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Asset Exposure and Personal Liability in Business

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Many directors are completely oblivious of their obligations and duties, thinking only of what they will make from the successes of their new enterprise. They do not consider the downside or risk—particularly their personal exposure—should things go wrong. The cold-hard reality is company directors face many and varied potential risks.

From our experience, it seems the main reason asset protection/structuring advice is generally not acted on comes down to cost. The simple fact is asset protection/structuring advice, and its implementation, comes at a cost.

To offer some educated, qualified, and experienced guidance on some of the risks that directors face and the effects of insolvency, we discuss the more common issues that expose directors to personal liability.

This guide includes a link to our **Asset Exposure Checklist** (page 14). It helps identify potential risks and gives useful tips to assist your clients to make informed decisions about how assets/securities are treated.

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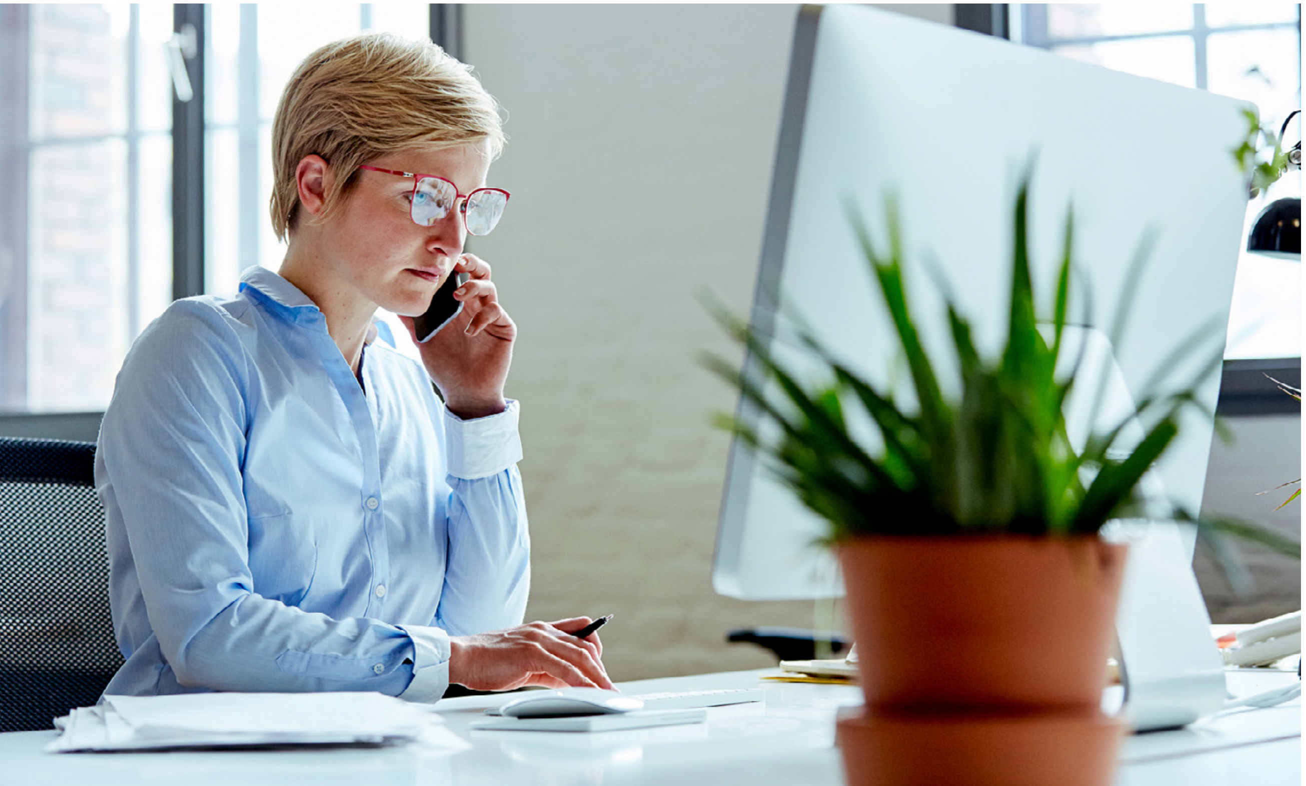
Personal guarantees

This may seem like an obvious one, but it is often not properly considered. For clarity, a personal guarantee is a document that a director (or another interested person, such as the director's spouse) signs to guarantee the debt the company incurs. This means that should the company fail to pay that debt, the creditor holding the personal guarantee can rightfully seek payment personally from the director (or similar guarantor).

