income and consumption taxes and company matters are the responsibility of the Federal government. Payroll and health and safety taxes, occupational licensing and business names are State government responsibilities. Requirements for occupational licensing differ from state to state. Nevertheless a common requirement is that a builder's licence, for instance, is not provided to anyone who has been bankrupt or a director of a failed company for a period prior to submitting an application for the licence. A link has been provided for the Fair Trading Office in New South Wales, the state that the ATO reports is the most prevalent for phoenix activity.

Members of the public are entitled to free searches of basic details (including the names of directors) recorded on the company database and the registers of occupational licence holders.

General details of the liquidation of a company are stored on the corporate database. Liquidators are required by law to report to ASIC in certain circumstances. This includes if a company is expected to return less than 50 cents in the dollar to creditors. Liquidators must report if they suspect offences may have been committed and that includes if the company is alleged to have been trading whilst insolvent. These reports are not made publicly available. Recently ASIC has introduced a new form which can be lodged online. This allows the liquidator to report to ASIC more quickly. ASIC specifically asks the question whether phoenix activity is suspected.

Detecting phoenix activity

It is evident from the Cole Royal Commission that many participants in the building and construction industry were aware of, and were concerned about, the abuse of the corporate form and the principle of limited liability by phoenix operators. Nevertheless, ASIC received virtually no complaints from these participants. ASIC's own research in 1996 indicated that 80% of SMEs affected by phoenix did not report the matter to the authorities.

Cole has found that there "is an urgent need for structural and cultural reform" in the building and construction industry in Australia (p. 3 of the Final Report). This comment refers in part to a conspiracy of silence from industry participants that protected phoenix practices from being discovered and reported.

Although the ATO gathers evidence, and takes action to combat phoenix activity in the industry, the ATO is prevented by strict secrecy provisions in the Income Tax Assessment Act from passing information of this nature to ASIC. The Memorandum of Understanding between ASIC and the ATO, which encompasses information sharing, is subject to these secrecy provisions. Cole recommended that government agencies not be prevented from pursuing phoenix operators by secrecy provisions or lack of resources, that guidelines be established between agencies for clarifying responsibility for halting fraudulent phoenix activity and that legislative amendments to overcome impediments to information sharing be explored. The Government has responded by setting up a working group to consider this recommendation fully. ASIC and the ATO are reviewing their MOU.

C. What measures exist in your jurisdiction to counter phoenix activity and how successful are they?

D. What additional/improved measures need to be introduced to combat phoenix activity in your jurisdiction?

In considering suggested remedies in this section, it is important to remember that phoenix activity involves the failure of successive companies which are unable to pay their debts and who deprive creditors of access to company assets to meet those debts. As discussed in the Introduction to this Report, activity that can seem on the surface to have all the hallmarks of a phoenix may not in fact be against the law.

Phoenix activity can be attacked from a number of different angles:

Defining phoenix activity

There is no legislated definition of objectionable phoenix activity. Cole accepted a definition from the ASIC 1996 study which in turn was adapted from the Victorian Law Reform Committee:

“Phoenix activities are those where an incorporated entity either:

- (a) (i) Fails and is unable to pay its debts; and/or

- (ii) Acts in a manner which intentionally denies unsecured creditors equal access to the entity's assets in order to meet unpaid debts; and
- (b) 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 entity.”

Cole commented that some uncertainty presently exists as to the boundaries of conduct which should be regarded as fraudulent and a definition such as the one above accepted by ASIC and the ATO would help to overcome this uncertainty. Cole stopped short of recommending that this definition be included in legislation.

Preventing undesirable directors from incorporating companies

Directors' Duties

The Corporations Act contains general duties of directors and other officers of a corporation and includes criminal offences and civil penalty provisions for breaches of these duties. ASIC must prove contravening conduct by an officer but the conduct may relate to a single company and proof of insolvency of the company is not required.

Disqualification Provisions

A person may be automatically disqualified from taking part in the management of a corporation if they are convicted of certain offences and this can include convictions relating to breaches of directors duties mentioned above (s206B of the Act). A person who is automatically disqualified can 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 (s206C of the Act); if the person has been at least partly responsible for the failure of two or more corporations within 7 years (s206D) or repeatedly has contravened the Act (s206E). The court orders are at the court's discretion.

ASIC may disqualify a person from managing corporations if the person has been managing two or more failed corporations within 7 years and the liquidator has reported to ASIC regarding those

failed companies (s206F). Cole recommended that this be amended to apply after one failed company.

The maximum ban that can be imposed by ASIC in relation to multiple failed companies is currently 5 years, whereas the court can order a ban up to 10 years. In amendments proposed by the Government, ASIC will be given the right to approach the court to extend an ASIC-imposed ban. The court will be able to order a ban of up to 20 years.

Fraud against the Revenue

When the phoenix company activity is characterised by the non-remittance of tax to the ATO, one action which might be taken in respect of phoenix company operators is a prosecution for defrauding the Commonwealth. Upon conviction, that person may then be disqualified from managing a corporation under section 206B of the Corporations Act.

ASIC maintains a disqualified directors' register which is publicly searchable. However, this register is not comprehensive as it only includes directors disqualified following action by ASIC or a court disqualification order applied for by ASIC. If a person has been automatically disqualified following conviction of an offence brought by the ATO, this person's name does not appear on the register.

Limitations on use of the corporate form

The Victorian Law Reform Committee recommended that restrictions be placed on the use of corporate names similar to those that were used in previous failed companies. There are already restrictions on certain names being used by corporations, including where there is a registered business name in use and the name is identical to one already used. It is possible for a phoenix operator to flout the rules with a similar (but not identical) name. If an asset transfer from an insolvent company is part of a phoenix operator's methods, then the asset transfer can include the company name. The name of the insolvent company is then changed to the company registration number and a new entity is given the old company name.

Since the beginning of 2003, ASIC has been data matching new company office-holders against the disqualified persons register. ASIC will soon commence data matching of new office holders against the National Personal Insolvency Index and new bankrupts against the companies database. In addition, Cole recommends that ASIC ensure that procedures are introduced to

ensure that companies are not left without directors following the bankruptcy of a serving director. On this last point, the Government is investigating whether procedural and/or law reform is required.

Permitting the 'lifting of the corporate veil' in certain circumstances

Insolvent trading

Australia's insolvent trading laws impose a duty on directors to prevent insolvent trading and provide for both civil and criminal penalties if the director breaches this provision. In conjunction with civil penalty provisions, the director may be ordered to pay compensation to the company. This is one way of lifting the corporate veil to address phoenix concerns.

Disqualified person responsible for corporation's debts

Upon application by a liquidator, a court may order a person disqualified from managing a company to be responsible for the debts of the company if they ignored the disqualification and continued to manage the company.

Holding company to be responsible for debts of subsidiary

There is a provision that makes a holding company responsible for debts incurred where a subsidiary was trading whilst insolvent. This lifts the veil on the type of phoenix activity where a number of entities are set up and a subsidiary is allowed to carry all the debt while assets are held by a holding company. Cole recommended that all members of a group of companies be made jointly and severally liable for the taxation debts of all other companies in the group. The Government has not agreed to this change as it would require a significant change to corporate law and insolvency law policy.

Unpaid employee entitlements

A provision was inserted into the legislation in 2001 to render a person liable to pay compensation where they have entered an agreement or a transaction with the intention that employee entitlements remain unpaid.

Restrictions on occupational licensing

As mentioned, restrictions already exist for insolvents or failed directors to hold particular types of licences. Cooperation is required by government agencies to ensure that failed directors are not acting through nominee licence holders (usually family members) as well as failed licensees acting through puppet directors. In the small number of cases that have arisen, such cooperation has been evident.

Ensuring the activities of liquidated and deregistered companies are investigated

In 1988 a General Inquiry into Australia's insolvency laws recommended that an "assetless companies" fund be set up to provide resources for insolvency practitioners to carry out an investigation where there are no assets available to fund an investigation. Government has not taken up this suggestion although it has been re-visited by both the Victorian Law Reform Committee and Cole.

The Victorian Law Reform committee recommended that an investigation be carried out where a company is struck off the register (for instance, where it fails to pay an annual fee). At the present time, if this occurs, the assets of the company vest in the Crown. The company needs to be reinstated and then liquidated by court order. The ATO is the usual creditor who will make application for the company to be liquidated. However, the ATO will only do this if some return is expected.

Education and Publicity

The Victorian Law Reform Committee and the ASIC 1996 study both mentioned education as a preventative measure – to educate creditors to report phoenix offenders. The law reform committee also stated that publicity would be an effective remedy to prevent phoenix activity. Cole encountered the conspiracy of silence in the building and construction industry where phoenix practices were widely known but not reported.

Other

Cole also recommended the introduction of a system to ensure security of payment to subcontractors to eradicate one of the environmental factors that promote the use of phoenix activity. Following Cole, some State Governments have considered introducing security of

payments legislation for sub-contractors and the Federal Government is considering whether to follow suit.

Conclusion

Cole has made it clear that detection and eradication of fraudulent activity is not the responsibility of one agency. It requires co-operation from a number of government agencies. It is too early to say whether the recommendations made by Cole, if implemented, will prove to be an effective response to the problem of phoenix activity in the building and construction industry. The spotlight has been placed on the building and construction industry which, according to anecdotal evidence and the ATO results, accounts for the majority of fraudulent phoenix activity in Australia. If focused activity in this industry proves successful, it could be a worthwhile model for other industries where phoenix activity is also suspected (for instance, the long haul transport sector).

Useful Links

ASIC: <http://www.asic.gov.au/>

ASIC Annual Report:

http://www.asic.gov.au/asic/asic.nsf/lkuppdf/ASIC+PDFW?opendocument&key=annual_report2001-02_pdf

Cole Royal Commission into the Building and Construction Industry:

<http://www.royalcombcgi.gov.au/>

Victorian Parliament Law Reform Committee Reports on "Curbing the Phoenix Company"

<http://www.parliament.vic.gov.au/lawreform/>

Australian Taxation Office: <http://www.ato.gov.au/>

Office of Fair Trading New South Wales: <http://www.fairtrading.nsw.gov.au/>

Corporations Act: http://www.austlii.edu.au/au/legis/cth/consol_act/ca2001172/

AUSTRALIAN SECURITIES AND INVESTMENT COMMISSION

Chapter 3

Australia

(Insolvency & Trustee Service Australia)

Introduction

This chapter aims to explain how combating the practice of “phoenix” businesses is complemented by specific industry regulators and is not be the sole responsibility of the corporate and insolvency regulators.

The building industry in Australia has experienced a higher than average incidence of problems resulting from:

- a lack of competence in performing work; and
 - financial failure including the phoenix practices
- in both corporate and non-incorporated businesses.

The Queensland Building Services Authority Act establishes a regulatory regime that is based largely on:

- technical competency of licence applicants;
- financial requirements based on annual net tangible assets for levels of turnover, and independent financial review and audits; and
- excluding individuals who become bankrupt or are associated with a failed company.

The aims of the financial requirements are:

- to promote more financially viable businesses; and
- to foster more professional business practices in the building industry.

This is achieved by setting financial requirements which limit annual turnover to defined assets or capital levels and by testing whether debts can be met when they fall due (a liquidity test). In addition, licensees and licence applicants of significant size, regardless of whether they are builders or trade contractors, are required to provide an Independent Review Report or an Audit Report demonstrating that they satisfy the financial criteria. If individuals are associated with an insolvency they are excluded from the industry for 5 years and, if two insolvencies occur, for life. This effectively counters the practice of “phoenix” businesses.

This Queensland approach is not unique in Australia because other states have schemes which regulate the building and construction industry. These schemes are examples where governments have focused on combating a range of problems such as the phoenix practices with their regulatory approach.

Building Industry Regulator

The Queensland Building Services Authority has licensed house and general builders since 1972 and trade contractors since 1992. The licensing scheme now includes:

- 56 licence classes to cover every conceivable builder and subcontractor, e.g., specialists for kitchens and bathroom installation, swimming pools, landscapers
- an “insurance” scheme for rectifying shoddy workmanship for at least 6 years
- minimum qualifications or competency assessments
- compliance audits to support financial requirements, and
- disciplinary procedures.

Disclosure Requirements

The licensing scheme also combats the “phoenix” practice by way of comprehensive disclosure requirements. Directors of companies and proprietors of un-incorporated business have to disclose:

- administrations of their affairs under any part of the Bankruptcy Act;
- directorships, positions of control or substantial influence of a company within 12 months of a company being placed in any insolvency administration under the Corporations Law.

The requirement is comprehensive to the extent of licensees and applicants for licences providing copies of:

- reports to creditors issued by a trustee in bankruptcy
- copy of an ITSA search showing discharge from bankruptcy
- copies of debt agreements or Part X’s and evidence of completion of administration
- Australian Securities and Investment Commission historical extract and any orders
- records of convictions or a police records search
- documents relating to court proceedings

Excluded Individuals

With the aim of preventing the re-emergence of businesses through the phoenix practice (stated in the second reading speech in State Parliament) the law provides for “excluded individuals” who may not hold a licence.

A person becomes an “excluded individual” when they:

- become bankrupt or otherwise take advantage of bankruptcy laws by entering into a Part IX or Part X agreement under the Bankruptcy Act; or
- are a director, secretary or influential person for a company at any time up to a year before the company has a provisional liquidator, liquidator, administrator or controller appointed, or is wound up or ordered to be wound up.

An “excluded individual” is not entitled to hold a BSA licence of any kind for five years. Also, a company cannot hold a licence if a director, secretary or influential person for the company is an excluded individual.

