PERSONAL ASSET RISK REDUCTION STRATEGIES

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WHAT CAN BUSINESS OWNERS AND COMPANY DIRECTORS DO TO PROTECT THEIR PERSONAL ASSETS IN THE EVENT OF BUSINESS FAILURE?

In the wake of recent high profile business collapses in Australia and the US, many questions have been raised. These range from an examination of corporate practices and corporate governance to the role of directors, their assets and their apparent ability to maintain expensive lifestyles while others suffer the financial fallout. While corporate failures are not always like these, they are a part of the business world and risk reduction strategies should therefore be incorporated into any business.

Many businesspeople are now asking their advisers how they can legitimately protect their assets. The question is not new but is becoming a primary consideration for both established businesspeople and those about to embark in business. There are now a number of Acts that make directors personally liable for debts and obligations which were previously the sole domain of the company. The corporate veil is no longer an iron curtain which will protect company office-bearers. Directors – new, old or prospective – need to be fully informed about their duties and obligations with regard to corporate governance. Failure to do so may expose them to personal liability, penalties and/or incarceration.

An individual performing the role of corporate governor may seek to limit his or her financial exposure through directors and officers insurance coverage, or corporate and shareholder indemnities, all of which may be of some use as long as negligence is absent. However, in a challenging and changing business environment the propensity for litigation seems to have increased – you only have to turn to the business section of the newspapers to read about the most recent corporate scalp – and this has led to escalating insurance premiums. So while insurance is an available strategy to limit financial exposure, it is increasingly becoming unaffordable. It is possible that the situation may become so dire that only the brave will be willing to anoint themselves as a director.

A further complication is that many company operators allow personal financial matters to become intertwined with corporate financial affairs, unnecessarily exposing themselves and their families. In today's corporate society, handshakes are no longer enough – personal guarantees and caveats are the norm, company failure becomes very personal and financial hardship follows. What is needed is a strategy to limit or avoid personal exposure in these situations.

LIMIT DIRECTORSHIPS

One simple strategy is to limit the number of 'same family' directorships held. For private companies the Corporations Act was amended several years ago to allow for one-director companies.

The two-director requirement often led to a non-participating family member, normally the spouse, becoming a 'silent' director. The silent director often had little knowledge of or practical involvement in the affairs of the company yet was exposed to all the obligation and duties of the law. Moreover, the courts were adamant that ignorance was not a defence.

Accordingly, the one-director minimum requirement was a welcome change and many businesses have taken advantage of this by retiring additional directors. In practical terms this has meant that where the business principal faces personal, company-related financial exposure, the family assets are afforded some protection and a strategy to limit losses may be available, all within the confines of the law. Without this simple change all family wealth may have been lost in the event of a company collapse.

It is worth noting that the definition of 'director' under the Corporations Act is broad enough to deem an individual as director for purposes of the Act, where a person is acting as a director even though they do not officially hold that position. Professional advisers are to some extent excluded from the deeming provisions.

AREAS OF RISK

The more common reasons given for company failure include:

- inadequate management resources/skills
- poor financial management, record-keeping and/or reporting
- failure to reinvest
- economic downturn
- natural disaster
- industrial relation issues
- poor economic environment.

In addition to these potential dangers, the business landscape is dotted with a variety of risks arising from a broad array of laws, including tax, product liability, trade practices, employment and occupational health and safety laws, among others. The associated risks of being in breach of these laws are increasingly real and can lead to

financial problems in a relatively short period of time. Some breaches can lead to significant financial and operational impositions. When amending these laws, all regulators have given attention to the duties of directors and to removing the corporate veil to achieve greater transparency and clarity.

Company structure strategies are one way of limiting exposure for the company itself. Most private companies do business with the one corporate entity, meaning assets, liabilities and operations are subject to the same risks. Careful planning and structuring for the acquisition of assets can allow for real estate and other business assets to be held by entities disassociated with the trading company.

ASSET HOLDING ENTITIES

A corporate structure that limits the exposure of physical assets to commercial risks is a desirable option. This can be achieved at arm's length and within the law and still allow the trading entity access to these assets for business purposes. This may include rental of business premises, hire of plant and equipment and licensing of 'goodwill'.

Of course the legal, tax and commercial implications of entering into such arrangements need to be carefully considered and expert advice sought. The funding of such asset acquisitions also needs careful consideration and the beneficial ownership of such entities is also critical. There is little point in the risk-exposed director owning the assets, indirectly or otherwise! Ensuring that valuable assets are not unnecessarily exposed to commercial risks is the aim. In many cases, trusts, superannuation funds or additional companies can provide the best arrangement.

ASSETS HELD BY A THIRD PARTY

This is probably the most frequently used strategy to allow for some asset protection. Typically the spouse, who is not a director of the company, is the registered owner of the family home and does not enter into company guarantees or act as surety for the company. They are usually also completely isolated from any commercial or financial risks to which the company is exposed. While it is still possible that the assets owned by the third party may still be at risk, taking these steps will, however, ensure that risk is limited.

