Economic theory informing approaches to phoenix activity in small business: A neo-Schumpeterian analysis

Anne Matthew*

1. Introduction

New firms, micro, small and medium enterprises (‘MSMEs’) and entrepreneurship offer economic potential capable of being leveraged worldwide for development and stability. Not least of this potential is the propensity for innovation and the facilitation of new employment opportunities. The Organisation for Economic Co-operation and Development (‘OECD’) has suggested that to maximise the economic benefits of MSMEs and entrepreneurship, governments ought to introduce specifically targeted innovation strategies.1 It recommends that these strategies ought to be conducive to entrepreneurship culture and aim to increase participation of new firms and MSMEs.2 The success of new firms tends to be premised upon innovation; such success benefits growth and productivity more generally throughout the economy.3 While few new firms experience rapid growth, the impact of those few can have a major positive impact.4 Even a small number of highly innovative, rapid-growth enterprises can lead to considerable economic benefit flowing from associated employment and productivity.5

These OECD recommendations resonate in the Productivity Commission Report, Business Set-Up, Transfer and Closure,6 and the recently announced National Innovation and Science Agenda which identifies innovation as ‘critical for Australia to deliver new sources of growth, maintain high wage jobs and seize the next wave of economic prosperity’.7 Innovation is identified as being vital to

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* Lecturer, School of Law, Queensland University of Technology (QUT), Commercial and Property Law Research Centre.

1 Organisation for Economic Co-operation and Development (‘OECD’), OECD Studies on SMEs and Entrepreneurship: SMEs Entrepreneurship and Innovation (OECD, 2010) (‘OECD Studies on SMEs and Entrepreneurship’).

2 OECD Studies on SMEs and Entrepreneurship, above 1, 19.

3 Ibid.


5 Ibid.


all sectors of the economy and dependant upon the creation of a ‘culture that backs good ideas and learns from taking risks and making mistakes’.8

Adoption of pro-innovation, pro-entrepreneurship approaches focus upon the economic benefits of entrepreneurship and the value of innovation in the long and short term. Long term economic development and wealth creation has been closely linked to innovation and the corporate form, particularly limited liability and the concept of a company as a separate legal entity.9

Phoenix activity casts MSMEs and entrepreneurship in a different light, focusing not upon the economic benefits of entrepreneurship, but upon the immediate ramifications of business failure. Entrepreneurship is innately associated with risk and uncertainty.10 The risk of business failure is real. Legal analysis of business failure tends to focus upon financial failure attracting legal consequences.11 Australian Securities and Investments Commission (ASIC) reports on corporate insolvencies consistently reveal a pattern of corporate failure dominated by MSMEs.12

Support for entrepreneurship is challenged by phoenix activity. Phoenix activity is not limited to a particular corporate demographic: it occurs in MSMEs, large companies, and in corporate groups.13 Corporate law offers new firms and MSMEs considerable freedom in corporate enterprise particularly when it comes to choice of corporate form, the nature of the enterprise and internal organisation. Phoenix activity challenges the extent of these freedoms since it

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8 Ibid.
10 Frank Knight, Risk, Uncertainty and Profit (Chicago University Press, 1921).
11 Economic analysis of business failure tends to include subjective considerations such as the objectives and perspectives of the entrepreneur. For an analysis of the legal and economic perspectives of business failure see Norman S Buchanan, ‘The Economics of Corporate Reorganization’ (1939) 54(1) Quarterly Journal of Economics 28, 29-31; See also Department of Industry, Innovation, Science, Research and Tertiary Education, Australian Small Business Key Statistics and Analysis, December 2012, 15-17.
12 See for example, Australian Securities and Investments Commission (ASIC), ‘ASIC reports on corporate insolvencies 2014-15’, Media Release 15-337MR, 17 November 2015 in which it was revealed that 79% of external administrator’s reports related to companies with less than 20 employees and 85% failed companies had assets estimated to be less than $100,000. The report also revealed that the outlook for creditors of failed MSMEs is bleak: 97% of creditors of small and medium corporate insolvencies received 0-11 cents in the dollar.
represents an abuse of limited liability. Where phoenix activity is characterised by repeated cyclical business failure, the long term economic benefits of supporting entrepreneurship and innovation tend to become a secondary consideration to the immediate plight of vulnerable unsecured creditor groups such as employees.\textsuperscript{14} MSMEs are not provided with a simplified insolvency regime, but are subject to the same regime as larger companies, though ASIC statistics suggest that these businesses tend to fail at a rate that outstrips larger organisations.\textsuperscript{15} Phoenix activity is frequently characterised by a cyclical pattern of failure and re-entry,\textsuperscript{16} at immense cost to the economy.\textsuperscript{17} Economists have long studied entrepreneurship, including the propensity of entrepreneurs to take risks undaunted. Indeed one of the most studied and puzzling aspects of entrepreneurship is the pattern of behaviour that sees failed entrepreneurs re-enter a market to try and try again.\textsuperscript{18}