A person who becomes an “excluded individual” for a second insolvency, either during or after the first five-year period of exclusion, becomes an “excluded individual” for life.

To prevent injustice a person who becomes an “excluded individual” may apply to BSA to have that status expunged if they prove that they could not have avoided the relevant financial catastrophe.

Provision is also made for a “100 point” identification check which is the same requirement for opening bank accounts; photo identification (e.g., passport) with supporting documents.

Financial Requirements for Licensing

The Queensland Building Services Authority (BSA) has guidelines setting out the minimum financial requirements for licensing building categories.

The intentions of the guidelines are to ensure the majority of sound, well-managed building businesses in Queensland are not subjected to unreasonable levels of reporting and red tape.

For many businesses, the requirements set out in the guidelines will improve their financial management and long term viability and allow them to have better control over their business.

Financial requirements for licences are summarised as follows:

Category	Annual Turnover	Net Tangible Asset (NTA) or Other Requirement
-	\$75,000	\$5,000
-	\$250,000	\$15,000
1-3	\$250,000 to \$10m	Independent Review Report
4-8	More than \$10m	Independent Review Report (year 1) or Audit Report

The expectation used to be that a company with a turnover of over \$200m would have NTAs of \$10m.

Definitions

“Annual Turnover”	Total revenue by licensee excluding salary and wages.
“Tangible Net Assets”	Assets owned by licensee minus liabilities. Assets include all forms of tangible assets i.e. real estate, cash, investments, shares, plant and equipment, debtors and motor vehicles. Assets do not include furniture, boats, shares not in public listed companies and assets held in trust.
“Liabilities”	Include all debts or obligations which must be paid within a certain period or payable on demand

The guidelines and definitions aim to maximise the accuracy of the financial information and minimise the opportunity for providing misleading information. An examination of some independent review reports by the regulator has alerted accountants to the possibility of action in respect of inaccurate certification of financial data.

The guidelines require that an Independent Review Report be prepared based on financial information of the business, by an independent appropriately qualified person. In most cases this will be the external accountant or auditor of the business.

These reviews are required to be carried out by the independent appropriately qualified person at the time of an initial licence application and on an annual renewal basis. A review of the licensee's/applicant's financial position is required to be conducted in order to provide the Independent Review Report. The review is not considered to be an audit.

The person conducting the review (for turnover of more than \$250,000) is to clearly state in the Independent Review Report the Australian Accounting Standards and policies applied in the preparation and presentation of the Report.

A Deed of Covenant and Assurance must be provided to enable licensees to meet the minimum Net Tangible Asset (NTA) requirement for the level of turnover sought, in instances where the applicant or licensee is unable to meet the level from their own assets and liabilities.

Should a licensee wish to increase its Allowable Annual Turnover at any time during the licence year by more than 10% it is required to notify BSA and have BSA adjust its Allowable Annual Turnover before this occurs. Should a licensee exceed its Allowable Annual Turnover by more than 10% without prior approval, the licensee will have breached a condition. This may result in the suspension or cancellation of the licence at the time of renewal or compliance audit. Licensees may also be subject to disciplinary proceedings.

Licensees are required to notify BSA of any decrease in their net tangible assets (NTA) of 10% or more, which exists for a period of 1 month, within 30 days of the expiration of the 1 month period. Failure to notify BSA may result in the suspension or cancellation of the licence at the time of renewal or compliance audit.

The strict compliance regime includes provision of financial statements and disclosure of information about any insolvency accompanying the annual licence renewal; random audits; suspension and cancellation of licences; compliance audits and disciplinary proceedings before a tribunal.

The BSA administers an industry "insurance" scheme to pay for building work to be completed or rectified where there is a failure of a builder. This results in the BSA becoming a creditor in an insolvency and has the right to fund the administrator to investigate.

Conclusion

The scheme operates effectively with the support of the building and contracting industry to exclude individuals associated with “serial insolvency”. Creditors and consumers have benefited from the resulting improvement in qualifications and training and protection from bad workmanship and minimisation of the incidence of financial failure and “phoenix” type practices. This paper gives a complete explanation of the scheme rather than just the aspects of financial failure so the scheme can be appreciated as a whole. Bad workmanship seems to often precede financial failure.

INSOLVENCY AND TRUSTEE SERVICE AUSTRALIA

Chapter 4

BRITISH VIRGIN ISLANDS

A. How big a problem is the phoenix company and what is its impact in your jurisdiction?

In considering the phoenix company issue in the British Virgin Islands (BVI), account must be taken of the specifics of the local economy. The BVI is a small jurisdiction but an important offshore financial centre.

Under BVI companies legislation, two types of company may be registered; local companies and International Business Companies ("IBCs"). An IBC business and management must be carried on outside the BVI. The benefits of incorporating an IBC in the BVI include tax neutrality and a straightforward, cost effective structure.

There are many more IBCs registered than local companies, with the result that the vast majority of BVI registered companies have their operations overseas. The statistics at the end of 2002 were as follows:

IBCs registered	524,902
Local companies registered	10,105

No specific research has been carried out in the BVI on phoenix companies, and it is not considered to be a particular problem here. In view of the IBC situation, it would, in any event, be extremely difficult to conduct meaningful research. In addition to the difficulties associated with these entities trading in a multitude of different jurisdictions, insolvency proceedings involving IBCs are frequently dealt with as local proceedings in the jurisdiction of operational residence rather than as BVI proceedings.

The risk profile in respect of IBCs may well be lower than that in respect of more typical companies. IBCs are frequently incorporated to provide special purpose vehicles to hold assets, rather than to conduct a trade or business. However, there is no research or evidence to support this view.

B. What legal/regulatory/other conditions assist the formation of phoenix companies in your jurisdiction?

There are few barriers in the BVI either to setting up a company or an IBC, or to acting as a director for the first time:

- No minimum capital requirement
- No prohibition on the re-use of company names
- No restrictions or qualification requirements for persons becoming directors for the first time.

In relation to IBCs, there is no requirement to disclose the identity of the directors on the Companies Registry file that is available for public inspection (although voluntary disclosure may be made). Also, since IBCs fall outside the tax net, there is no form of registration with the tax authorities.

There is no requirement for an IBC to file audited accounts. A lender, creditor or trading partner would have to come to an agreement with an IBC for disclosure of financial information if it wanted to monitor the IBC's financial health.

Regulated financial services businesses, whether local companies or IBCs, are nevertheless required to disclose (inter alia) the identity of directors, shareholders and beneficial shareholders to the regulator (the BVI Financial Services Commission). Most are also required to submit audited accounts to the regulator.

There are no specific initiatives in place to identify phoenix companies.

There remains a good deal of stigma in connection with business failure in the BVI. However, this would not affect IBCs since the results of their insolvency would not impact to any great extent on the local economy.

C. What measures exist in your jurisdiction to counter phoenix activity and how successful are they?

There are currently few measures to counter phoenix activity. However, new insolvency law (The Insolvency Act 2003¹) has passed through Legislative Council and has been gazetted. It draws heavily on the UK 1986 Insolvency Act. The date of commencement has not yet been set, but

¹ The Insolvency Act 2003 came into force on 16 August 2004.

should be within the next few months. It would therefore be appropriate to mention the relevant provisions from the new Act.

The measures that will help to counter phoenix activity are reactive in nature; they may deter but are unlikely to prevent first time offenders. Repeat offenders are more likely to be identified and punished.

There is no statutory definition of a phoenix company or phoenixism.

The principal measures are as follows:

- There will be a director disqualification regime. Phoenix activity will be one of the factors that insolvency office holders consider when reporting their findings. The responsibility of applying to Court for disqualification orders will fall to the Official Receiver. The regime incorporates shadow and de facto directors, as well as insolvency practitioners. A disqualified person involved in the management of a company will incur personal liability for its debts. In addition, it will be a criminal offence to engage in a “prohibited activity”, including acting as a director of a company.
- There will be a summary remedy against delinquent directors and others who have misapplied, retained or become accountable for money or other assets of the company. The Court may make an order requiring a director to repay, restore or account for money/assets removed, or to pay compensation for any misfeasance or breach of duty.
- There will be a remedy against directors or other persons where a company’s business has been carried on with the intent to defraud creditors or for any other fraudulent purpose. The Court may make an order requiring a person to make a contribution to the company’s assets.
- There will be a remedy against directors and former directors in respect of insolvent trading. Again, the Court may make an order requiring a person to make a contribution to the company’s assets.
- The BVI Financial Services Commission will license insolvency office holders. The regulator will be able to take disciplinary action in any cases where a licensed insolvency practitioner

is found to have colluded with a director to facilitate a transfer of assets to a phoenix operation at less than market value or without appropriate marketing.

No other BVI authorities or regulators are currently acting to counter phoenix activity, and no public funds are earmarked for this purpose.

D. What additional/improved measures need to be introduced to combat phoenix activity in your jurisdiction?

No additional measures will be considered unless and until a problem with phoenixism is identified that cannot be addressed through the new insolvency legislation.

BRITISH VIRGIN ISLANDS FINANCIAL SERVICES COMMISSION

Chapter 5

Canada

In a bankruptcy context, the concept of a “phoenix company” refers to a situation where a company ceases trading or goes bankrupt and then starts up again in business under a new identity. There are legitimate reasons to establish parallel or subsidiary businesses and few restraints on what solvent businesses are permitted to do. As a result, defining what is a “phoenix problem” is somewhat difficult. Likewise, it may be difficult to distinguish between the honest and responsible business failure which may result in a new business being established (e.g. where parties related to the debtor offer the trustee the highest price for the assets in circumstances in which the sale is also approved by the secured creditor and inspectors) and the unscrupulous business practices which achieve the same result.

As in a number of other countries, there is no formal definition of “phoenix companies” or “phoenix activity” in Canadian law. For the purposes of this discussion, we will use the following description of “phoenix activity”:

- Typically, there is a company which experiences financial difficulty. A “new co.” is created in the same or closely related industry just prior to or soon after the company ceases carrying on business. Directors or management of the existing company may load up on inventory and the company is operated until there has been a successful transfer of inventory, receivables, customers and good will to new co. In addition, there may also be a sale of some of the debtor’s assets to new co. for a fraction of their value.

In the 1990s, consideration was given to prohibiting “asset rollovers” - the sale of the assets of a bankrupt company to its principals, primarily its directors. This is typically a phenomenon in small company bankruptcies. Although this aroused concern among some creditor groups, no such prohibition was adopted. During the course of recent public consultations on various insolvency reform issues, the majority view continued to be that asset rollovers should not be prohibited. The rationale for allowing them is that they typically generate the best returns for creditors and produce the most efficient allocation of assets.

If such activity is to be challenged, it may be attacked through the use of civil and criminal remedies. It is noteworthy that the treatment of such activity in Canada closely parallels that which

exists in the United States. If there is a formal insolvency, the trustee may pursue assets through fraudulent conveyance actions. Trustees may also challenge arrangements which result in certain creditors receiving preferential treatment (payment for their goods and/or services or commitments to pay outstanding liabilities in exchange for a promise to continue to supply new co.). Such remedies are also available outside of a formal insolvency through the use of provincial fraudulent conveyance and preferences legislation.

Criminal sanctions for fraudulent activities are also available although it is difficult to determine the extent to which such sanctions are imposed in the bankruptcy context. In the normal course, if the Office of the Superintendent of Bankruptcy receives a complaint involving a “fraudulent flip” or “phoenix” type activity, a referral is made to the police (RCMP) for investigation. This type of investigation does take place from time to time, but there are no reliable statistics regarding the frequency of such investigations. There is, however, no indication that this is a major problem in Canada.

Moreover, there may be liability on the part of directors and officers of the company which is not extinguished when a company ceases carrying on business or makes an assignment in bankruptcy. This includes personal liability of directors and officers for source deductions and GST (a federal value added tax) which can be large amounts. Oftentimes, directors will also have given personal guarantees to their secured creditor and these obligations will survive the insolvency of the company. The idea of establishing and maintaining a public registry of directors of failed companies has been discussed but is not widely supported.

THE SUPERINTENDENT IN BANKRUPTCY

Chapter 6

ENGLAND & WALES

A. How big a problem is the phoenix company and what is its impact in your jurisdiction?

Unfortunately, we have no data that would help us in responding to this question. We also take the view that the term “phoenix company” does not lend itself to exclusive definition and do not see all “phoenix companies” as bad. If a failure is not the directors’ fault and they pay the best price for the assets, they should not be prevented from running a successor business - it would generate wealth and employment if successful.

Pejorative use of the term “phoenix” usually refers to situations where directors “walk away” from the debts of a failed company and assume management of a successor business often from the same premises, using the same or a similar name and with the assets of the failed company, which they are assumed to acquire at an under-value.

As well as complaints from creditors who have lost money, others complain that “phoenixism” allows unfair competition because such companies do not factor in all their costs (e.g. taxes). This sort of conduct (i.e. deliberate serial failure) is essentially fraudulent and, therefore, criminal under existing law.

In essence, “phoenixism” is seen as an abuse of the privilege of limited liability and so we have sanctions in place to deal with those who abuse the privileges of corporate personality. Others are free to try again.

There is a problem of perception, in which moral (if not legal) responsibility for a company’s debts is seen to lie with the owner/director of the failed company – and which he/she “ought” to discharge before undertaking any new venture.

B. What legal/regulatory/other conditions assist the formation of phoenix companies in your jurisdiction?

Generally speaking there is no bar on an individual incorporating another company to operate a business (whether similar or different to his previous business) following the collapse of his/her previous company. Some individuals will have learnt from their mistakes, others may not have been responsible for the failure of their previous venture and next time around they may make a real success of their enterprise.

