Know Your Advisor

It's hard to know where to turn in times of business and personal financial distress. One would hope, and even expect, clients will reach out to their trusted advisor to articulate what options are available to them and to help with the hard choices ahead.

However, this does not always occur. And as a trusted advisor, you cannot save them all. But you can point clients in the right direction and help them avoid the risk of personal liability.

Avoid the dubious salesman

An element of being a trusted advisor is that you can quickly diagnose your client's issues and challenges and make appropriate recommendations to improve their situation.

A client experiencing financial distress should be referred by their trusted advisor; an accountant or lawyer, to a qualified person or firm with specialist expertise and knowledge of insolvency events to help them understand the options available to their specific situation.

Unfortunately, some dubious parties pose as qualified professionals; providing pre-insolvency advice which could be detrimental to both the business and individuals should they encounter an insolvency event.

Common practices see these advisors assisting clients strip companies of cash and assets in order to avoid paying taxes and creditors. Known as a phoenix and illegal under Australian law, this has been well documented in the media of late and has drawn the attention of both the Australian Securities and Investments Commission (ASIC) and the Australian Taxation Office (ATO).

Recent regulatory action

ASIC and the ATO have joined forces specifically to combat this issue as part of a multi-agency taskforce targeting suspect pre-insolvency advisors and illegal phoenix activity. The taskforce exists to actively pursue advisors for improper advice, and company directors who are acting in breach of their statutory and common law duties.

The ATO has intensified their focus recently and in addition to regularly auditing and reviewing cases where phoenix behaviour is suspected, they are also conducting surprise raids on businesses in conjunction with other government agencies. In 2016 the taskforce initiated raids on 13 businesses and residences across the country, aimed at cracking down on pre-insolvency firms advising clients how to avoid paying tax and creditors by engaging in phoenix activity.

In August 2017, a judgement was handed down in the prosecution of Melbourne based Philip Whiteman (Deputy Commissioner of Tax v Whiteman [2017] FCA 951) who, after cold calling potential clients to obtain work, assisted hundreds of clients in liquidating their companies and transferring assets into new entities, thereby robbing creditors of assets which would otherwise be available to a Liquidator. Mr. Whiteman also appointed "dummy" directors to prevent the real company directors being liable when the companies were placed into liquidation. He was ordered by the Federal Court to pay $8.45 million to the ATO in unpaid income tax from the years 2010-2016. The tax liability is understood to be linked to the unpaid liabilities of several companies the ATO forced into liquidation earlier this year on the basis they were used to facilitate the phoenix activity of his clients.

These recent actions are soon to be further supported and regulated as the Government announced on 12 September 2017 a comprehensive package of reforms to address illegal phoenix activity. The reforms will see the introduction of a Director Identification Number (DIN) which will allow activities and relationships of directors to be more easily tracked across government agencies and databases, as well as a range of other possible measures.

Look out for red flags

Unlicensed professionals are known to use persuasive tactics to obtain your clients' trust. Warning signs may include:

- Cold calling with an offer of advice;
- Receiving unsolicited correspondence following court action by a creditor;
- Receiving advice to transfer assets to a third party without making payment for the assets;
- The advisor refusing to provide advice in writing;
- Suggesting they have a 'friendly' liquidator who can be appointed that will protect your clients' personal interests;
- Advising records be withheld from the Bankruptcy Trustee or Liquidator; and
- Suggesting they will deal with the Liquidator/Trustee exclusively on your clients' behalf.

Trusted advisors should take care to verify the professional is appropriately qualified, for example as a registered liquidator or trustee with regulators such as ASIC and the Australian Financial Security Authority (AFSA), or contact industry body, the Australian Restructuring Insolvency & Turnaround Association (ARITA) for assistance.

Navigating the technicalities

Unlicensed advisors aren't the only landmines to be navigated.

It is recommended to check the practitioner has sufficient insolvency experience relevant to your clients' situation. Following the wrong pre-insolvency advice could cause your client to unknowingly breach their duties as a director or officer of a company.

Director duties

The law imposes a number of legal responsibilities on company directors and officers. If your clients follow improper advice and engage in activities which are not in the best interests of the corporation, they may be pursued by a subsequently appointed liquidator or prosecuted by ASIC.

Some of the most significant duties are:

- to act in good faith in the best interests of the company and for a proper purpose;
- to exercise due care and diligence;
- to avoid conflicts between the interests of the company and your personal interests;
- to prevent the company trading while insolvent (i.e. while it is unable to pay its debts as and when they fall due); and
- if the company is being wound up, to:
  - report to the liquidator on the affairs of the company; and
  - help the liquidator fulfil their role (e.g. by giving the liquidator the company books and records in their possession).

Should your client believe they are being coerced into a course of action, trusted advisors also need to be aware of Section 79 of the Corporations Act 2001 which imposes liability on those "involved in" contraventions of the Act. This section captures anyone who has aided the contravention, induced the contravention, is a knowing party of the contravention or has conspired to affect the contravention.

This includes lawyers as was the case in ASIC v Somerville & Ors [2009] NSWSC 934. ASIC successfully prosecuted Mr. Somerville, a solicitor for aiding and abetting directors of 15 companies to breach their duties by engaging in phoenix activity. Mr. Somerville was found guilty of breaching the Act relating to directors' duties; notwithstanding, he was not a director of the companies. As a result, he was banned from acting as a director of any company for six years.

Safe harbour

With the introduction of the safe harbour legislation in September 2017, a director, advisor, or other officer may not necessarily be found to be in breach of their duties if they have taken a reasonable course of action to restructure the company which was likely to lead to a better outcome than the immediate administration or liquidation of the company.

In the event that the restructuring plan failed and the company entered liquidation, directors would only be able to rely on the safe harbour provisions if they comply with various obligations during the liquidation process.

A director will also be unable to rely on books and records as evidence of compliance with the safe harbour requirements unless he/she has provided access to those books and records to the liquidator or administrator.

Therefore, any advice suggesting that books and records be withheld from the liquidator may not only cause directors to breach their legal obligations, but could impact their reliance on those documents as evidence of a restructuring plan and thus the safe harbour protections which may have otherwise been available to them.

How to assist your clients as their trusted advisor

Accountants and lawyers who refer their clients to FTI Consulting for advice are strongly encouraged to participate in pre-insolvency meetings. We provide professional, independent advice tailored to your clients' unique circumstances in accordance with the law.

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About FTI Consulting

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