The adequacy and efficiency of existing legal and regulatory frameworks dealing with corporate phoenix activity have been repeatedly called into question over the past two decades through various reviews,\textsuperscript{19} inquiries,\textsuperscript{20} specifically focussed

\textsuperscript{15} ASIC, ‘ASIC reports on corporate insolvencies 2014–2015’, above n12.
\textsuperscript{16} Helen Anderson, A O'Connell, Ian Ramsay, Michelle Welsh, H Withers, Defining and Profiling Phoenix Activity (Melbourne Law School, December 2014).
regulatory initiatives,\textsuperscript{21} and the implementation of piecemeal legislative reform.\textsuperscript{22}

In just the last 12 months we have seen the formation of a new ATO phoenix taskforce,\textsuperscript{23} an ASIC crackdown targeting gatekeepers enabling phoenix activity


\textsuperscript{22}Tax Laws Amendment (Transfer of Provisions) Act 2010 (Cth); Tax Laws Amendment (2011 Measures No 8) Act 2011 (Cth); Pay as You Go Withholding Non-compliance Bill 2011 (Cth) lapsed at dissolution on 5 August 2013 http://www.aph.gov.au/Parliamentary_Business/Bills_Legislation/Bills_Search_Results/Result?bId=r4690&print=1; Tax Laws Amendment (2012 Measures No 2) Act 2012 (Cth); The Corporations Amendment (Phoenixing and Other Measures) Act 2012 (Cth); Corporations Amendment (Similar Names) Bill 2012 (Cth). Not all bills specifically targeting phoenix activity passed into law. See for example, Corporations Amendment (Similar Names) Bill 2012 (Cth).

\textsuperscript{23}The Phoenix Taskforce has emerged from the Inter-Agency Phoenix Forum. Membership of the Inter-Agency Phoenix Forum includes the state and territory revenue authorities, Australian Crime Commission, Australian Federal Police, ASIC, ATO, Clean Energy Regulator, Department of Education, Employment and Workplace Relations, Department of Sustainability, Environment, Water, Population and Communities, Fair Work Building & Construction and the Fair Work Ombudsman. The membership of the Inter-Agency Phoenix Forum is identified on the Inter-Agency Phoenix Forum webpage available at ATO, https://www.ato.gov.au/General/Gen/Inter-Agency-Phoenix-Forum/. Most members of the Forum have information about the Forum on their own websites, for example Department of Employment (Cth), Inter-agency Phoenix Forum https://employment.gov.au/inter-agency-Phoenix-forum. The \textit{Tax Administration Regulations 1976} (Cth) have been amended so as to facilitate the sharing of information between the ATO and other members of the Phoenix Taskforce. Disclosures of protected information by taxation officers for this purpose now fall within an exception for law enforcement and related purposes. This has been accomplished by prescribing the Phoenix Taskforce for the purpose of \textit{Tax Administration Act 1953} (Cth), Schedule 1, s 355-70(1). See \textit{Tax Administration Regulations 1976} (Cth), Part 6A, reg 48.
including tax advisers, lawyers and other insolvency practitioners,\textsuperscript{24} the Productivity Commission Report, \textit{Business Set Up, Transfer and Closure},\textsuperscript{25} and the Senate Economic References Committee Report: \textit{I just want to be paid: Insolvency in the Australian construction industry}.\textsuperscript{26} Internationally a range of approaches has been adopted with mixed success. Despite these efforts, phoenix activity does not appear to have abated. This paper considers how neo-Schumpeterian economic theory focussed upon entrepreneurship and innovation can, to some extent, explain why this is the case and also offer a sound basis for the evaluation and reconsideration of the existing law.