Many of the changes we have recently made to our insolvency legislation have been aimed at rescuing viable companies and/or businesses and encouraging the individual, involved in an "honest" failure, to have another go.

Where an individual has or is involved in a phoenix operation, our focus is on any misconduct that individual has committed rather than the fact that there is a phoenix business in operation.

Misconduct, in relation to a phoenix business, is treated seriously and usually detected by insolvency practitioners, who have an obligation to report it to the authorities, although creditors and the public may also report it.

C. What measures exist in your jurisdiction to counter phoenix activity and how successful are they?

As indicated above, we do not see phoenix activity as a bad thing of itself. Our concern is any misconduct, which might be associated with it. We therefore have various mechanisms in place to deal with abuses:

Disqualification

Courts can disqualify directors from between 2 to 15 years if they are unfit. "Phoenix" companies are particularly targeted and the courts take such cases very seriously. But hard evidence is needed in all cases.

Prosecution

Directors can be and are prosecuted for offences relating to "phoenix" operations and on conviction they can, additionally, be disqualified from being directors.

Clawback of Money and Assets

Where a company's money and assets have been deliberately put out of reach of its creditors, clawback provisions can apply. However, there are often no funds for a court action and creditors are generally unwilling to risk losing more by funding the liquidator to take such action. Also, unscrupulous directors try hard to cover their tracks.

Re-Use of Name/Similar Company Name

There are restrictions on the re-use by directors of the failed company's name and where these are ignored directors can be prosecuted. They can also be made personally responsible for a company's debts.

We maintain a public register of disqualified directors, which sets out the length of the disqualification. The register of companies, for each individual company, will disclose its directors and whether it is subject to any type of insolvency procedure.

Where regulators become conscious that a particular form of abuse in relation to phoenix companies is becoming prevalent, they may take action to pool information and so act concertedly so as to deal with it more effectively.

D. What additional/improved measures need to be introduced to combat phoenix activity in your jurisdiction?

There are no plans to make any changes at present.

THE INSOLVENCY SERVICE

<http://www.insolvency.gov.uk/>

Chapter 7

FINLAND

A. How big a problem is phoenix companies and what is their impact in your jurisdiction?

The phoenix syndrome is familiar also in Finland. We don't have any research information or figures of phoenix companies. Anyhow the general idea is that they are common in construction businesses and in small service trade like in restaurant businesses.

These phoenix companies have often the following characteristics:

- limited companies, where owners or directors have no personal liability
- minimum share capital and little assets
- a change of the company's name before bankruptcy (and then taking the old name for the new company)
- the new company operates in the same business area as the failed entity, often with the same directors, workers and the same location of business
- big public debts are left behind (tax authorities, pension companies, wage guarantee authorities)
- the phoenix company starts its business with a "fresh start".

B. What legal/regulatory/other conditions assist the formation of phoenix companies in Finland?

Finland is a market economy which more and more seeks to encourage entrepreneurship. Establishing and registering a limited company is quite easy. Minimum share capital is €8,000, and one owner is enough.

There are no legal obstacles to being a director in the limited company when your former company business has failed.

C. What measures exist in your jurisdiction to counter phoenix activity and how successful are they?

There is no legal definition of a Phoenix Company in Finnish legislation. We have some measures to address the problem in different laws:

Business Prohibition (disqualification)

A Court judgement where a person is prohibited from conducting business for a certain period (3-7 years).

A public register of prohibitions.

(from year 1986)

Bankruptcy Law

A provision in bankruptcy law which complicates selling of business as a going concern to a company with same or near owners: creditors' meeting decision with majority of both secured creditors and unsecured creditors is needed (other decisions need only simple majority of the represented votes).

(from year 1995)

Labour Law

A provision of assignment of business: where an enterprise is assigned by a bankrupt's estate the assignee is not liable for the workers' claims, except if there are same or near owners in the assignee enterprise and bankrupt enterprise.

(from year 1993)

Report of debtor's pre-bankrupt actions

A trustee in every bankruptcy must make a report of debtor's actions before the bankruptcy. This report contains, for instance, information on the former bankruptcies of directors and on any depletion of assets shortly before the bankruptcy.

This report works as important document for further investigations and actions of creditors, authorities and the bankruptcy ombudsman.

(from year 1998)

Credit Status Information

Credit information companies collect and register information on the directors in bankrupt companies.

This information can prevent a new company with bankrupt background directors from getting credit and de facto starting a new business.

D. What additional/improved measures need to be introduced to combat phoenix activity in your jurisdiction?

There are no new law proposals to address just this problem. Still the new Bankruptcy Law that will come into force in 2004 includes wider powers for the Bankruptcy Ombudsman's Office to examine company bankruptcies with no assets.

OFFICE OF THE BANKRUPTCY OMBUDSMAN

Chapter 8

IRELAND

A. How big a problem is phoenix companies and what is their impact in Ireland?

While there were 147,127 companies incorporated in Ireland on 31 December 2002², there is no reliable statistical information relating to Phoenix Companies in Ireland. At present, the Office of the Director of Corporate Enforcement (ODCE) has a small number of cases on hands which exhibit phoenix characteristics. The Revenue (the Irish tax authorities) monitors a list of approximately 400 companies, together with the individuals who operate these companies³. The number of actual Phoenix Companies is thought to be a multiple of this figure.

The failed business and the Phoenix Company are usually companies with one or two shareholders, a minimal share capital (normally two shares of €1 apiece with a nominal absolute maximum of 100 shares of €1 apiece) and one or two directors. The directors of the old and new companies may be similar. However, the controller of the company may not be an actual director and may act as a shadow director.

It is often the case that the employees are the same as is the premises from which the company trades. The company's premises and equipment are normally leased or used in an informal arrangement with its controller. The only assets are normally the company's trading stock. A bank account may only contain sufficient cash to continue running the business on a day-to-day basis. Invariably, the banks and the leasing companies who provide services to the failed business are the same financial institutions who provide services to the phoenix entity.

The business name of the company may on occasion be maintained by the controller of the company and may be transferred by way of licence to the new entity.

There is usually a failure to maintain the company's books and records, and consequently, the previous entity normally has failed to comply with the requirements to submit annual returns.

If books were maintained, income or tax liabilities (normally Value Added Tax (a tax on sales) and employee taxes) would often be understated.

² Companies Report, 2002, page 22.

³ Pages 33 et seq., Annual Report of the Comptroller & Auditor General, 2001

The primary creditor in Phoenix Companies is invariably the Revenue. While Revenue is legally entitled to preferential payments in respect of certain of its liabilities⁴, few assets usually remain, and its liabilities tend to average in excess of €100,000 but may exceed €1 million.

The remaining creditors comprise service providers (e.g., the electricity supplier) and consumers. The losses incurred by these creditors often average less than €1,000 per creditor.

Financial institutions are invariably secured creditors or hold security from the principals of the company and are therefore usually protected from significant loss.

Phoenix activity appears in industries which require few assets but considerable input from employees. The primary sectors in which Phoenix Companies arise in Ireland are:

- Construction (primarily the construction of dwelling houses)
- Transportation (specifically haulage firms)
- Licensed premises (such as public bars).

While there is no precise figure for losses incurred by the abuse of limited liability (including phoenix activity), the Revenue have estimated that the associated tax write off in 2001 was €140 million⁵.

Furthermore, legitimate competitors of Phoenix Companies have indicated that by reason of the failure of their competitors to discharge due taxes, they are at a competitive disadvantage.

B. What legal/regulatory/other conditions assist the formation of phoenix companies in Ireland?

Ireland is an open market economy which seeks to encourage entrepreneurship. Company formation costs are low, typically less than €350. The liberal corporate regime and corporate tax rate of 12.5% encourages individuals to utilise corporate entities for business ventures.

It is considered that the stigma surrounding business failure has declined. Creditors will deal with Phoenix Companies if the loss suffered in the previous business failure has been small.

⁴ Section 285, Companies Act, 1963 as amended by Section 10, Companies (Amendment) Act 1982

⁵ Pages 33 et seq., Annual Report of the Comptroller and Auditor General, 2001.

There are no restraints on incorporation in respect of companies with Irish resident directors. A company which has no Irish resident director must maintain a bond of about €25,400⁶.

Tax registration is available to all entities, and immediate tax clearance is given save in specific cases outlined below. Whilst the Revenue has power to obtain securities⁷, it does not utilise these powers without specific reason.

A company may be dissolved by reason of the cessation of business⁸, a failure to make annual returns⁹ or if a non-resident company, by a failure to comply with the tax codes¹⁰.

Upon re-incorporation following dissolution, a company must comply with all of the provisions of the Companies Acts (including registration of all outstanding annual returns) and discharge all outstanding tax liabilities to the Revenue¹¹.

While there are no legal or training requirements for directors, the ODCE has published useful guidance to assist company law compliance. A person is not prohibited from being a director unless he or she is disqualified or restricted (see below) or is an undischarged bankrupt. A person may not act as a company director of more than 25 companies subject to exceptions¹².

There is no automatic inhibition on a person acting as a director following the insolvency of a previous company. However, the liquidator of an insolvent company must report to the ODCE on the company's insolvency and the directors' conduct within six months of being appointed liquidator and at specified intervals thereafter. S/he must subsequently instigate High Court proceedings for the restriction of all of the company's directors unless the ODCE grants relief from making this application¹³. A director will be restricted if s/he was the director of an insolvent company within 12 months of the date of the liquidation of an insolvent company and s/he cannot satisfy the Court that s/he has acted honestly and responsibly and there is no other reason why s/he should not be restricted¹⁴. (Note the reverse burden of proof.) If the Court restricts a person, s/he cannot act as a director of another company unless it is adequately capitalised (i.e., the

⁶ Sections 43 – 44, Companies (Amendment) (No.2) Act, 1999

⁷ Section 35, Value Added Tax Act, 1972 as amended

⁸ Section 311, Companies Act, 1963 as amended by section 11, Companies (Amendment) Act, 1982

⁹ Section 12, Companies (Amendment) Act, 1982 as amended by Section 245, Companies Act, 1990 and section 46, Companies (Amendment) (No. 2) Act, 1999

¹⁰ Section 12A, Companies (Amendment) Act, 1982 as amended by Section 46, Companies (Amendment) (No. 2) Act, 1999

¹¹ Sections 12B & 12C, Companies (Amendment) Act, 1982 as inserted by Section 46, Companies (Amendment) (No. 2) Act, 1999

¹² Section 45, Companies (Amendment) (No. 2) Act, 1999

¹³ Section 56, Company Law Enforcement Act, 2001

¹⁴ Section 150, Companies Act, 1990 as amended by Section 41, Company Law Enforcement Act 2001

company must have a paid up share capital paid in cash of €317,435 in respect of public companies and €63,487 in respect of private companies). Since this reporting provision commenced in 2002, about 150 directors have been restricted. This sanction also applies to unliquidated insolvent companies¹⁵, where the ODCE or other parties may make the High Court application.

A person is automatically disqualified from being an officer of a company or from being involved in its management if convicted on indictment of any indictable offence in relation to a company or involving fraud or dishonesty. Application may also be made by the ODCE and other parties for disqualification for reasons of fraud, persistent default with the requirements of the Companies Acts or unsuitability to be concerned in the management of the company¹⁶.

Companies are required to submit an annual return and accounts (with some exceptions) to the Companies Registration Office at least once every year.¹⁷ These are open for public inspection.

The liquidator of an insolvent company is obliged:

- to make annual returns to the Companies Registration Office¹⁸
- to hold annual meetings of the members and creditors¹⁹
- to report on the company's insolvency and the directors' conduct to the ODCE within six months of being appointed liquidator and at specified intervals thereafter²⁰; and
- to report to the ODCE and the Director of Public Prosecutions on the commission of offences by the officers of the company²¹.

Creditors primarily detect Phoenix activity. There is no reliable facility by which the common directorships of companies may be identified, because directors do not have to prove their identity on registration as a director. The planned application of a unique identifier to each individual in the State (the PPS number) may help to detect common directorships in the future.

Creditors are usually willing to continue trading with the new entity if the company's principal has arranged for the discharge of the majority of trading creditors prior to the cessation of trading.

¹⁵ Section 251, Companies Act, 1990 as amended by Section 54, Company Law Enforcement Act 2001

¹⁶ Section 160, Companies Act, 1990 as amended by Sections 14 and 42, Company Law Enforcement Act 2001

¹⁷ Section 125, Companies Act 1963 and related provisions

¹⁸ Sections 272 and 306, Companies Act, 1963

¹⁹ Section 272, Companies Act, 1963

²⁰ Section 56, Company Law Enforcement Act, 2001

²¹ Section 299, Companies Act, 1963 as amended by Section 143, Companies Act, 1990 and Section 51, Company Law Enforcement Act, 2001

While the distribution of assets favouring some creditors over others ('fraudulent preference') is a civil wrong which is actionable²², creditors are usually unwilling to act for economic reasons i.e. lack of availability of assets. In particular, creditors perceive that there is a lack of benefit from the taking of such action especially given that the benefits of this action will accrue to creditors in general or may be completely subsumed by outstanding Revenue liabilities.

The liquidation of insolvent companies is not a mandatory requirement in Ireland. When appointed, liquidators have often acted to pursue parties responsible for phoenix activity. However, a liquidator has been known to assist phoenix activity by depressing the value of the pre-existing company's assets prior to their sale to the Phoenix Company, although the incidence of such cases is very low.

Until recently, there was a lack of resources available to enforce company law. The result was that a person who breached the Companies Acts was reasonably sure that they would not be prosecuted. With the establishment of the ODCE, this perception is changing.