Once a company goes into liquidation, creditors holding personal guarantees will pursue the guarantors to pay the outstanding company debt. Frequently, directors cannot determine which creditors actually hold a personal guarantee due to the directors' paperwork not being in order. The creditors that will almost always have personal guarantees include financial institutions, a landlord, and major suppliers.

In certain circumstances, a liquidator may also pursue a director personally for "guarantor" preferences, if payments are made to creditors whose debts have been personally guaranteed (section 588FH of the *Corporations Act 2001*). These provisions also extend more broadly to related entities.



Caveats: charging clauses over property

Many personal guarantees include a 'charging' clause. These clauses provide a 'charge' in favour of the creditor, in the event of non-payment, and often allow a creditor to place a caveat over any real property the guarantor owns. These creditors then become a secured creditor over that real property. The creditor may then lodge a caveat over the property, and if necessary, commence legal action to enforce their charge. This may ultimately lead to the sale of the property and a distribution of proceeds, firstly to the secured creditors (mortgagee and caveat holders) with surplus funds (if any) paid to the property's owners.

Clearly these clauses are a very powerful tool for creditors; and directors must be acutely aware of these.

Secured creditors: financial institutions

A financial institution providing a company with finance will almost always take security over the company and a personal guarantee along with a mortgage over any real property the directors own. Should the company be unable to pay its debt, the lender will call upon the guarantees and mortgages. Ultimately, if directors don't pay the debt, the sale of any real property offered as security will, in most cases, be enforced. Once the debt is satisfied in full, the surplus sale proceeds (if any) will be paid to the property's owners.

Director loan accounts (debit)

Worrells is increasingly seeing the use of director loan accounts. Directors often make the conscious decision to only pay themselves a small salary (or sometimes none) and take company funds structured as a directors' loan account. The perceived advantage is that directors don't need to remit pay as you go (PAYG) withholding tax to the Australian Taxation Office (ATO). However, in a liquidation scenario, the liquidator will immediately identify an outstanding director loan account/s and promptly demand repayment. Often a significant amount is outstanding, and the liquidator is obligated to recover the loan account.

Related-party loan accounts (credit)

We regularly ask advisors if their clients (or their related parties) have credit loan accounts, and whether they're formally documenting them in a written agreement that gives them a security interest over the company's assets, and then registering that security on the PPSR (under the *Personal Property Securities Act 2009*).

PPSR

It's certainly worth considering as it will advance your clients' status above the interests of unsecured creditors, increasing their prospects of a return in the event of liquidation. It may also mean that repayment of a credit loan account can't be 'attacked' as a preferential payment if the borrower company is liquidated (as the debt is secured).

Director penalty notices (DPNs)

The corporate veil has been well and truly pierced for various types of tax liabilities and superannuation.

Company directors are legally responsible for ensuring that their company meets its PAYG withholding, "net" GST (goods and services tax, wine equalisation tax, and luxury car tax) and superannuation obligations. If a company fails to comply with its obligations by the due date for payment, company directors become personally liable for the amount the company should have paid (a director penalty).

The ATO does not need to issue any notices or take any action to make a director personally liable; personal liability is automatically imposed by operation of law. The Commissioner, however, must not commence proceedings to recover a director penalty until 21 days after a DPN is issued to a director.

If directors are issued a DPN, it's vital they immediately seek appropriate advice on what they should do, as in some circumstances they can take action that results in the director penalty being remitted (i.e. cancelled). But if they choose to be in a space of denial—the problem will only get worse.

Our knowledge base details how DPNs work click here.

Director Penalty Notices

ATO preferences and director indemnity

Directors and their advisors often overlook this potential liability when considering a company winding up. If a liquidator determines the company made a 'preferential payment' to the ATO (by paying the ATO in preference to other creditors), the liquidator will take appropriate action to recover it e.g. via a court order. If successful, the court may, on the application of the ATO, order that each person—who was a company director when the payment was made—liable to indemnify the Commissioner in respect of any loss or damage resulting from the order.

Insolvent trading

Section 588G of the Corporations Act imposes a positive duty on directors to prevent insolvent trading. Essentially, a liquidator conducts investigations to form an opinion on the point in time the company became insolvent, and the value of unpaid debt incurred after that date. This amount is what the liquidator can pursue the director to pay personally (i.e. the insolvent trading claim). Ultimately, a court determines whether a company has traded while insolvent.

As an aside, not only are directors at risk of a claim for insolvent trading, but holding companies are also at risk (section 588V of the Corporations Act). This exposure can be overlooked in asset protection planning strategies.