2. What is phoenix activity?

Phoenix activity is an international phenomenon occurring wherever limited liability corporate structures exist.\textsuperscript{27} The behaviour underlying phoenix activity is largely associated with business failure, and may be triggered by an impending solvency crisis. While there is no single definition of phoenix activity, Australian scholars tend to describe phoenix activity as an abuse of the corporate form to avoid debts or legal obligations.\textsuperscript{28} Consider for example a company that transfers its business and assets to a new or related company that continues the business of the old company free of its debts. The new company, the phoenix, is shielded from the debts of the first company by its existence as a separate legal entity. The phoenix company operates the same enterprise as the first company, within the same market, at the considerable commercial advantage of being debt free. The first company is wound up or abandoned leaving unsatisfied creditors likely to include the ATO, trade creditors and employees. Limited liability and the status of both companies as separate legal entities generally preclude the creditors of the old company from seeking satisfaction from the phoenix, even where the controllers and shareholders of the two companies are the same. At its

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\textsuperscript{24} Greg Tanzer, ‘Rise of the Phoenix: ASIC Campaign Focuses on Gatekeepers’ (2014) April \textit{Law Society Journal} 34, 34.
\textsuperscript{25} \textit{Business Set-Up, Transfer and Closure}, above n6.
\textsuperscript{26} Australia, Senate Economics References Committee, \textit{I just want to be paid: Insolvency in the Australian construction industry}, December 2015.
\end{footnotesize}
worse, phoenix activity is organised, systematic, criminal and fraudulent; a cyclical, deliberate and illegal scheme to avoid creditors. The phoenix company may use a name deceptively similar to that of the old company; this may be an implicit part of the scheme to defraud the creditors of the old company.\textsuperscript{29}

Remedying the mischief of illegal phoenix activity is of practical importance. The benefits include continued economic confidence, law that inspires best practice among directors, law that is articulated in a manner such that penalties act as a sufficient deterrent, and a regulatory system able to swiftly and efficiently detect offenders and bring them to account. While there is no law that says phoenix activity is illegal, behaviour that amounts to phoenix activity can transgress a vast array of law: insolvency law, corporate law,\textsuperscript{30} employment law,\textsuperscript{31} tax law,\textsuperscript{32} criminal law,\textsuperscript{33} and environmental law. The sheer extent of this law addressing illegal behaviour underlying illegal phoenix activity suggests that there are no gaps in the law such that where illegal phoenix activity occurs there is no law that captures the underlying illegality.\textsuperscript{34} In these circumstances it is logical to conclude that a focus on enforcement would be effective in addressing phoenix activity.\textsuperscript{35} Yet the detection and enforcement burden incumbent upon regulators is significant and reform targeting reduction of this burden would be welcomed. The Productivity Commission has made three recommendations targeting this detection and enforcement burden: (1) ‘introduction of a director identification