The time lag in detection and continuing creditor support of phoenix activity remain the major outstanding problems.

C. What measures exist in Ireland to counter phoenix activity and how successful are they?

There is no legal definition of a Phoenix Company in Irish legislation. However, we would agree with the characteristics of the Phoenix Company which is outlined in Chapter 1.

There is no general prohibition on the existence of Phoenix Companies per se.

There are no minimum capitalisation requirements save in the case of restricted directors.

There is no bonding save in the case of companies with non-Irish resident directors.

There are no certification procedures nor are there legal presumptions.

²² Section 286 of the Companies Act, 1963 as amended by Section 135, Companies Act, 1990

The Registrar of Companies maintains the Register of Companies, but it may be some time before it is clear that a company is no longer trading. The Phoenix Company may have been formed in the interim, and so company law enforcement action will often take place in arrears.

There is no offence or civil wrong of being involved in phoenix activity. Liquidators, creditors and the ODCE have entitlements to investigate and seek the sanctioning of phoenix activity by applying the insolvency and winding up provisions to the pre-existing entity. These provisions which also apply to unliquidated insolvent companies²³ include:

- Criminal and civil liability for fraudulent trading²⁴
- Civil liability for fraudulent preference²⁵
- Civil liability for misfeasance²⁶
- Criminal liability for transfer of assets with intent to defraud creditors²⁷.

However, personal liability has been imposed on few controllers of Phoenix Companies. Obtaining proof of fraud is very difficult without having direct statements from individual directors. Also, the directors may successfully defend the action if they can show a subjective belief that they were acting honestly or that they were under economic duress.

While ODCE staff are bound by a duty of confidentiality in relation to information which they receive during the course of their duties²⁸, legal information-sharing gateways exist with various State and other regulatory authorities, e.g., Revenue and the police²⁹. The ODCE is also subject to the Data Protection Acts, 1988-2002, but these provisions have not inhibited the Office in operating the information-sharing gateways to date.

No formal task forces on phoenix activity are in place, and information-sharing with private creditors or their representatives is not permitted by law.

The Revenue have taken action in certain areas. For example, a tax clearance certificate is now a prerequisite for the annual renewal of a public bar licence. This certificate will not issue where, in the previous year a person entitled to control with connected persons at least 50% of the share

²³ Section 251, Companies Act, 1990 as amended by Section 54, Company Law Enforcement Act 2001

²⁴ Sections 297 & 297A, Companies Act, 1963 as amended respectively by Sections 137 and 138, Companies Act, 1990

²⁵ Section 286, Companies Act, 1963 as amended by Section 135, Companies Act, 1990

²⁶ Section 298, Companies Act, 1963 as amended by Section 142, Companies Act, 1990 and Section 50, Company Law Enforcement Act 2001

²⁷ Section 295, Companies Act 1963

²⁸ Section 17(1), Company Law Enforcement Act, 2001

²⁹ Sections 17(2), 17(3) and 18, Company Law Enforcement Act, 2001

capital of the company which retained the licence, tax was owed by that company and a similarly controlled company now retains the licence³⁰.

The list of known disqualified and restricted directors is published annually in the Companies Report based on information received by the Registrar of Companies from the Courts. However, this list is not comprehensive.

It is the ODCE's intention to publish on its website the names of all restricted and disqualified directors arising out of proceedings initiated directly or indirectly by the Office.

There is no official public funding available at this time. However, the Revenue occasionally initiates and supports liquidations in respect of companies having considerable tax liabilities.

The Revenue interventions have achieved some success. While it is too early to assess the impact of the ODCE and its new powers, the sanction of restriction incorporating the reverse burden of proof offers potential in curbing phoenix activity.

D. What additional/improved measures need to be introduced to combat phoenix activity in Ireland?

Securing active co-operation among relevant national regulators in investigating business malpractice remains a priority for the ODCE. International co-operation from corporate and insolvency regulators would also support these efforts.

In order to secure greater co-operation from creditors, the ODCE would like to see the introduction of incentives for creditors similar to the provisions in the Australian legislation and the proposals by the New Zealand Ministry of Economic Development.

OFFICE OF THE DIRECTOR OF CORPORATE ENFORCEMENT

<http://www.odce.ie/>

³⁰ Section 1064 Taxes Consolidation Act, 1997 as amended

Chapter 9

JERSEY

In this small jurisdiction, with a small number of insolvencies each year and all compulsory liquidation being dealt with by the Viscount, it is virtually impossible for phoenix operations to surface.

Jersey has the usual and necessary raft of statutory provisions that prevent bankrupts acting as company directors and provide for directors' disqualifications and regulatory compliance etc. But the essential point, it seems, is as expressed above – it is hardly possible in Jersey for an enterprise to rise from the ashes without key entities (the Royal Court, the Financial Services Commission, the Viscount, the media) knowing about it. Likewise there are few “shelf companies” and beneficial ownership of new companies needs to be declared and vetted.

VISCOUNT'S DEPARTMENT

Chapter 10

NEPAL

A. The problems of phoenix companies and their impact in Nepal?

Nepal does not have reliable statistical information relating to phoenix companies. As per the record of the Office of Company Registrar as of October 2003, the total number of private companies is 25,667 and that of public companies is 856. Since the company law enforcement administration is weak, there is no proper record of dormant and operative companies. Similarly, there is no proper record of phoenix companies.

The style of operation of phoenix companies is unique in Nepal. We may also call it shadow or proxy companies. A person or group of persons while incorporating a company for operating a particular type of enterprise (for example, carpet weaving or garment stitching or any other enterprise that does not require heavy machines and huge capital investment) normally incorporate two or more companies. One of these companies may be operated and others would remain non-operative. The company is controlled by the person who does not directly hold any shares (for them the term "shadow shareholders" may be used). In due course when the liability of the first company towards the tax authority, creditors and employees increases, the first company is left as it is, not even applying for dissolution. Then the business is carried on by the other already registered companies from the same premises. Normally the premises are changed only where the first company is made defunct as a result of increased liability towards the employees. This mechanism of doing business is also prevalent among some of the foreigners doing business in Nepal in a small scale.

These companies are normally of the similar name. The name is normally prefixed by "new". For example, "A" company and "New A" company.

The parties suffering most from the phoenix companies are employees, the revenue department, unsecured creditors and service providers (e.g. electricity, water, telephone etc.). Since no research has been done, the exact amount of loss suffered cannot be quantified.

Phoenix activity appears in industries which require few assets like machinery and equipment but which require considerable input from employees. The primary sectors in which phoenix companies arise in Nepal are:

- Woollen
- Carpet weaving
- Garment making
- Textile producing (small scale)
- Trekking operators
- Auto workshops
- Motels, lodges (small scale).

B. The legal/regulatory/other conditions assisting the formation of phoenix companies in Nepal

Nepal is moving towards an open market economy which seeks to encourage entrepreneurship. The legal and administration cost for the formation of companies is low. The registration fee payable to the Government for the incorporation of a private limited company with an authorised capital of Rupees 1 crore (US\$135,135.13) (which is a substantial sum in Nepalese context) is only Rupees 12,000 (US\$162).

Apart from the cost of the incorporation, there are factors assisting or motivating the formation of phoenix companies. Some of them are: rampant corruption in tax administration, unfriendly labour laws which unduly favours the workers and employees, the lack of a business friendly attitude among the Government officials dealing with business matters, the lack of effective enforcement of company legislation, the lack of rule based administration, etc.

There are no restraints on incorporation in respect of companies with Nepali citizens as promoters. However, the registration/formation with foreign investment requires an approval of the competent legal authority.

A solvent company may be dissolved voluntarily by shareholders. The Office of Company Registrar (OCR) may issue a liquidation order by reason of the cessation of business, a failure to make an annual return, on application by lenders representing 50% of total outstanding loans which are outstanding for more than two years.

Tax registration is available without delay.

There is no law debarring the reincorporation of a dissolved company.

There are no legal or training requirements for directors. A bankrupt person cannot be appointed as a director. The existing law does not limit the number of companies for directors. A person may hold the position of director in an unlimited number of companies except in case of banking and finance companies.

A person is automatically disqualified from being a director of a company if convicted on indictment of any indictable offence in relation to a company or involving fraud or dishonesty.

Companies are required to submit an annual return and accounts to the Office of the Company Registrar at least once every year. The annual returns and accounts of public companies are open for public inspection but those relating to private companies are not open to the public. However in practice, the disclosure requirement is not strictly adhered to by the companies nor enforced by the Office of the Company Registrar.

The creditors are the main detectors of phoenix activity. This may also be detected through common directorships. However, there is no reliable facility by which the common directorships of companies may be identified, as the directors do not have to prove their identity on registration as a director.

In the past, there have been examples, especially among government owned banks, of their facilitating phoenix activity.

The Nepal Rastra Bank (the Central Bank) has recently introduced a new directive requiring banks and financial institutions to blacklist the defaulters of big loans (more than Rs. 2.5 millions (US\$33,784.00)). In Nepal, the creditors are now not able to extend credit facilities to a debtor who defaults in making repayment, and this restriction also extends to the shareholders and the directors holding more than 15% of the total shares of defaulting company.

Though this Directive may not encourage the facilitation of phoenix activity, the Directive is a poorly made law and kills entrepreneurship. This approach should not be followed.

Insolvency practice is not well developed in Nepal. There is also no law dealing with good practice. Therefore at this stage, practitioners' conduct in discharging their responsibilities cannot be measured.

The time lag in detection and continuing creditor support of phoenix activity remain the major outstanding problems.

C. What measures exist in Nepal to counter phoenix activity and how successful are they?

There is no legal definition of a phoenix company under the existing law in Nepal, and this concept itself is unknown in a Nepalese context.

There is no general prohibition on the existence of phoenix companies per se.

There are no minimum capitalisation requirements save in the case of the formation of companies with special objectives such as banking, finance and insurance companies. However, the proposed Company Law Bill prescribes a minimum capital requirement for public companies.

The proposed Company Law Bill prohibits the use of a company name similar to the insolvent company for a period of three years from the date of the completion of the insolvency procedure.

No arrangements exist in Nepal relating to information-sharing or cooperation.

There are no regulators countering phoenix activity.

No system of keeping a public register of disqualified directors exists in Nepal.

D. What additional/improved measures need to be introduced to combat phoenix activity in Nepal?

In the context of Nepal, reform in the tax and company law administration and rationalisation of labour law may improve the situation to a great extent. In addition, the introduction of provisions similar to the one contained in section 216 of Insolvency Act 1986 of the United Kingdom would deter phoenix activities.

PIONEER LAW ASSOCIATES

Chapter 11

MEXICO

A. How big a problem is the phoenix company and what is its impact in your jurisdiction?

Regarding the incidence of phoenix companies in Mexico, unfortunately there are no figures available. This is due mainly to the fact that informal commerce is considered a more serious problem. There is a great number of businesses that do not register before the tax authority, follow the legal requirements to be formally constituted, or have a permanent establishment. Therefore, phoenix activity has not been largely studied or measured.

Nonetheless, the phenomenon certainly is present in Mexico, although there are no formal studies describing it. Its main characteristics are perceived by different social actors, such as entrepreneurs, companies, public accountants, notary publics or lawyers, among others. The features of phoenix companies in Mexico are more or less those that are described in Chapter 1. However, we have also detected a variation on the phoenix company. In this case, a “reborn” or new company is not necessarily formed after the dissolution of the first one. It is created and operates in a parallel way to its sister. Its main features can be one or several among the following:

- There is a group of companies that do not share stocks, but act as an economic entity, usually attached to a holding company. Losses are accumulated in one of the companies, and the rest of them enjoy the profits. Under this scheme, directors of the phoenix company proceed to initiate insolvency proceedings regarding the company that concentrates the losses
- A parallel twin company is created in the same operating area, while the insolvent company is in charge of all operations so a particular market can be supplied
- Operations between related companies are not duly controlled. There are no formal contracts between the phoenix company and its sister entity, nor a register of funds transfer.
- Usually, in these operations the phoenix company does not charge its sister, or charges a significantly low price. Hence, the twin company can profit from a larger profit margin.

- The phoenix company grants loans to another related company. These loans are not entered into the accounting registers. In most cases, they do not have an expiration date and interests are not charged
- When a related company asks for a loan, in many cases the phoenix entity endorses it, with the risk that it may not have enough assets to respond for its value
- The phoenix company issues promissory notes, without sufficient cash flows to cover their total amount
- Related companies sell obsolete stock to the phoenix entity
- The phoenix entity hires a related company to perform certain services. These services usually are not justified, and there is no formal contract between the companies
- The twin company shares directors with the phoenix company
- Generally, directors of the phoenix entity or the other related entities are shareholders of the sister company
- Related foreign companies exchange merchandise with the phoenix company at prices lower than the market.

On the other hand, the parties who most suffer losses from the failure are, in many cases, the phoenix or the insolvent companies' suppliers, since generally they are not secured creditors. The government, through the tax authority, also suffers a great loss, since it usually is owed very large, due credits. Financial institutions are almost always secured creditors; hence, they do not face such a difficult situation.

It is also worth mentioning that phoenix businesses are prevalent in the hospitality industry. This industry is very large in Mexico, and phoenix activity has been identified in restaurants, bars and night clubs.