Our knowledge base details how insolvent trading claims work click here.

Insolvent Trading Claims

Safe harbour

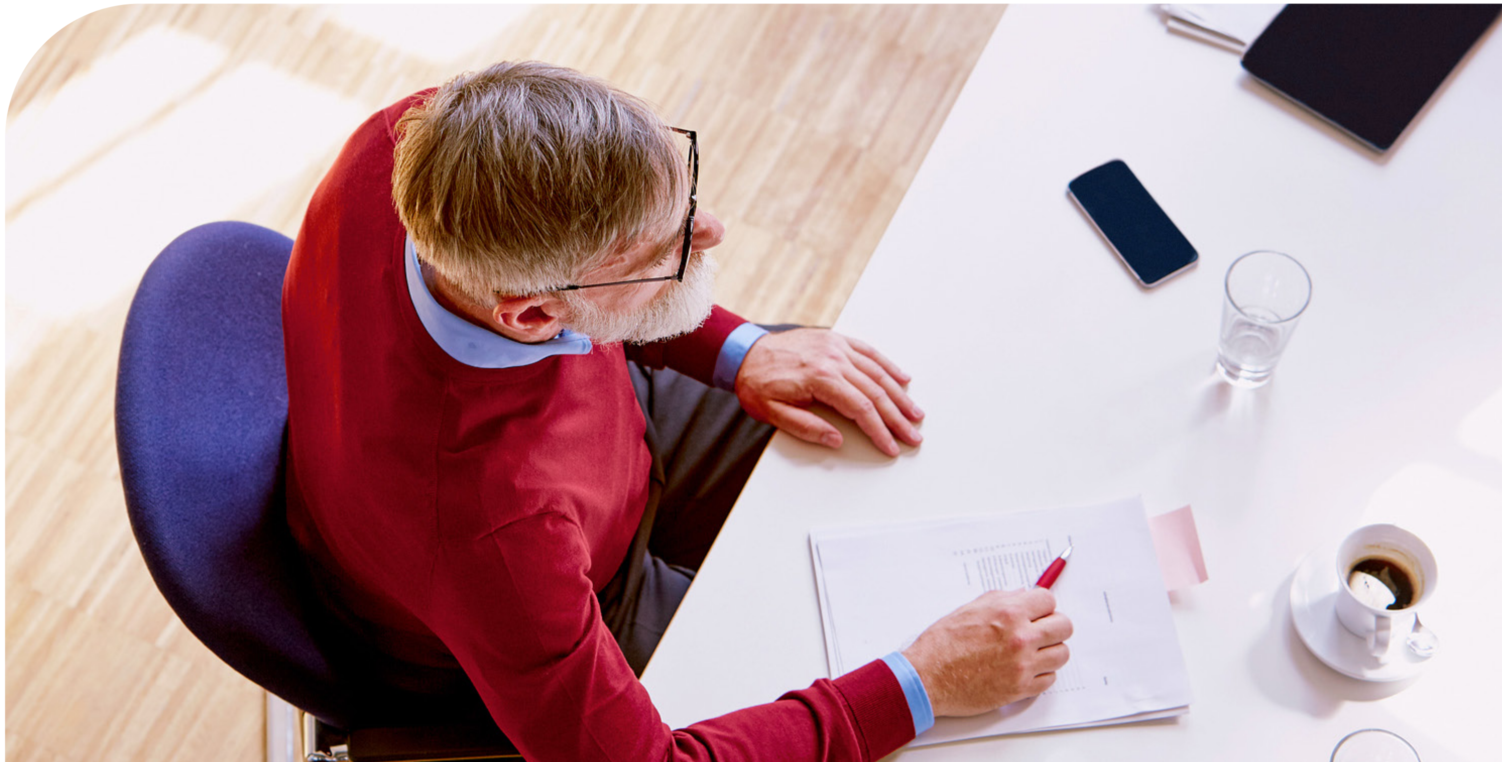
Safe harbour (where it genuinely exists) enables directors to have support and assurance to turnaround the business without the possible threat of insolvent trading looming over their heads during the process.

The 'safe harbour' regime can provide directors with an opportunity to seek proper advice to develop and implement an action plan, with the aim of achieving a better outcome for the company and its stakeholders when compared to simply closing the doors and appointing an administrator or liquidator.

However, safe harbour is not necessarily available to all companies and its directors. A range of criteria must be met to take advantage of the protection the safe harbour regime offers.

Our knowledge base details how insolvent trading claims work click here.