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  \item[30] Illegal phoenix activity invariably contravenes various provisions of the \textit{Corporations Act 2001} (Cth) such as for example, asset-stripping (ss 588FB(1), ss 588FE, 588FC), insolvent trading (s 588G), failure to make forthright disclosures (ss475 and 530A), falsification of books and records (ss 286, 1307), preventing recovery or reducing employee entitlements (ss 596AB, 596AC(2)), fraud (s 596), breach of officers’ duties (ss 180-184). Third parties involved in the breach may be in contravention of the Act: ss 79, 181(2), 182(2), 183(2), 588G(2). Fraud is a well-accepted basis for piercing the corporate veil. See \textit{Briggs v James Hardie} (1989) 16 NSWLR 549, 567. ASIC has power to disqualify persons from managing companies (s206F) and power to wind up abandoned companies (s489EA).
  \item[31] For example, failure to pay employee entitlements may contravene an award: \textit{Fair Work Act 2009} (Cth), s45.
  \item[32] Illegal phoenix activity may be an offence under Part III of the \textit{Tax Administration Act 1953} (Cth), and where it is a scheme to avoid taxation, may trigger the provisions of the \textit{Income Tax Assessment Act} (Cth), Part IVA. Non-compliance with director penalty notices may lead to personal liability for unmet corporate tax liability: \textit{Taxation Administration Act 1953} (Cth), Division 269, Schedule 1. Security deposits for an existing or future tax-related liability may be required: \textit{Tax Administration Act 1953} (Cth), Schedule 1, s255D. For a comprehensive analysis of security deposits, see M Broderick, ‘Legislative change to director penalty notices and security for tax payments’ (2011) 40 \textit{AT Review} 60, 63.
  \item[33] Relevant criminal law includes providing false or misleading information to a Commonwealth entity such as ASIC, the ATO or the FWO, forgery or the production of false or misleading documents in purported compliance with a Commonwealth law: \textit{Criminal Code Act 1995} (Cth), s137, 144, 145.
  \item[34] Matthew, above n14.
  \item[35] Ibid, 117-118.
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number, underpinned by an identification process along the lines required to establish a bank account, to enable the monitoring of director registration', (2) collection of data associated with director appointments over time in order to ascertain patterns of involvement in repeated business failure, and regulatory collaboration and (3) cooperation via the Inter-Agency Phoenix Forum in order to alleviate the significant detection and enforcement burden.\textsuperscript{36} The question that remains is whether legal phoenix activity presents a problem that ought to be addressed by the law.

3. Economic theory underlying tolerance of the failed entrepreneur

Not all phoenix activity is illegal. Phoenix activity can be a genuine, honest and legal attempt to restructure following business failure.\textsuperscript{37} Tolerance of legal phoenix activity is a reflection of economic policy sympathetic to legal business failure, encouraging of innovation and supportive of entrepreneurship. Legal business failure and restructuring should not be demonised nor should the operators of the failed business suffer the same consequences as those engaged in illegal activity, unless there is a clear economic imperative for such an approach.

The role of corporations within the economy cannot be understated: corporations dominate the supply of goods and services, access to information, employment, and media.\textsuperscript{38} Corporations play an increasing role in human rights and social welfare.\textsuperscript{39} As Bottomley explains, ‘the activities of corporations shape or influence national economies, they affect the quality of the environment, and they influence the actions of nation states’. In essence, an examination of phoenix activity is an examination of a particular aspect of corporate behaviour and its ramifications. Accordingly, if we are to limit or discourage particular aspects of corporate behaviour, then we must consider the underlying context in which such behaviour occurs.\textsuperscript{40} That underlying context includes the economic purpose served by corporations.

It is logical for an evaluation of the law relating to a particular aspect of corporate behavior to use an economic lens to consider the interdependence that exists between corporations on the one hand and the economies in which they operate on the other. Reform should only be implemented after a consideration of the broader economic impact of legal or regulatory change. An economic lens adds a valuable and important dimension to this analysis since companies are

\textsuperscript{36} Business Set-Up, Transfer and Closure, above n 6, 28, 88.

\textsuperscript{37} Anderson et al, Defining and Profiling Phoenix Activity, above n 16.

\textsuperscript{38} Stephen Bottomley, The Constitutional Corporation: Rethinking Corporate Governance (Ashgate, 2007), 1-3.


\textsuperscript{40} Bottomley, above n 38.
economic entities that exist in an economic context.