B. What legal/regulatory/other conditions assist the formation of phoenix companies in your jurisdiction?

In order to understand the environment in which phoenix activity exists, it is necessary to briefly describe how companies are formed, and what legal requirements have to be complied with. In general terms, for the constitution of a company there has to be more than one shareholder (Mexican legislation does not permit companies where there is only one owner) and a minimum capitalization of approximately \$5,000.00 U.S.D. The bye-laws of a company have to be agreed upon before a notary public, who is in charge of the registration of the corporation in a public registry. The names of the shareholders are also inscribed. Next, the company and the

shareholders have to register before the tax authorities. A corporation cannot be named after another company. However, there is no restriction on a commercial entity bearing the name of a dissolved company.

It is clear then that there are no strict rules regarding incorporation. This is also the situation for dissolution and re-incorporation. Mexican legislation does not provide any restraints for a person to act as a company director for the first time, to act as a company director for multiple businesses or to act as a company director of a new business following a company insolvency.

So far, it may look like a grim scene for the detection and combating of phoenix activity. Nonetheless, it is not so for a number of companies. It is important to distinguish two distinct groups of corporations: publicly traded companies and those that do not trade publicly. This difference is not trivial, since there is a high level of supervision for public companies. There are strict rules regarding corporate governance, and there are other authorities, besides the tax authority, that supervise these companies.

Additionally, there is special regulation that applies to a certain kind of corporations, such as financial institutions, companies that have public concessions, and other credit institutions (like non-bank banks). Therefore, it is virtually impossible for phoenix companies to arise when it comes to companies listed in the stock exchange or companies with special regulation. Thus, it can be concluded that the phoenix syndrome represents a serious problem mostly within small to medium corporations.

C. What measures exist in your jurisdiction to counter phoenix activity and how successful are they?

There is no legal or other accepted definition of a phoenix company which applies in Mexico. As mentioned earlier, there is only a notion of the phenomenon.

When it comes to the subject of the disclosure of failed businesses or disqualified directors, we still face a great challenge. Recently, a law that regulates the information that government can disclose to the public entered into force. Its main objective is to compel state agencies to provide the public with more information (more than was already available). Unfortunately, that was not the result regarding the Judiciary Branch. The law makes it difficult for certain data found in judicial files to be disclosed, such as the names of the parties. Therefore, there is a lot of information that cannot be revealed, including the names of persons or entities subject to an insolvency proceedings. In sum, there are no public registers that may facilitate public monitoring of possible phoenix companies

available. However, there is a national public registry –as well as local registration offices– where anyone can consult data on a particular company. It is mandatory for a company to inscribe certain information, such as mortgages, pledges or the judicial declaration of insolvency or bankruptcy.

It was mentioned earlier that, when it comes to some specific kind of companies, there are other authorities involved, depending on the nature of the entity, such as the following:

- The National Banking and Stock Exchange Commission (Comisión Nacional Bancaria y de Valores). This authority supervises banking and credit institutions, stock exchanges and publicly traded companies
- National Insurance and Bonding Commission (Comisión Nacional de Seguros y Fianzas). This commission supervises insurance and bonding institutions
- Public concessions. They are supervised by the public entity that granted the concession or license (for example, the Communications and Transportation Department for radio and television, or the Energy Department, for natural gas).

Naturally, the tax authority (Revenue Administration Service) has supervision powers over all kinds of companies.

All of these government bodies are in constant communication, and report any irregular situation they might discover. Fiduciary and banking secrets constitute restrictions on information sharing. Notwithstanding this, there are no special divisions within these agencies dedicated to the detection of phoenix activity, or any budget assigned to this activity.

It is also noteworthy that public companies have a wider obligation to disclose information.

Measures to counter phoenix activity

These are the main measures adopted to counter phoenix activity:

- **Voidance of transactions celebrated to the detriment of creditors**
The Federal Civil Code, most state Civil Codes, and the Insolvency Act all establish that transactions celebrated to the detriment of creditors, can be declared void. A requirement for the voidance is that these –in most cases fraudulent or intentional– transactions are the cause that led a company to a state of insolvency.

- **Lifting of corporate veil**

Congress is currently discussing a bill that, if passed, would permit the lifting of the corporate veil, in the case of limited liability companies. This unveiling would permit extending liability to the partners of a company and making them respond for civil and, in some cases, criminal responsibility.

Even though it is not considered an offence or civil wrong to have been involved in a phoenix company, there are several types of conduct considered criminal, that may occur in phoenix-related activities. For instance, once a merchant has been declared judicially insolvent, he will be punished by imprisonment for one to nine years if it is proven that he intentionally caused the company's insolvency. It is also considered a felony to give false data regarding the identification information of a company, or to use simultaneously two different registration numbers issued by the tax authority.

- **Corporate governance rules**

There is a Corporate Governance Code for Mexico, which was issued with the help of the relevant authorities, the Mexican Stock Exchange (Bolsa Mexicana de Valores) and business organizations. Although it is not mandatory to abide by it, listed companies usually follow its principles. In any case, financial institutions have already adopted these provisions.

- **Accounting principles**

The Mexican Institute of Public Accountants (Instituto Mexicano de Contadores Públicos), through its Accounting Principles Commission concluded that professionalism and transparency have to be sought in financial statements. Therefore, all entities that fit into the description of an insolvent company given by the Insolvency Act, have to reveal this situation in their financial statements, adding that any creditor or the attorney general can initiate insolvency proceedings against such a company. Thus, public accountants have to disclose an insolvency situation.

- **Insolvency culture**

Phoenix companies often appear because of a bankruptcy situation. By promoting the benefits of the Insolvency Act, it can be expected that more and more companies use it as a restructuring instrument. The idea that has to be stressed is that merchants do not have to reach the critical point of being unable to pay their debts, dissolve their corporation and create a new one. This is considered a cultural issue because insolvency or bankruptcy

proceedings have historically been considered pernicious for a company. There is still a negative stigma surrounding insolvency, even after almost four years of the entering into force of the Insolvency Act. This is the prejudice that has to be fought.

D. What additional/improved measures need to be introduced to combat phoenix activity in your jurisdiction?

There are several measures that can be introduced in the Mexican system in order to combat phoenix activity, but the following are considered the most important:

- **Public disclosure of entities declared insolvent or bankrupt**

It would be of benefit, in order to deter phoenix activity, to reform the law that regulates public information. The aim of this reform would be to specifically deal with insolvency proceedings, so the names of the entities declared insolvent or bankrupt can be revealed.

- **Strengthening corporate governance in small to medium companies**

Corporate governance rules for small to medium enterprises could be improved, and they could even form a uniform standard with those that apply to publicly traded companies. Some of the issues that should be addressed are:

- Requirements to act as a director for the first time, or as a director for multiple businesses
- Direct responsibility and accountability of the board of directors
- Stricter rules regarding accounting and auditing
- Disqualification of the directors of a failed company
- Publication of the list of disqualified directors
- Regulation of corporate groups.

**INSTITUTO FEDERAL DE ESPECIALISTAS DE CONCURSOS MERCANTILES
(FEDERAL INSOLVENCY SPECIALISTS INSTITUTE)**

<http://www.ifecom.cjf.gob.mx>

Chapter 12

NEW ZEALAND

A. Extent and impact of phoenix companies in New Zealand

Statistics

There were 307,461 companies incorporated in New Zealand on 1 July 2003. There is no information on the number of phoenix companies, which have been created as a result of the failure (or imminent failure) of a related company.

New Zealand is currently in the process of reforming its insolvency law and one of the areas under review is the issue of phoenix companies. While some anecdotal evidence was provided about the problems that can occur with phoenix companies, the view of officials was that the use of phoenix arrangements which is counter to stakeholders' interests was only a subset of cases.

Many phoenix situations will, in fact, promote the interests of creditors (including employees) through lower transaction costs and a higher sale price than would occur without phoenix companies. The business fetches a higher price through it being sold as a going concern than if its assets were broken up and sold individually. A higher price will be received, for example, where the existing managers and directors increase the company's sale value, or where a sale to the managers will realise the highest price, for example. The value of phoenix arrangements is particularly pronounced where the business generates a large income stream yet has relatively few assets, for example, a computer consultancy business.

Nature of phoenix businesses

The feature of identified phoenix companies in New Zealand is that they usually have a nominal shareholding (\$100) and the directors are those who were involved in the associated failed company. It is relatively common for the new company to have a name similar to that of the failed company.

The Official Assignee has noted the prevalence of phoenix companies in the construction industry, primarily among contractors and sub-contractors. There are no figures on losses suffered by parties, but anecdotal evidence indicates that suppliers and the Inland Revenue Department are the parties most affected by phoenix activity.

General economic and other known impacts

There is no firm information about the economic impact of phoenix companies in New Zealand. Many of the companies identified by the public as phoenix companies have been established after the failure of another company and have the same personnel, but have not acquired any tangible assets from the failed entity.³¹

It has been recognised that depending on the prevalence of the problem, the inappropriate use of phoenix companies could lead to less confidence in the value of creditor security and the use of measures to counter risk to that security (for example, insurance such as income protection for employees, and increased monitoring of debtor behaviour). This in turn could lead to higher transaction costs and an increased cost and reduced availability of credit. There are also redistribution consequences, that is, assets being transferred from creditors to the owners/managers/directors of the failed company.

B. Legal, regulatory and other conditions

New Zealand has a regulatory regime encouraging entrepreneurship and few barriers to commercial activity. This includes low cost and simple company incorporation processes, which enable the swift establishment of new companies by directors/shareholders in the light of the failure of previous companies.

While there is some stigma associated with business failure, creditors tend to be realistic about the effect of failure and dealing with new entities in the absence of any concerns about previous mismanagement or bad faith dealings.

Legal pre-conditions, incorporation and public disclosure

There are few restrictions on the incorporation of a new company in New Zealand. There is no minimum capital requirement and few limits on who may be directors, though persons who are bankrupt may not be a director, along with persons who have been formally disqualified from being a company director. There are no qualifications or training requirements for a company director.

A company may be incorporated on approval of a reserved name, submissions of an application for incorporation (with consents from directors and shareholders) and payment of the prescribed fee. The company may register separately with the Inland Revenue Department for tax purposes.

³¹ <http://website/ri/insolvency/review/tierone/phoenix/index.html> - link to Ministry of Economic Development, *Insolvency Law Review: Tier One Discussion Documents – Phoenix Companies*, Wellington, January 2001

There are no public disclosure requirements for companies, other than for issuers of securities and overseas companies. Both issuers and overseas companies are required to file audited financial statements with the Registrar of Companies in accordance with the Financial Reporting Act 1993. All companies are required to provide annual reports to shareholders providing financial information.

Detection of phoenix companies

Detection is primarily by creditors. Most phoenix companies may be identified by common directors / shareholders. Members of the public may carry out a search on directorships or shareholdings with the Companies Office at www.companies.govt.nz. A search result can display both current and historical information about directorships and shareholdings, including involvement in any failed companies (in liquidation, receivership or those removed from the register).

Creditor activity to facilitate / deter phoenix activity

The ease of incorporating a new company in New Zealand means that there is little action that can be taken to prevent the creation of a new company. Anecdotal evidence is that creditors are willing to change with the new company, and this has been reflected in the Official Assignee's experience of this issue relating to property development, where the main examples of phoenix activity have been identified.

The main method of deterring phoenix activity is New Zealand's director disqualification provisions, which are set out at C below.

Other factors assisting phoenix activity

Concerns in New Zealand about phoenix activity have focussed on perceptions of ineffective enforcement contributing to phoenix activity by providing few deterrents to stop such activity. Perceptions of ineffective enforcement appear to stem from:

- the cost of accessing the judicial system (these are the monetary and time costs in taking an action in the courts);
- low levels of action by enforcement bodies;
- the free rider problem whereby, for example, a creditor, in choosing to fund an action, "subsidises" other creditors, as any success is for the benefit of all;
- the high transaction costs associated with many small creditors attempting to co-ordinate their actions; and

- the creditors' perceived probability of successfully challenging the phoenix arrangement (creditors must assess the likelihood of overcoming prescribed evidential hurdles with the information available to them).

C. Measures in New Zealand to deter phoenix activity

The definition of a phoenix company in New Zealand set out in a government discussion paper dated January 2001 on this issue was:

“A phoenix company is a company that has been “reborn” soon after and in some cases before) its failure. The new company takes on the failed company’s business, often using a similar name, the same managers and directors, and the same assets. The use of phoenix arrangements to sell the business as a going concern is an alternative to breaking up and selling the business assets individually”.³²

The description outlined at Chapter 1 is consistent with the position as recognised in New Zealand.

There are no measures in place in New Zealand to prevent the incorporation of a phoenix company, following the failure of an associated company.

Criminal and civil measures to investigate and address phoenix activity

Where a director has been involved in one or more failed companies, the Registrar of Companies has powers to disqualify persons from acting as a director of a company under section 385 of the Companies Act 1993, where he is satisfied that there has been mismanagement on the part of the director. 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.

In addition, it is an offence under section 380 of the Companies Act 1993 for any director, with intent to defraud the creditors of a company, to transfer property of a company. This includes the phoenix situation where property is transferred from a failing company to a phoenix company for less than its full consideration.

The following civil remedies are available:

Pursuant to the Companies Act 1993

- Section 271 - Pooling of assets of related companies:

³² Ministry of Economic Development, *Insolvency Law Review: Tier One Discussion Documents – Phoenix Companies*, Wellington, January 2001

Section 271 allows a court to order that a company that is or has been related to a company in liquidation must pay to the liquidator the whole or part of any or all claims made in the liquidation.

- Section 297 - Transactions at undervalue:
Section 297 provides, among other things, that a liquidator may recover from any other party to the transaction any amount by which the value of the consideration or benefit the company provided exceeded the value of the consideration it received.
- Section 298 - Transactions for inadequate or excessive consideration with directors and certain other persons:
Section 298 provides for the liquidator to recover from the person, relative, company or related company any amount by which the value of the business (including goodwill) exceeded the value of any consideration the company received.
- Section 301: Power of court to require persons to repay money or return property
Section 301 allows the court to order a person (including past or present directors or managers) to restore money or property, or contribute compensation where that person has been guilty of a breach of duty or trust in relation to the company.

