Rising from the Ashes – Confused about Illegal Phoenix Activities?

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"What are you going to do about the Phoenix Activities of the Directors?" That is a common question asked by creditors and even some accountants and solicitors.

There seems to be so much confusion over what is and is not illegal phoenix activities. This is because there appears to be no commonly communicated definition that is generally understood by the average person. I did an internet search and found numerous different versions from legal practices, government agencies and insolvency practices. No wonder everyone is confused.

The Australian Securities and Investments Commission ("ASIC") recently released a statement advising they will be cracking down on illegal phoenix activities. So the issue has been brought back into the limelight once again.

However, there is limited information on the internet that supports the concept that a transfer prior to the appointment of an Insolvency Practitioner can be legal. So therefore everyone seems to jump to the conclusion that it must be illegal. Not only can it be legal, it can also be beneficial to creditors. This is due to the fact that a "going concern" sale will usually return a higher value to the Company and therefore ultimately to creditors. As such, a sale prior to an Insolvency Practitioner being appointed can sometimes be more beneficial and these pre-appointment transfers in and of themselves do not automatically become illegal phoenix style activities.

Firstly, there is a need to sell a business quickly during an insolvency administration to limit the exposure to liabilities. For example, when deciding on trading a business during an external administration the Insolvency Practitioner must consider the ability to cover the liabilities for any costs or claims (negligence, damages, defaults, contractual obligations etc.) incurred during the process of selling the business. So it is a balancing act as any shortfall and costs incurred would result in a reduction in the return to creditors being traded off against the potential of squeezing out a few extra dollars from the purchaser.
Secondly, an Insolvency Practitioner is in a weaker bargaining position to negotiate a higher value for the sale. He needs to sell and with time restrictions a purchaser does take on a few more risks as the time for due diligence is reduced.

How can you tell if it is legal or illegal?

Commonly there is a sale agreement in place and the transfer has been done on legitimate grounds. These transfers only become illegal phoenix activities when they involve any or all of the following common aspects:

i. It was uncommercial;
ii. It was undervalued;
iii. It was hidden; or
iv. It involved illegal conduct.

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Rest assured, the law does however protect creditors should the company be placed into liquidation and the business has already been transfers. This protection is the ability to overturn any transfer found to be illegal phoenix activities. All Insolvency Practitioners are required to conduct an analysis and investigation into pre-appointment transfers. This involves, amongst other things, an analysis of the assets, values and liabilities transferred compared to the amount paid and how the transaction was completed. Basically what needs to be considered is if the amount received is more than what would have been recovered if the Insolvency Practitioner sold the business.

So creditors and their advisors should stop automatically jumping to the conclusion that any transfer of a business prior to an insolvency practitioner being appointed is illegal. There are some valid reasons why these occur legally and may actually be beneficial to them in the end.

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