Schumpeter, Neo-Schumpeterian theorists and more liberal economic thinkers such as McCloskey, firmly position entrepreneurship and willingness to engage with risk and innovation as being at the heart of long-term wealth creation in capitalist economies.\(^\text{41}\) Schumpeter was one of the earliest economists to identify the critical importance of innovation and entrepreneurship to economic growth and productivity. As Schumpeter explained, capitalism without entrepreneurship is like Hamlet without the Danish prince.\(^\text{42}\)

Schumpeterian theory is well suited to explain the cyclical behaviour of phoenix activity, and the innovation of business models that may give rise to such behaviour. Schumpeterian theory is premised on the behaviour of entrepreneurs within the market, and the impact of that behaviour upon the market itself.\(^\text{43}\) Phoenix activity presents a challenge in that it can be cyclical and may involve rapidly changing business models, some of which are legal and some of which are not.\(^\text{44}\) These factors highlight the imperfect nature of competition and the challenges to achieving equilibrium. Schumpeter’s theory focuses upon business cycles. It recognises that markets are in a constant state of change and evolution.\(^\text{45}\) Schumpeter’s theory is best known for its consideration of the perennial gales of creative destruction, a process Schumpeter considered to be


\(^{42}\) Schumpeter, *Capitalism, socialism and democracy*, above n41, 86.


\(^{45}\) Schumpeter, *Capitalism, socialism and democracy*, above n41, 31.
the essential fact of capitalism’. Schumpeter observed capitalism as involving an evolutionary process driven by the impact of innovation or new competition. That process is characterised by disruption that may lead to qualitative change, industry mutation, potentially culminating in the forced exit of individuals or even entire industries incumbent in the market. This process is creative in the sense that the new firms are innovative and tend to be less shackled by existing industry constraints. For those that succeed, innovation or the innovative approach manifests as a market advantage capable of displacing incumbent firms constrained by their traditional approaches and technological restraints. For incumbents the mere prospect of this type of competition ‘acts not only when in being but also when it is merely an ever-present threat; it disciplines before it attacks’. Entrepreneurship and innovation thus drive new firms, which in turn drive economic growth by removing less competitive players from the market, and spur incumbents to innovate in order to become more competitive. Business failure is an inevitable part of this cycle, but it is accompanied by the entry of new firms, bringing new employment opportunities and new innovative practices and technologies.

Neo-Schumpeterian economic theory builds upon Schumpeter's work with a focus on the development of mature, robust economies and the role of government dealing with the ramifications of innovation. The Schumpeterian origins of neo-Schumpeterian theory include recognition of the role of innovation and entrepreneurship. However neo-Schumpeterian theory takes a very broad view of innovation, such that the neo-Schumpeterian concept of innovation is not confined to products or technology, but extends to ‘organisational, institutional and social innovation’. Thus, innovation, at its broadest sense, is the normative principle of neo-Schumpeterian economics. Business restructuring would fall within the notion of innovation. Neo-Schumpeterian theory suits a study of phoenix activity as it is primarily concerned with economic analysis of, and government responses to innovation and entrepreneurship. Neo-Schumpeterian economics supports the development of a social contract, implemented by government, to deal with ‘the peculiarities and imponderables of innovation processes’ in a manner that is both supportive of innovative processes and attendant to social responsibilities arising in the face of innovative success.

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46 Ibid, 83.
47 Ibid, 82.
48 Ibid.
49 Schumpeter, *Capitalism, socialism and democracy*, above n 41, 85.
50 Ibid.
51 Ibid.
52 Hanusch and Pyka, ‘Principles of neo-Schumpeterian economics’, above n 41, 15.
53 Ibid, 276.
54 Ibid, 15.
Phoenix activity, both legal and illegal, involves a sometimes elaborate scheme to continue trading in the same market at a competitive advantage over incumbent firms. The corporate form is abused to this end. To the extent that phoenix activity amounts to innovation of a business model allowing repeated, unfettered access to limited liability even in the face of repeated business failure, Schumpeter would see this as further proof that capitalism is ultimately doomed.55

The paradox observed by Schumpeter is that capitalism is advanced by the creative destruction afforded by innovation and entrepreneurship, but that ultimately capitalism will be destroyed by its success rather than its failure.56 While Schumpeter's work focused upon the role of the bold, risk-taking, innovative entrepreneur, ultimately he saw entrepreneurship being necessarily replaced by a new mode of economic organisation.57 This suggests that ultimately capitalism will be unable to tolerate entrepreneurship at its most rampant.