Other Statutory Civil Remedies

In addition to the Companies Act, section 234 of the Employment Relations Act 2000 provides a mechanism whereby officers, directors or agents of an insolvent company can be held personally liable for unpaid minimum wages and holiday pay if they have directed or authorised the default in payment of these monies to the employees.

Additional arrangements (information sharing etc) and their success

Both the Official Assignee for New Zealand and the Registrar of Companies are based in the Ministry of Economic Development. They have established a National Enforcement Unit which acts for both the Registrar and the Official Assignee. That Unit carries out prosecutions under the Companies Act 1993 as well as preparing reports on candidates for director disqualifications, which often involve directors who have established phoenix companies. Those reports are prepared by investigators dedicated solely to director disqualification activity.

There were 15 director disqualifications in 2003, many of which involved elements of phoenix activity. There was considerable national press coverage relating to director disqualifications,

informing the public of the possible consequences of improper phoenix activity and general corporate mismanagement.

D. Additional or improved measures to address phoenix activity in New Zealand

As part of its current review of insolvency law in New Zealand, the government has considered the issue of phoenix activity in New Zealand, as set out in a discussion paper dated January 2001 and has announced measures intended to reduce the negative effects of that activity. The review arose from the failure of a New Zealand stevedoring company, where the circumstances behind the failure and losses to creditors heightened concerns over the ability of directors and managers of a failed entity to defeat creditors' legitimate interests in pursuit of their own interests.

In February 2003, the Minister of Commerce announced the government's proposals for reform to curb abuse of phoenix activity. The announced decisions were:

"Another focus is the problem arising out of what have been termed 'phoenix companies', where a business is sold as a going concern to another company or to its directors and/or managers, usually soon after its failure."

"We [the government] want to ensure that there are effective penalties available to the courts when directors deliberately abuse phoenix company arrangements. This will be achieved by providing for criminal penalties when directors have acted in bad faith to defeat creditors' legitimate interests."

"We will also restrict the re-use of a company name by any director of the company after it has gone into insolvent liquidation. This will prevent directors from continuing to trade off the goodwill of an insolvent company by selling it to another company they control."

In addition, decisions have been made proposing that lawyers be able to operate on a contingency fee basis when enforcing insolvency provisions. That will provide greater scope for action to be taken under the Companies Act 1993 to set aside transactions at undervalue, or with related parties for excessive or inadequate consideration.

An Insolvency Bill is currently being drafted for introduction to Parliament in 2004.

THE OFFICIAL ASSIGNEE FOR NEW ZEALAND

Chapter 13

NORTHERN IRELAND

A. How big a problem is the phoenix company and what is its impact in your jurisdiction?

The comments contained in this reply are based partly on experience and partly on available statistics. We have not undertaken any detailed study of the “phoenix” syndrome as it affects the market in Northern Ireland.

I think it useful to record that phoenixism, while a nuisance to creditors and customers, is not (in Northern Ireland at any rate) the problem that it is generally assumed or made out to be – particularly in the tabloid press.

I should also say that it is possible that some phoenix companies become insolvent but escape the formal forms of insolvency (and thus any official investigation of the conduct of the directors and the reasons for the failure) or enter into a voluntary arrangement with the creditors (which also avoids an investigation).

Since 1995 the Court has made disqualification orders against the directors of 106 companies – 24 (approx. 23%) involved phoenixism in some form (either of a previous company or the incorporation of an insolvent sole-trader/partnership business).

Generally the main trades were clothing and textiles (mainly manufacturing with some retailing) and quarrying. Textiles and clothing were once major employers but have now diminished almost to extinction, so I would be surprised if phoenixism proved to be a problem in the future. Quarrying is now subject to stricter environmental controls and it is hard to see uncapitalised operators opening new quarries. The possibility that they might acquire existing quarries cannot be ruled out but so far there has been no evidence of this.

There have been failures in the software business but with minimal evidence of phoenix companies being created.

The other sectors with a traditionally high rate of corporate failures – hospitality and construction – are not showing any significant signs of phoenixism. There have been indications from time to time that services related to construction such as glazing are hatching phoenix companies but we have yet to see any signs in the insolvency statistics.

The one common theme throughout phoenixism in Northern Ireland is that trade creditors tend not to suffer since their credit will be required in the new company. Similarly banks and finance companies are often treated well on the basis that their financial support will be essential in the phoenix.

Those mainly affected are Government departments for value added tax, rates (a property tax) and employees' income tax which was deducted but retained to finance insolvent trading.

Consumers have been known to suffer with deposits taken for goods which have not been supplied (at a time when the directors were or ought to have been aware of the company's insolvency).

I doubt whether the incidence of phoenixism has had any significant effect on the local economy save perhaps that some customers might be more wary of the problem when paying deposits. The trend is now towards paying deposits by credit card to take advantage of the protection thus afforded allowing the consumer to have an equal claim against the credit card company. This applies even where only a deposit is paid.

The one significant factor has been the significant reduction in the number of phoenix insolvencies since the first disqualification order was made in 1995. In the early days it was notable that a significant number of directors had a previous history of insolvent companies (often of phoenixism) but that is no longer the case. Phoenixism is now relatively rare – probably on the basis that the career serial directors have been taken out of the system.

The figures and statistics quoted above are compiled from information held by the Insolvency Service for administrative purposes. They have not been collected for the specific purpose of a statistical analysis of insolvency or phoenixism.

B What legal/regulatory/other conditions assist the formation of phoenix companies in your jurisdiction?

In considering the conditions in which phoenixism exists, it is probably better to consider the factors that allow it to exist:

- almost anyone (including the director of a failed company) may incorporate a company and be a director unless specifically prohibited (for example by a disqualification order or by being a bankrupt);

-
- it is accepted that – in certain circumstances – insolvency practitioners often have no choice but to dispose of the assets of a failed company to its directors in the knowledge that they will use them in the formation of a phoenix. There are often sound reasons for this type of sale – for example for a quick sale or because the assets are of a specialist nature with a limited market or that their value will diminish if not disposed of quickly;
 - property owners (especially those who own older or less favourably located properties) are often only too glad to have a tenant and accept that any rent is better than an unoccupied building (it is noticeable that landlords apply to the Court for possession orders only in exceptional cases);
 - financial institutions are willing to deal with phoenix companies where the previous company did not abuse its overdraft or loan facility and/or where suitable security is provided;
 - suppliers often have short memories and are willing to take risks or are willing to trade for cash;
 - tax authorities have no legislative basis upon which to prevent a phoenix – all they can do is be more alert and take earlier steps to apply for a winding-up order;
 - there is no significant shame attached to phoenixism. Indeed such a continuation of a business is often the only way to preserve employment (the underlying strength of the employment is not usually challenged);
 - registered companies are required to file accounts in the companies registry. The amount of information disclosed varies according to the annual turnover. Smaller companies are exempt from the requirement to produce audited accounts. All files in the Companies Registry are available to the public for inspection and copying;
 - enterprise is something to be encouraged and the draft Enterprise Order will (if approved by Parliament) encourage the earlier financial rehabilitation of bankrupts whose business has failed through no fault of their own and whose conduct has not given rise to any matters which would require an extension of their bankruptcy;

- insolvency practitioners, as professionals, have a duty to act in the best interest of their client. Where the practitioner is acting as a liquidator his duty is to the creditors and he is required to ensure that the assets are sold for the best possible price. Where he is acting for a debtor his duty is to that debtor and this can involve advising the debtor of the most appropriate means to acquire the assets of the failed business.

There is no evidence that any one of the above factors (except possibly the first) plays a part of significantly greater importance than the others. However, they have been placed in the order of what is considered to be their relative importance.

C What measures exist in your jurisdiction to counter phoenix activity and how successful are they?

There is no statutory definition of a “phoenix” company but the Court in Northern Ireland has relied on the comments of Sir Nicholas Brown-Wilkinson V-C in re *Travel Mondial (UK) Limited*:

“This was an attempt to carry on the same business . . . leaving behind the creditors of the old business . . . the use of the fabric of a limited company to deprive creditors of their money and simply to change the cloak in which that is done from one company to the next”.

As noted in “B” above, there are no legislative hindrances to phoenixism *per se*, and it is not established that there should be. The real problem with a phoenix company lies with the directors who fail to learn from previous mistakes and who repeat them with the same ruinous effect.

There are no specific legal obstructions in Northern Ireland to the creation of a phoenix or any other company. Article 180 of the Insolvency Order (Northern Ireland) 1989³³ restricts the use of a “prohibited” name (i.e., a name identical or similar to that used by the insolvent company) - either by a new company or by an individual - without permission. This might be regarded as a preventative measure. This makes it a criminal offence to use a “prohibited” name. In practice, however, there have not been any prosecutions although it has been used as an allegation in disqualification proceedings.

As previously noted, a person who is an undischarged bankrupt or the subject of a disqualification order is prohibited from acting as director of any company without the leave of the Court.

³³ http://www.legislation.hmso.gov.uk/si/si1989/Uksi_19892405_en_1.htm

Thus there is no specific criminal or civil deterrent to the creation of a phoenix company. Similarly there are no minimum capital requirements to be satisfied before incorporating a new company.

There is a register of disqualification orders made in Northern Ireland and (since 5 September 2003) provision for details of those orders to be included in a national register along with those made in Great Britain. There is no statutory requirement to advertise the making of a disqualification order but it is our practice to issue a press release giving basic details of the director, his town of residence, the period specified in the order, the name of the company and brief details of the unfitness. The press release may also be viewed on the Department's website (<http://www.detini.gov.uk/>).

The Data Protection Act 1998 places restriction on the use of information held, inter alia, by Government departments and such sharing of information takes place as is requested and as is permitted.

No other regulatory body is known to take any action to counter phoenixism, and there is no public funding available to any party to investigate allegations of phoenixism.

In general, existing legislation copes with phoenixism to the degree compatible with an open and democratic society. Prohibition through prohibited names and disqualification orders seems, generally, to be satisfactory.

D What additional/improved measures need to be introduced to combat phoenix activity in your jurisdiction?

No additional or improved measures are required to combat phoenixism in Northern Ireland. The existing provisions of the Insolvency (Northern Ireland) Order 1989 and the Company Directors Disqualification (Northern Ireland) Order 2002, which deal with prohibited names and make a breach of a disqualification order a criminal offence, are already satisfactory mechanisms for dealing with the phoenix cases which have arisen in this jurisdiction.

INSOLVENCY SERVICE OF NORTHERN IRELAND

Chapter 14

UNITED STATES OF AMERICA³⁴

A. The scope of the problem

An accurate assessment of the “phoenix problem” is essentially impossible, for reasons that will become apparent later in this discussion; only the roughest of estimates can be attempted. Among the many impediments to an accurate estimate of the problem are the matters of defining the universe of business entities that should be studied and interpreting available statistics, which have not been collected with this problem in mind.

At any given time, there are approximately 600,000 corporations registered in the United States.³⁵ There are roughly another 400,000 partnerships and limited liability companies.³⁶ These figures do not include other forms of business ownership, such as sole proprietorships, which may not need to register with the state. To provide a sense of scale to the figures in this chapter, the U.S. Bureau of Economic Analysis estimated that after-tax corporate profits for the second quarter of 2003 were \$671 billion.³⁷ During the first six months of 2003, assets at filing for chapter 11 reorganization of publicly traded companies totalled \$38 billion, compared to \$104 billion for the first half of 2001 and \$147 billion for the first half of 2002.³⁸ According to Dun and Bradstreet, a new business is started every minute, a business fails every three minutes, and a business files for bankruptcy every eight minutes.³⁹ During the year ending June 30, 2003, there were approximately 1.6 million bankruptcy cases filed in the U.S.,⁴⁰ of which approximately 37,000 were “business bankruptcies.”⁴¹ This category includes all forms of business enterprises, such as sole proprietorships, corporations, etc., as well as individuals with predominantly business debts.

The phoenix problem, as defined in this paper, embraces activities that are usually, but not always, criminal, or which may violate both civil and criminal laws. Assets transferred to phoenix organizations may therefore often be pursued through civil suits or through criminal proceedings,

³⁴ The views expressed in this article are solely those of the author and do not reflect the official positions of the U.S. government or any other group or individual.

³⁵ Extrapolating from information found on the State of Delaware website, <http://www.state.de.us/corp/>.

³⁶ *Id.*

³⁷ <http://www.bea.doc.gov/bea/newsrel/gdp203p.htm>.

³⁸ Significant Decline and Change in Profile of Public Company Bankruptcies in the First Half of 2003, http://www.abiworld.org/pdfs/PhoenixForecast_2003.pdf. This number relates, as stated, only to reorganizations under chapter 11 of the Bankruptcy Code of publicly traded companies; the phoenix problem extends beyond this category of cases, of course, and includes closely held companies, sole proprietorships, companies liquidated under chapter 7 of the Code and under state law procedures, etc.

³⁹ <http://www.dmb.com/us/weblogo>. The time periods are assumed to be 24 hours per day for a five day week, which then yields a rough agreement with filing statistics maintained by the Administrative Office of the U.S. Courts.