The risk could come from a constructive trust claim. The argument runs along the lines that the non-director spouse is holding the asset or part of it in trust for the director, the director having contributed toward its purchase, creation or enhancement in some way. However, legislators have recently begun to draft amendments to the family and bankruptcy laws to close loopholes that exist between the two Acts which effectively provide some debtors with the ability to place their assets beyond the reach of creditors. Further still, the Corporation Law is being amended nearly on a real-time basis, to ensure that corporate assets are not placed outside the grasp of company creditors. Recent examples are the amendments relating to employee claims and payments to directors. This is a sign of the times ahead.

Directors often seek to transfer assets from their personal names when financial difficulty looms, a step fraught with danger due to the 'claw back' provisions contained in bankruptcy law, which effectively unwind transactions and recover the assets. This does not have to be the case, however, as long as you take into account time and solvency status, the cornerstones of a solid strategy.

WHAT ABOUT THE BANK?

In most private company situations funding from financiers requires a number of securities. These normally include:

- registered first mortgage over real estate, corporate or otherwise
- cross-collateralisation against other business assets interests and facilities held with that institution
- personal guarantees from directors, relatives and shareholders
- fixed and floating charge over the company assets and undertaking.

As the secured creditor, the bank or financier ranks above all others in relation to any return of funds from the sale of fixed assets in the event of corporate failure. Once this source is exhausted, the secured creditor will call on any third party securities they may have, such as the family home.

Accordingly, the strategy is obvious in this regard – find a financier who only wants corporate security, or limit the personal security given.

The fixed and floating charge provides the secured creditor with wide ranging and significant rights. You should read the charge document carefully, as it will show you exactly what rights your financier has. For example, unknown to you, you may be in technical default of the charge, because you have not paid taxes on time or have an 'unofficial overdraft'. This may give your secured creditor the right to appoint a receiver without notice. This appointment has the ability to destroy your business in a short period of time, as suppliers and customers lose confidence.

Hopefully, over a period of time the value of the securities given will increase and the amount owing to the financiers decrease, with the result that the financiers hold security significantly in excess of commercially necessity. For example:

	Year 1	Year 5
Real Estate (secured + registered charge)	1,000,000	3,000,000
Debt	(1,000,000)	(500,000)
Equity	Nil	2,500,000

A further strategy to reduce exposure is to review your security position regularly with the view to having financiers reconsider the situation and releasing some security.

Funding for the business is usually from a combination of shareholders, finance and trade credit. Accordingly, where related parties lend funds to the company, they should take advantage of all the strategies to protect their investment that other financiers do – securities, liens, caveats, guarantees and sureties. It is lawful and leaves you in a far better situation than being an unsecured creditor. Taking advantage of securities and the like does, however, still require careful consideration of the objectives and the impact of such a step on other commercial matters such as lending covenants in existing securities.

DIVEST OR ENCUMBER?

Commonly many asset management strategies may divest the asset, particularly where real estate exists. This may create significant capital gains tax and stamp duty implications. Alternatively, the equity held in an asset can be reducing by borrowing against it, to fund other assets.

It is important to consider the flow of funds and whether loans are being created between entities in these situations. These strategies do have limitations. However, some protection is always better than none.

COMMON EXPOSURES

Read any financial periodical or newspaper, listen to any financial broadcast or watch a television program, and without too much searching an example of the risks directors and related third parties face will hit the headline news.

Through experience we have identified the following as some of the more common exposures which could have been avoided or at least mitigated if appropriate strategies had been employed from the outset:

- non-director related party executing corporate guarantees
- director(s) offering personal assets as corporate security
- using the taxman as a financier
- funding personal assets with corporate money
- failure to investigate options when entering credit arrangements
- inadequate corporate structures
- failure to meet laws that govern business.

Each one of these forms of risk can be dealt with by having an effective strategy in place. And the time to develop these strategies is now.

RECOMMENDATIONS

The question 'How can I legitimately reduce my financial risk to corporate activities?' will be increasingly asked of advisers. For the businessperson, understanding the risks and seeking professional advice is critical at the start rather than when problems arise. Actions contemplated at business start-up or enacted while the parties are solvent in the normal course of business are clearly the best proposition. Actions taken just prior to the onset of financial difficulties are questionable and susceptible to recovery actions.

Any strategy being contemplated requires detailed planning and assessment. It is vital to factor in the commercial and legal implications of taxation, capital gains tax (CGT) and stamp duty. In particular, the CGT small business concessions and having a 'controller' for clients that may benefit from these concessions are always important factors. In addition, access to the main residence exemption for CGT is a significant incentive that should not be automatically given up.

When considering any business structure or restructure, it is also important to consider the commercial basis for the arrangements and in particular the links to estate planning issues. Consideration should also be given to the impact of any changes contemplated on shareholders agreements, buy/sell agreements and wills.

Time spent planning now is worthwhile – and remember, time and solvency are the two essential ingredients to get it right. **NA**

MANY COMPANY OPERATORS ALLOW PERSONAL FINANCIAL MATTERS TO BECOME INTERTWINED WITH CORPORATE FINANCIAL AFFAIRS, UNNECESSARILY EXPOSING THEMSELVES AND THEIR FAMILIES.

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