Safe Harbour



Unreasonable director-related transactions

Liquidators can pursue a director for an 'unreasonable director-related' transaction under section 588FDA of the Corporations Act. To determine whether a transaction may be considered 'unreasonable', the liquidator must establish the following:

- The payment or transfer of property was made by the company; the company issued securities; or the company incurred the obligation to make such a payment or disposition.
- The payment or disposition was made to or for a director's benefit, or a close associate or person on behalf of a director.
- A 'reasonable person' in the company's circumstances could be expected not to enter into the transaction when considering the benefits and detriment to the company.

This gives liquidators quite a wide scope to pursue company transactions and examine any transactions made to the directors' close associates (usually their family).

Our knowledge base details how unreasonable director-related transactions work click here:

Unreasonable Director-related Transactions

Creditor-defeating dispositions

More recently, 'Creditor-defeating disposition' legislation was introduced at section 588FDB of the Corporations Act. This provision contains mechanisms to combat illegal phoenix activity, specifically transfers of company assets for less than market value (or less than the best price reasonably obtainable) that prevent, hinder or significantly delay creditors' access to the company's assets in liquidation.

"Creditor-defeating dispositions" are defined as the transfer of company assets when the company was insolvent, became insolvent because of the transaction within 12 months of the relation-back day, or enters external administration within 12 months of the transaction.

Transactions of this nature attract both new criminal offences and civil penalty provisions that can be pursued against directors and third parties (including lawyers, accountants, or pre-insolvency advisors) who procure, incite, induce or encourage a company to make creditor-defeating transfers of company assets.

Liquidators can apply to court or to the Australian Securities and Investments Commission (ASIC) for orders undoing a creditor-defeating disposition in certain circumstances within the latter of three years from the relation-back day or 12 months from the first appointment of a liquidator.

ASIC may also make such orders under its own initiative.

Breaches of directors' duties

Liquidators must investigate a company's affairs for the period prior to the liquidation. These include reviewing the director's actions to determine if they breached any of their director duties under the following sections of the Corporations Act:

- **Section 180:** Care and diligence—civil obligations.
- **Section 181:** Good faith—civil obligations.
- **Section 182:** Use of position—civil obligations.
- **Section 183:** Use of information—civil obligations.
- **Section 184:** Good faith, use of position and use of information—criminal offences.

If a breach is identified, liquidators will lodge a report with ASIC under section 533 of the Corporations Act. ASIC will then review, and if deemed appropriate, prosecute the directors.

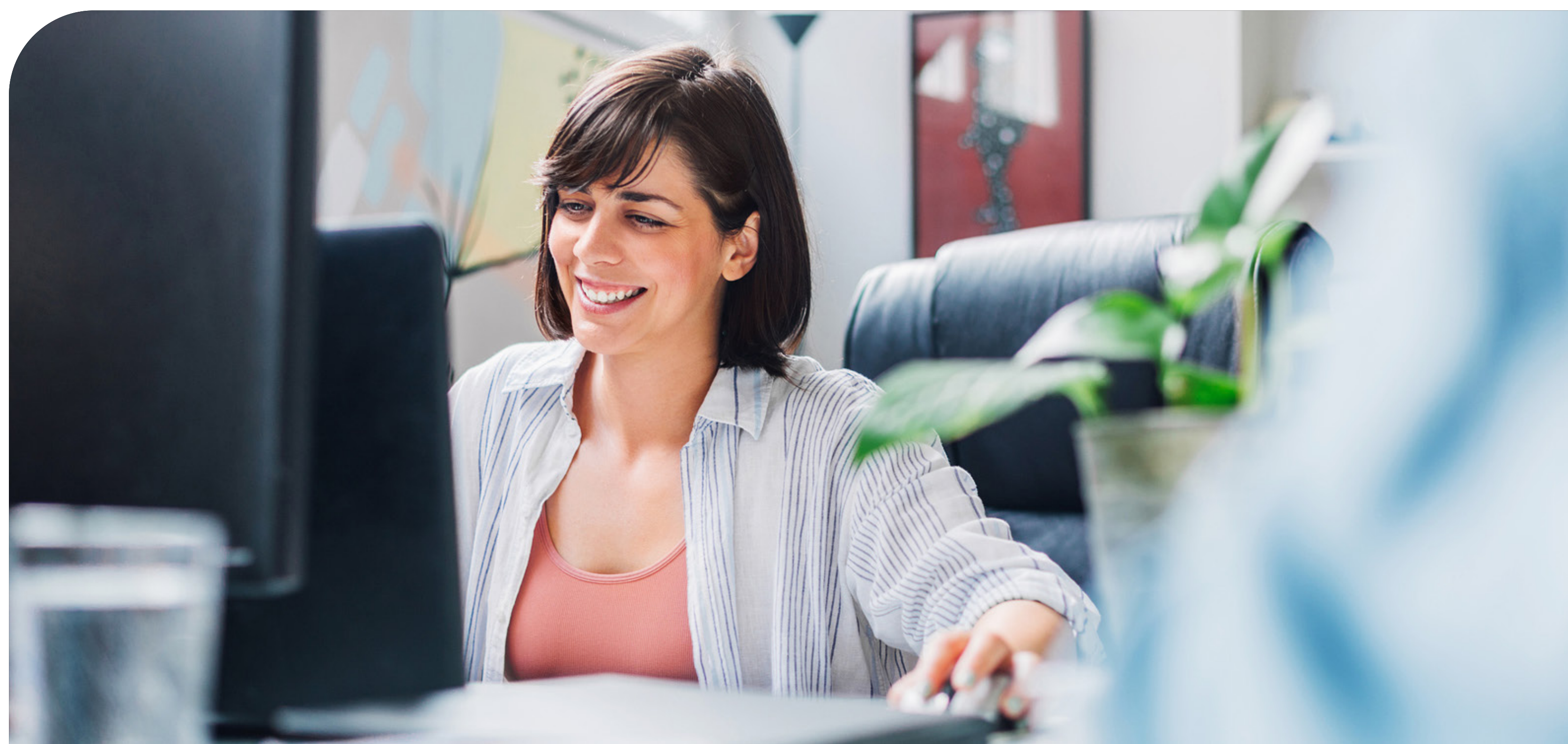
A director may also become liable to the company for damages as a result of director duties breaches.