⁴⁰ http://www.uscourts.gov/Press_Releases/index.html

⁴¹ *Id.*

or both. No accurate estimate of civil actions brought in the bankruptcy courts to pursue property transferred to phoenix organizations exists, although roughly 5,000 to 10,000 lawsuits to recover funds or property are filed in bankruptcy courts each year. Additionally, there is no reliable record of insolvency proceedings which take place outside of bankruptcy, such as out of court workouts, assignments for the benefit of creditors under state laws, and the like.

The majority of business bankruptcies involve small businesses, although large business failures probably involve a greater amount of assets, and certainly receive a greater amount of publicity. There is no reason to suspect that any particular industry is disproportionately afflicted with the phoenix problem, although bankruptcies are currently concentrated in the telecommunications and services industries.⁴² Certainly the problem inflicts economic loss on unsecured creditors of every variety, although secured parties may also suffer to the extent the activity impairs their security interests. Competitors of the phoenix company suffer as well due to distortion of the competitive marketplace in favor of companies which unfairly exploit this tactic. Perhaps the most pernicious effect of the phoenix problem is to undermine confidence in the integrity of the marketplace and the insolvency process. This effect probably magnifies the significance of the problem considerably beyond the direct economic impact it has.

B. Conditions affecting formation of phoenix companies

The free market economy favours the rapid formation of large amounts of capital. Toward this end, there are few restrictions on the formation of businesses or upon the ability of one to serve as a company officer or director. If a company is publicly traded, there are various reporting requirements imposed by the Securities and Exchange Commission and other regulatory bodies that assist potential investors and creditors in ascertaining the solvency of a company. There are also rating companies, such as Standard and Poor's and Moody's, that provide information of use to investors and creditors. Companies such as Dun and Bradstreet also provide useful information, such as the promptness with which companies that they list make payment on accounts. And, of course, creditors have various mechanisms to protect themselves, such as retaining security interests in property they provide, asking for surety bonds, monitoring the promptness of payments on receivables, etc. The trade press and business reporters for major news organizations also report developments that may reflect a company's solvency. For the most part, the free market requires creditors and investors to protect themselves through gathering information or structuring their relationship with their debtors, rather than using regulatory means to assure creditworthiness.

⁴² Significant Decline and Change in Profile of Public Company Bankruptcies in the First Half of 2003, http://www.abiworld.org/pdfs/PhoenixForecast_2003.pdf.

Because there are legitimate reasons to establish parallel or subsidiary business organizations, and because there are very few restraints on what solvent businesses are permitted to do, detection of phoenix activity before the fact is extremely difficult.

C. Countermeasures

There is no standard definition of phoenix activity in U.S. law. The United States Trustee manual offers this description of the problem,⁴³ which corresponds closely to that used in Chapter 1:

A long-standing company experiences financial problems. Insiders create a new business in the same industry just prior to or soon after the bankruptcy filing. In some cases, a sale of some of the debtor's assets is made to the new entity for a fraction of their value just prior to the bankruptcy. The non-debtor entity is usually not disclosed. The insiders operate the debtor until they have successfully transferred the debtor's inventory, receivables, customers, and good will to the new company. In addition, the insiders may use the debtor to purchase goods and services for the new company with the intent of never repaying the chapter 11 administrative creditors. This is usually a lawyer-assisted fraud.

Phoenix activity is addressed through civil and criminal sanctions. Trustees may pursue assets through the use of several civil remedies, such as fraudulent conveyance actions for the return of property, or recovery of its value, transferred to a phoenix entity. When a company becomes insolvent, the law imposes fiduciary duties upon officers and directors toward the company's creditors. Breach of these duties can lead to individual liability on the part of the officers and directors. Remedies of this type are available in any insolvency regime, whether under federal bankruptcy law or state procedures. In the federal bankruptcy system, a company is required to disclose, under oath, transactions that may reveal phoenix activities.⁴⁴ The law also provides various mechanisms, such as statutory meetings of creditors,⁴⁵ appointment of trustees or examiners,⁴⁶ appointment of creditors' committees,⁴⁷ examination of any entity under oath,⁴⁸ and the like, which enable trustees and creditors to detect and undo phoenix activity.

⁴³ U.S. Trustees Manual, section 5-10.3.1.3 Parallel Entities, http://www.usdoj.gov/ust/ustp_manual/vol5ch10.htm#5-10.3.1.3.

⁴⁴ <http://www.uscourts.gov/bankform/form7.pdf>.

⁴⁵ 11 U.S.C. sections 341 and 343. The U.S. Bankruptcy Code, title 11 of the U.S. Code, can be found at <http://www.access.gpo.gov/uscode/title11/title11.html>

⁴⁶ 11 U.S.C. section 1104.

⁴⁷ 11 U.S.C. section 1102.

⁴⁸ Federal Rule of Bankruptcy Procedure 2004. The Federal Rules of Bankruptcy Procedure can be found at <http://www.abiworld.org/legis/FRBP.pdf>. This rule empowers the court to order the examination of any entity, not just the debtor, upon motion of a party in interest to the bankruptcy case.

The criminal law also sanctions phoenix activities.⁴⁹ In addition to direct prohibitions on the fraudulent transfer of assets, indirect sanctions, such as penalties for conspiracy, aiding and abetting criminal activity, and the like are provided for in the criminal law.

It is extremely difficult to estimate the efficacy of criminal remedies for bankruptcy fraud of any kind, including phoenix activity. In 1995, the Federal Bureau of Investigation estimated that ten percent of all bankruptcy cases involve some form of criminal activity.⁵⁰ An audit of the U.S. Trustees' fraud prevention program by the Inspector General of the U.S. Department of Justice was performed in 2003.⁵¹ The audit shows that criminal referrals to the U.S. Attorney's Offices by the U.S. Trustee program are rare and the number of prosecutions is rarer still. There are a number of possible explanations for this. The wide variety of civil recovery mechanisms available to trustees and creditors reduces the need for criminal enforcement activity. Also, bankruptcy fraud never occurs in a vacuum; almost always, bankruptcy fraud accompanies other criminal activity, such as mail or wire fraud, embezzlement, tax fraud, and the like. Investigation and prosecution of "white collar" crime is very labor intensive and complex. Often a criminal conviction can be obtained without inclusion of bankruptcy fraud counts in the indictment or without prosecution of such counts if they are included in the indictment.

For the most part, due to resource constraints on the law enforcement community, phoenix activity is countered through civil remedies invoked by trustees and creditors. These remedies are financed by the creditors, or through the estate of the debtor, which, in the case of an insolvent organization is ultimately at the expense of the creditors; public funds are not available for these private enforcement activities. Phoenix activity is not specifically addressed by regulators outside of the insolvency community, such as taxing or licensing authorities, although these authorities may become involved once phoenix activity is detected by parties to a particular insolvency case.

Detection and remediation of phoenix activity is presently extremely difficult and frequently is incidental to civil or criminal proceedings occasioned by other activities.

D. Possible additional countermeasures

Both the government and the private sector responded vigorously to the wave of spectacular corporate scandals (which may or may not have involved fraudulent activities with parallel entities)

⁴⁹ 18 U.S.C. chapter 9, http://www.access.gpo.gov/uscode/title18/parti_chapter9_.html.

⁵⁰ <http://www.fbi.gov/hq/cid/fc/ec/bf/bf.htm>

⁵¹ <http://www.usdoj.gov:80/oig/audit/0317/index.htm>.

such as Enron, WorldCom, and Global Crossing, and the collapse of Enron auditor Arthur Andersen.⁵² While this response does not directly address phoenix activity as such, the adjustments to business practices that were adopted or are under consideration will hopefully have beneficial consequences for the detection of phoenix activity as well.

The most visible legislative response, the Sarbanes-Oxley Act,⁵³ was designed to reform corporate governance in general, in addition to improving accounting practices. The sweeping provisions of this Act are too complex to discuss here, and their efficacy remains to be seen.⁵⁴ It seems inevitable, however, that the intense focus that this Act, and the resulting increased regulatory activities, brought to the issues of corporate governance and accounting practices cannot but help reduce fraudulent practices, including the phoenix problem.

Private sector activity concerning corporate responsibility has also been intense. For example, Standard and Poor's developed a corporate governance rating service based on 125 different aspects of corporate control to help investors gauge the risk of doing business with the companies rated. The stock exchanges also tightened their standards for the listing of a company's securities. Observers believe that improved corporate governance procedures may have begun to slow the rate of bankruptcy filings, at least among publicly traded companies.⁵⁵

There is an inherent tension between the ability to quickly form significant amounts of capital and the assurance of a well-behaved marketplace; too little regulation and supervision fosters volatility and corruption, while too much restrains innovation and flexibility. The globalization of the marketplace has added even more complexity to efforts to assure integrity and transparency. It is likely that new techniques for the regulation of investment will be necessary to assure an orderly expansion of global markets. For example, the authors of "Following the Money" suggest that a new computer language called XBRL will enable individual investors to analyze and manipulate financial data, making corporate transparency much easier to attain. They also suggest that some amount of competition should be fostered between the Generally Accepted Accounting Principles commonly used in the United States and the International Financial Reporting Standards, which are gaining widespread international acceptance, rather than mandating the use of one system or the other.

⁵² George Benston, Michael Bromwich, Robert E. Litan, and Alfred Wagenhofer, *Following the Money* (The Enron Failure and the State of Corporate Disclosure), (2003) <http://aei-brookings.org/admin/pdffiles/phpD9.pdf> (hereafter "Following the Money"), at page 3, list 15 major investigations or lawsuits involving accounting issues.

⁵³ http://www.pcaobus.org/rules/Sarbanes_Oxley_Act_of_2002.pdf.

⁵⁴ A useful discussion of issues relating to accounting practices and corporate governance reforms can be found in "Following the Money." A video presentation by Congressman Oxley at the World Bank, with other helpful links, can be found at http://www.worldbank.org/wbi/B-SPAN/sub_sarbanes_oxley.htm.

⁵⁵ Significant Decline and Change in Profile of Public Company Bankruptcies in the First Half of 2003, http://www.abiworld.org/pdfs/PhoenixForecast_2003.pdf.

The United States insolvency system will undoubtedly benefit from the reforms and innovations mentioned above. Its goals of speed, certainty and low cost are ultimately meant to result in an efficient reallocation of assets, but this cannot be attained without appropriate assurances of integrity as well. Recent events assure us that cures for abuses of the system, including the phoenix problem, will continue to be actively sought.

ADMINISTRATIVE OFFICE OF THE UNITED STATES COURT

Chapter 15

CONCLUSIONS

A. How big a problem are phoenix companies and what is their impact?

All responding jurisdictions endorsed the criteria underlying the phoenix syndrome as described in Chapter 1. Most jurisdictions accepted that there was a distinction between legitimate business recovery/rehabilitation (i.e., where there was no specific intention to evade payment to creditors) and the more reprehensible form of phoenix syndrome where such intentions were clearly present. Although no jurisdiction indicated that a comprehensive definition of phoenix activity was included in domestic legislation, many jurisdictions have introduced legal provisions which are available to counter phoenix activity.

It is also clear that there is no definitive statistical information in relation to the incidence of phoenix companies, although a number of contributors were able to make informed estimates based upon insolvency or tax authority statistics.

The primary sectors in which the phenomenon appears to arise are:

- Construction (including the construction of dwelling houses and quarrying)
- Transportation (including vehicle service providers and haulage firms)
- Hospitality Industry (including restaurants, hotels and public bars) and
- Clothing and Textile production.

The direct economic consequences of phoenix companies include the financial losses sustained by the creditors affected by the failed entities, the competitive distortions that arise for legitimate business and the associated increase in business risk. This results in diminished creditor security, which increases transaction costs (such as insurance) and reduces the availability of credit. Where effective deterrents are absent, phoenix activity undermines confidence in the market and encourages others to take similar unscrupulous actions to help maintain their market competitiveness.

There is general agreement that the primary victims of phoenix activity are the tax authorities (who are the primary creditor) and the legitimate competitors of the phoenix company (who are prejudiced by the resulting unfair competition). Other creditors, such as service providers, consumers and employees, usually suffer losses if their services are not required by the phoenix

entity. Financial institutions are invariably secured creditors or hold security from the principals of the company and are therefore usually protected from significant loss.

One clear conclusion from the survey is that in jurisdictions where a properly resourced insolvency or corporate regulator monitors the implementation of insolvency and corporation laws, the problem of phoenix activity has been successfully contained.

B. What legal/regulatory/other conditions assist the formation of phoenix companies?

The existence of one or more of the following conditions may assist in the formation and operation of phoenix companies:

- **Low qualification standards for directors**

A person is only prohibited from being a director, if he or she is explicitly disqualified or restricted or is an undischarged bankrupt. In most countries, there is no automatic ban on being a director after being involved in an insolvent company.

- **The limited restraints on incorporation**

In general, there appears to be no onerous pre-conditions to incorporation. Most jurisdictions only require minimum levels of capitalisation, although some jurisdictions impose moderate initial capital levels of up to €8,000.

- **The ready availability of tax registration to all entities**

In many jurisdictions, tax registration will only be refused if the tax authorities have sufficient reason to prove phoenix activity. Registration facilitates the establishment of new business (e.g., recovery of certain taxes which can be used to meet business expenses), while the company's demise often leaves tax debt outstanding.

- **Failure of creditors to take appropriate action**

Creditors frequently detect phoenix activity at an early stage. However, many trade creditors do not suffer from the consequences of phoenix activity, because the company's principal has often arranged for the discharge of the majority of their debts in order to secure their continuing support in the phoenix business. Also, the interests of financial institutions are often fully protected by adequate security, whether personal or otherwise. Consequently, there is little reason to impel such creditors to take remedial legal action themselves or to report phoenix activity to the responsible authorities.