If we value capitalist economic principles, then there is arguably a basis to reign-in entrepreneurial activity that positions itself for an unfair competitive advantage. Phoenix activity pushes tolerance of entrepreneurship to its limits. Phoenix activity demonstrates the difficulties presented when legality is used as a measure of fairness of a competitive advantage. Ought the law respond to persistent entrepreneurial failure, such as that at work in cyclical phoenix activity, irrespective of whether the failures are honest, misguided, or uninformed failed entrepreneurial efforts?

Honest business failure and restructuring are generally supported by financial and economic policy. Indeed a feature of most robust capitalist economies is a strong insolvency law regime that supports legal business failure. Incorporation and the choice of corporate form is a privilege afforded to enterprise.58 In accordance with this economic policy, the law must accommodate and tolerate legal phoenix activity, at least to some extent. The extent to which legal phoenix activity ought to be tolerated is directly linked to abuse of that tolerance. Intolerance might see persistent, yet legal, business failure construed as abuse of the privileges associated with the corporate form. This is most likely to be the case if the business failure is sufficiently frequent and has amassed significant economic wreckage at little personal cost to the controllers and shareholders of the failed entity. A more moderate approach would more closely align with economic theory supportive of innovation, tolerant of business failure and a

55 Schumpeter, Capitalism, socialism and democracy, above n41, 133-134.
56 Ibid.
57 Ibid.
highly developed capitalist economy. Such a moderate approach might involve setting a threshold tolerance limit of repeated business failure, even where that failure is honest. The tolerance threshold may trigger disqualification from completely unfettered access to limited liability in future endeavours. Capitalist economies are characteristically supportive of entrepreneurship but a mature and robust capitalist economy need not be supportive to the point of abuse of the privilege. One possible approach is for access to limit liability to be time barred. The time bar might give the business owners and entrepreneurs an opportunity to engage in education as to more appropriate business practices.

Given the prevalence of phoenix activity within MSMEs, rethinking dispute resolution mechanisms and the insolvency regime for these businesses may be valid approaches to continue to support legal business failure. This too might fit within a conceptualisation of business failure within a highly developed and functional capitalist economy.

4. Conclusion

It is implicit in capitalist economies that some individuals within the market stand to lose when a business fails. Vulnerable, unsecured creditors may be among those suffering losses. The critical consideration is that these losses occur within the broader economic framework in which long-term wealth creation throughout the economy may be ensured by supporting legal business failure. To focus intently on the losses of some unsecured creditors runs the risk of losing sight of the bigger economic picture. This is very difficult to do when the most vulnerable of all unsecured creditors are caught in the wake of phoenix activity albeit legal or illegal.

Reforms raise concerns for their potential impact on corporate behaviour and the delicate equilibrium sought to be achieved in a capitalist economy between support for entrepreneurship targeting long term wealth creation, legitimate business failure and the loss incurred by those impacted by that business failure. The Productivity Commission has estimated that approximately 2000 business each year engage in phoenix activity.59 The more limited liability is misused, the stronger the argument to limit access to limited liability.

This paper has proposed that economic theory can inform the law’s response to phoenix activity. Economic theory focussed upon entrepreneurship and innovation can to some extent explain why it may not be possible nor desirable to eliminate phoenix activity associated with business failure, since business failure is an inevitable part of the fabric of capitalist economies and phoenix activity is not always illegal. Even where phoenix activity is legal, abuse of legal business failure pushes economic policy supportive of a tolerant law to its limits. At this threshold point, it becomes more viable to limit the privileges associated

59 Business Set-Up, Transfer and Closure, above n6, 28.
with limited liability and yet still accord with the broad principles supportive of normative business failure. Business failure in abuse of the privilege remains outside the norm. Arguably this accords with how ASIC is already using Corporations Act 2001 (Cth), s206F – as a time out mechanism precluding access to control of a limited liability company, albeit for a relatively short time.