Where to from here?

So, what is the potential impact when a director becomes exposed to personal liability as a result of their company's failure?

Part of the answer depends on whether (or how well), the director has structured their personal affairs from an asset protection planning perspective.

To many people, asset protection is about separating adverse risk from a person's assets. While a well-drafted asset protection plan can go a long way in deterring a creditor from pursuing sometimes expensive litigation (and possibly obtaining a judgment that cannot be satisfied), the *Bankruptcy Act 1966* provisions also impede those who try to transfer/dispose assets in the period leading up to a bankruptcy.



Asset exposure checklist

Worrells Asset Exposure Checklist provides guidance on the risks faced by those in business. While not exhaustive and without considering specific circumstances unique to each individual or the need to obtain professional advice, it helps identify:

- Some key risks and exposures faced by those involved in a business enterprise.
- Whether your clients are exposed and the areas that may need to be managed.

Click here to access the Worrells Asset Exposure Checklist.

Worrells Asset Exposure Checklist

When planning for asset protection it is obviously important to remember:

- There is no perfect asset protection structure, it is a matter of considering the specific circumstances, balancing priorities and determining what is most important.
- Asset protection planning and circumstances evolve, both in terms of the legislation and the individuals' asset position, and therefore needs constant review.
- Financial problems must be addressed proactively, and asset protection planning strategies are far more effective if implemented well in advance.
- A comprehensive asset protection strategy must consider not only business risks (and holding appropriate insurance cover to mitigate those risks), business succession planning, and estate planning, but also a range of intersecting personal risks and legislation such as family law, trust law, etc.

Tips to make informed decisions about how assets/securities are treated

As readers can see, directors face many areas of potential exposure, some of them are very serious and may have a significant adverse effect. Advisors can give their clients the following tips to assist them make informed decisions:

- Know and understand how their business structure works—have a strong discipline about how the structure is administered.
- Read and understand all contractual documentation carefully, such as terms of loans, lease and supply agreements etc.—and negotiate before agreeing to them.
- Limit any personal guarantees—keep a register and put a maximum limit on any guarantee given.
- Never own assets personally—transfer any assets as soon as possible and before taking on any potential risk[1].
- Ensure any asset transfers are for full market value and proper consideration is paid (not just via journal entries).
- Ensure the at-risk person does not make any direct financial contributions to assets or servicing of debt—the non-at-risk-person holding assets needs their own income to service the debt.

1. Arguably assets transferred for asset protection purposes may satisfy the "main purpose" test in Section 121 of the *Bankruptcy Act 1966* of the transfer being to defeat creditors, and may be void in the event of bankruptcy even if transferred years prior (Wallace v Wallace [2016] FCCA 963 (31 May 2016)).

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