As the parties most likely to be adversely affected by phoenix activity, the tax authorities bear a special responsibility to protect their revenue base and to pursue those parties acting in an unscrupulous manner. Any unwillingness, inability or incapacity on the part of the tax authorities to pursue suspected phoenix activity by way of the appointment of an insolvency administrator or by sponsoring legal proceedings to sanction the culpable parties will encourage further phoenix activity.

- **Limited return from legal redress**

Even where there are clear civil wrongs which are actionable by creditors in an insolvent situation, creditors are usually unwilling to act for economic reasons, i.e., the lack of potential return to them due to an insufficiency of available assets or the superior claims of secured or preferential creditors.

- **Proper discharge by insolvency administrators of their legal/professional duties**

Although the placing of an insolvent company in an insolvency procedure is not a mandatory requirement in some jurisdictions, many insolvency administrators (when appointed) play a valuable role in detecting evidence of phoenix activity and (when the investment of legal and other resources justify it) in pursuing the parties responsible for phoenix activity. However where administrators fail to carry out adequate investigations in compliance with their legal and professional obligations or in rare cases even collude with the principals of the phoenix company to acquire assets at below market value, this can perpetuate the phoenix problem. This type of default is more likely to arise in jurisdictions without effective insolvency or supervisory regimes.

- **Poor disclosure of phoenix activity**

A pre-condition for successful intervention to deter phoenix activity is that information on suspected phoenix activity is made available on a timely basis. Adequate and prompt disclosure facilitates early action by creditors, insolvency administrators and regulators. In the absence of such information, phoenix activity may continue unchecked.

- **Capacity of the relevant regulatory authorities**

The ability of regulatory authorities to sanction phoenix activity is a function in particular of the legal powers and resources available to them. The investigation of a suspected phoenix company is likely to require time, money and forensic capabilities.

While low nominal barriers to market entry may assist phoenix activity, they are also important in encouraging genuine enterprise and facilitating business restructuring. Based on the responses of contributors to this research therefore, it appears that the attention of regulators must be on distinguishing genuine business restructuring from unscrupulous phoenix-type activity and taking appropriate remedial action against the latter phenomenon. This suggests that the main aim of regulators must be the elimination as far as possible of markets where conditions of poor detection or inadequate or belated disclosure of phoenix activity exist or where effective deterrents do not apply.

C. What measures exist to counter phoenix activity and how successful are they?

Due to the inability to adequately define phoenix companies, no jurisdiction reported that it had in place a civil wrong or criminal offence of being involved in a phoenix company.

The provisions mostly used by reporting jurisdictions to prevent and deter the phoenix syndrome are the measures which are available in the general insolvency procedures applying to non-phoenix companies. However, a number of special provisions are also employed. Accordingly, reporting jurisdictions employ a number of the following measures to counter phoenix activity:

- **Investigation by insolvency administrators or other parties**

Detection of phoenix activity is in general a forensic matter. Accordingly, a basic tool is the investigation by the insolvency administrator of the affairs of the insolvent company and the terms on which assets, staff, stock, etc. have been transferred to the phoenix company. In the absence of the appointment of an insolvency administrator, this work may occasionally be carried out by or on behalf of the relevant insolvency or corporate regulator.

- **Reporting of suspected phoenix activity**

Good reporting of suspected phoenix activity is critical, so that the relevant market participants, e.g., creditors, insolvency administrators, insolvency or corporate regulators, are in a position to determine what action is warranted. Legislation providing for reporting and information-sharing among key participants exists in many jurisdictions, and it is important that these provisions are utilised.

- **Civil actions**

All jurisdictions appear to have the following forms of civil action which may be taken by the insolvency administrator (or in limited circumstances by the creditors) of the company:

- Fraudulent conveyance;
- Fraudulent/Reckless/Insolvent Trading;
- Equitable remedies for the return of the assets of the company;
- Breach of duty or misfeasance by the directors of the company;
- Examination of directors under oath.

Invariably, the above events carry the risk of having personal liability imposed on the officers of the company.

However if the company's assets have been depleted, insufficient funds will usually be available to administrators or creditors to initiate and adequately prosecute such actions. Proof of the majority of these actions is of a high standard. Even if initiated therefore, the administrator often compromises such actions. Consequently, personal liability has been imposed on few controllers of phoenix companies.

- **Limitations on the sale of company assets to previous owners**

Most jurisdictions appear to have a prohibition on the sale of the business to the former managers of the company or to related parties without the consent of creditors. However, most insolvency administrators often have little choice but to sell assets to the prior owners, as there may be a limited market for the assets.

- **Disqualification of officers of the company**

A primary deterrent in many jurisdictions is the disqualification of officers of the company which prohibits them from being involved with companies for periods from two to fifteen years. A lesser form of sanction, that of restriction, also operates in Ireland, where the burden to prove honesty and responsibility rests with the relevant director(s).

Disqualification is normally a judicial decision, and the evidence required is of a high standard. However, it may be imposed administratively in some jurisdictions, e.g., with the consent of the director in Britain or by the Registrar of Companies in New Zealand.

While the sanction of officer disqualification is widely supported, sanctioning directors merely because of their involvement in insolvent companies is not supported. In particular, all jurisdictions require some form of dishonest or irresponsible conduct on the part of officers prior to the imposition of any form of sanction (including minor sanctions such as the publication of the names of directors).

- **Prosecution of directors**

Although criminal sanctions are available in all jurisdictions (which are similar in nature to the civil actions mentioned above), it appears that the participants in phoenix companies are not often prosecuted. This may be due to the burden of proof required, the resource-intensive nature of these prosecutions and the fact that they often straddle different codes of law, e.g., tax, company and insolvency.

- **Public disclosure of sanctioned parties**

Information on disqualified directors is generally made available on the web or in written form to the public under relevant legislation. Some jurisdictions also facilitate creditors by listing all known insolvent companies.

A variation on this theme has been introduced in one jurisdiction, where the Central Bank may blacklist persons who have been involved in phoenix activity. As these persons no longer receive credit from a financial institution, this is perceived by practitioners to be excessive and damaging to entrepreneurship.

- **Licensing Systems**

Certain jurisdictions primarily Australia have sought to ensure that the phoenix syndrome does not become endemic in a specific business area by operating a sector specific form of licensing. This form of licensing ensures that there is a minimum capitalisation, that repetitive offenders are not licensed and that there are audit procedures in place to ensure that the company is not allowed to decline into insolvency.

- **Other preventative/enforcement measures**

A number of jurisdictions reported the employment of a wide variety of other measures to help prevent unscrupulous business practices in phoenix companies:

- Minimum capitalisation requirements for companies (such as a minimum capitalisation of US\$5,000 for companies incorporated in Mexico);

- Limitation on the use of the name of the preceding company or the continuing use of the preceding company's business name or a variant thereof;
- A requirement on directors to pass an annual solvency resolution and to inform the regulator if this test cannot be passed;
- Proactivity in terms of matching the list of disqualified/bankrupt/restricted persons against the list of directors;
- Personal liability of disqualified persons for company debts;
- Sufficient regulation of accountancy practices;
- Use of pooling orders to make holding companies liable for the debts of subsidiary companies;
- Recovery of underpayments/overpayments made in connection with the transfer of assets to or from the company, the officers of the company or other connected persons;
- Restriction on entitlement of disqualified/restricted directors and related persons to obtain a further operating licence;
- The continuance of the liability of the new owners of the company for the employment costs of an undertaking where that undertaking or a part thereof has been transferred;
- The imposition of personal liability on company directors and/or agents for unpaid minimum wages and holiday pay where they have authorised the default;
- Ensuring the investigation of insolvent companies by way of mandatory reporting obligations on insolvency administrators;
- The provision of funds to ensure that assetless companies are investigated by insolvency administrators;
- Ensuring that the insolvency regulator has power to liquidate companies where appropriate;
- Facilitating press coverage of enforcement activity;
- Granting priority to company creditors who fund recovery actions over remaining creditors;
- Acceptance of the principles of good corporate governance by businesses;
- Actively seeking assistance from the general public by encouraging the making of complaints about suspected corporate misconduct.

A number of jurisdictions report the phoenix phenomenon as having been substantially contained. The relative success of such jurisdictions appears to be attributable to two principal factors namely:

- An adequate disqualification regime;

- A resourced and respected insolvency/corporate regulator.

D. What additional/improved measures need to be introduced to combat phoenix activity?

This comparative study has not identified any 'big idea' which would eliminate the problem of phoenix companies. In fact, most jurisdictions have not advocated a need for significant additional legal powers, although statute law in certain jurisdictions is constantly evolving to meet new challenges. The continuing phenomenon of phoenix companies in those jurisdictions appears to be more related to particular market circumstances and the continuing difficulties of implementing the measures which are already available to them in law.

What is encouraging about the study is that the problem of phoenix companies appears to have been substantially resolved in some jurisdictions by using the types of measures which are already familiar to many insolvency regulators. It is hoped that this research will enable each regulator to refine the measures, practices and procedures which it employs in tackling the phoenix syndrome and that in learning from the successes and failures of others, each will have greater success in the future in tackling this persistent problem.

INTERNATIONAL ASSOCIATION OF INSOLVENCY REGULATORS

www.insolvencyreg.org

Appendix 1

Structure of Contributions

Content of the Review by each IAIR Member of its Experience with Phoenix Companies

A. How big a problem is phoenix companies and what is their impact in your jurisdiction?

Include available figures/estimates of the incidence of phoenix companies and compare with the numbers of incorporated companies;

Describe your jurisdiction's phoenix businesses (e.g., amount of liabilities, amount of assets, amount of deficit of the failed entities) and the features of the phoenix company (e.g., amount of issued share capital, prevalence of common directors/employees, etc.);

Indicate the parties who most suffer losses from the failure and provide an estimate for each category (e.g., tax authorities, financial institutions, suppliers, employees, etc.);

Indicate if there is any prevalence of phoenix businesses in particular sectors (e.g., construction, transport, information technology, hospitality, etc.);

Indicate the general economic and other known impacts (e.g., financial losses/disruption, competition effects, etc.);

Identify the source(s) for these figures/statements and include hyperlinks where appropriate.

(Note: Those jurisdictions which have not done special research in the area of phoenix companies may not be able to answer the above in any great detail. Nevertheless, they should try to provide what limited information is available to them in as many of these areas as possible.)

B. What legal/regulatory/other conditions assist the formation of phoenix companies in your jurisdiction?

Describe the political/economic/social environment in which phoenix activity exists (e.g., focus on entrepreneurship, lowering the barriers to business start-ups, stigma surrounding business failure, etc.);

Describe the legal pre-conditions/restraints on company incorporation, dissolution and re-incorporation, on registration of a business for tax purposes, etc;

Describe the legal pre-conditions/restraints on acting as a company director for the first time, on acting as a company director for multiple businesses and on acting as a company director of a new business following a company insolvency;

Indicate the disclosure requirements facilitating public monitoring of company solvency;

Identify the manner in which phoenix businesses are or may be detected;

Indicate the ability and willingness of creditors to facilitate/deter phoenix activity;

Identify any other factors assisting phoenix activity;

Comment on the relative importance of each factor in assisting phoenix activity.

C. What measures exist in your jurisdiction to counter phoenix activity and how successful are they?

Indicate the legal or other accepted definition of a phoenix company which applies in your jurisdiction;

Describe the preventative measures in place to curb the incorporation of a phoenix company following an insolvency (e.g., minimum capitalisation, bonding, certification, legal presumptions, etc.);

Describe the punitive measures in place to investigate and sanction detected phoenix activity (e.g., criminal and civil proceedings by type);

Indicate what additional arrangements exist (e.g., information-sharing between State authorities/creditor representatives, provision of dedicated financial/staff resources, etc.);

Comment on the success or otherwise of each of these measures.

D. What additional/improved measures need to be introduced to combat phoenix activity in your jurisdiction?

Itemise the proposed measures and identify the reasons for each proposal.

Appendix 2

Phoenix Company Reference Material

The following identifies some websites which contain information relating to the Phoenix Syndrome:

<http://www.bankexperts.co.uk/phoenix/phoenix-company-1.htm>

which contains a brief description of phoenix companies, the reasons why phoenix companies cause difficulties and the assistance which may be given by professional advisers in relation to such companies.

<http://www.med.govt.nz/ri/insolvency/tierone/phoenix/>

which contains a comprehensive analysis by the Department of Economic Development, New Zealand of the issue of Phoenix Companies

http://www.5chan.com/articles/art0201_1.html

which provides a definition of Phoenix Companies and details some of the entitlements of creditors regarding Phoenix Companies

<http://www.ato.gov.au/corporate/content.asp?doc=/content/mr200160.htm>

which contains details of a case in which an individual who had defrauded the Commonwealth of Australia of Aus\$7.3 million through the use of 10 phoenix bricklaying companies was sentenced to 6 years imprisonment

<http://www.lawexchange.org/news/papers/phoenix.htm>

which details how legislation intended to rescue companies from insolvency can be perceived as an assistance to prolong phoenix syndrome

http://www.5chan.com/articles/art0201_1.html

which contains a report of **Archer Structures Limited v Christopher Griffiths**, 30 April 2003 concerning the responsibility of directors of a company trading with a name similar to an earlier insolvent company which states that the directors may be jointly and severally liable for the debts of a company under Sections 216 and 217 of the Insolvency Act 1986, where that company has been reformed to escape the debts of a predecessor company.

http://www.todsmurray.com/pdf/corporate_focus_5.pdf

which contains a summary of the implications of **Archer Structures Limited v Christopher Griffiths** and of **Inland Revenue Commissioners v Nash** 2003 All ER 373