Asset Protection - What Directors Need to Know.

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If you are thinking of becoming a Director, or are already a Director, then you will be told by advisors that you should protect your assets, and that you should go and see your accountant or a lawyer to get asset protection. In this article I will explore the issues that you need to consider when seeking to protect assets, and how you may avoid some common pitfalls.

What is asset protection?

Asset protection simply means holding assets in ways that are separate from liabilities.

It is important therefore to understand what your assets are, and what your liabilities or potential liabilities are.

Understand your present asset holdings

Every person will have their own circumstances, so it is important for your advisor to understand what assets you currently own in your own name, and also what structures (ie companies and/or trusts) you currently have.

You should put down on paper what you think your assets are, and what liabilities you have. I say 'what you think' because I have found over 20 years as a lawyer that most people don't fully understand their own asset position, let alone their liability position.

Take for example the primary residence. Most people considering board positions will say that they own the house that they live in (whether mortgaged or not). If the person has a spouse however, then the primary residence may actually be owned by

- only one of the couple;
- in both names as joint tenants;
- in both names as tenants in common in equal shares;
- in both names as tenants in common in unequal shares.

Each of the above presents different issues to consider.

For this reason your advisor should conduct searches of the available public registers to determine what your assets and liabilities are. Putting down on paper what you think your position is will however guide your advisor as to which public registers to concentrate on.

As a minimum, searches should be conducted as follows:

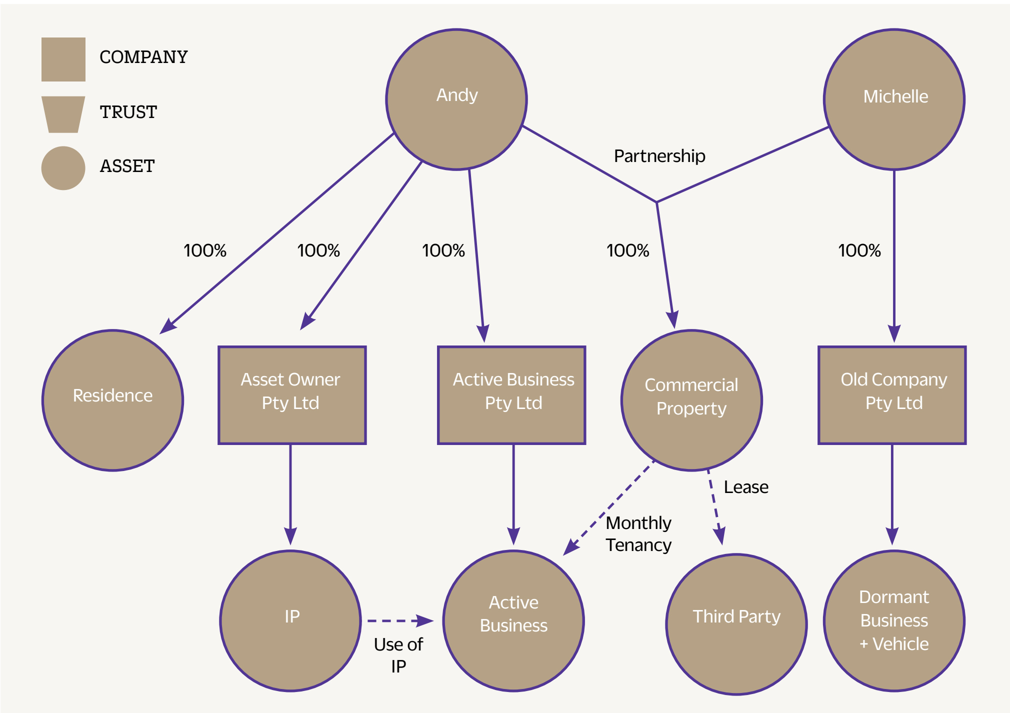
1. searches of the land titles office in the State where you hold property, including name search and address search;
2. searches at the Australian Securities and Investments Commission ("ASIC") as a personal name search to see what entities you are already involved in, whether as a director or shareholder;
3. searches of the Personal Property Securities Register ("PPSR") for you as a 'grantor', ie someone who has granted a security interest to another person ('secured party');
4. other public registers depending on your personal circumstances (eg a bankruptcy search, litigation searches, trade mark search etc).

Once all of the searches are conducted, your present asset and liability position can be drawn or mapped. Mapping a person's asset structure as a simple way of looking at the assets, which also can highlight where potential issues are. Over the years I have developed a simple key to assist with drawing.

Example

Below is an example of an asset map for 'Andy and Michelle' where the family home is owned by Andy. Andy owns and runs a business through two entities, one of which holds intellectual property which is used by the active business, and Michelle owns a company which is essentially dormant apart from owning a motor vehicle, and Andy and Michelle own a commercial investment property as a partnership, which is leased to a third party.

Apart from the interest in the commercial property, this is not a bad structure for Michelle to take on a board role, but as you can probably tell, Andy represents a single point of failure. If some liability should crystalise for Andy, all of the assets owned by Andy and Michelle are potentially affected.



Understanding your present and potential liabilities

Although companies have a separate legal personality to the directors, as a director of a company there are four main areas where personal liability can arise:

1. Where the director has signed a personal guarantee, the director has personal liability (according to the terms of the signed guarantee) for the performance of the contract by the company. Typically this happens in supply contracts, premises leases, equipment leases, vehicle leases, but can be in any contract;

2. Where the company trades while insolvent (ie unable to pay debts as and when they fall due), the director has personal liability for the debts incurred by the company while the company was trading while insolvent;

3. Where the company has not paid Pay AS You Go ('PAYG') withholding tax or Superannuation Guarantee Charge ('SGC'), the Deputy Commissioner of Taxation can issue a Director's Penalty Notice, whereby if the notice is not complied with the director becomes personally liable to pay the unpaid PAYG and SCG;

4. Where there is statutory liability on the director. The most common situation is where the director has personally breached, or been knowing involved in a breach of the Australian Consumer Law, for example by being misleading or deceptive. Other examples are more particular to certain industries, for example a director can have personal liability for breaches of work health and safety legislation.

A PPSR search on your name, and title searches of properties in your name, will show which creditors of yours have secured your liability to them against your personal assets.

For example, a director that has given a personal

guarantee for a contract for supply of goods to the company, may have also 'charged' their assets in favour of the supplier. A 'charge' is a grant of security over certain assets, meaning the supplier will have rights in relation to the assets if the primary obligation of the company is breached. A mortgage is a form of security that is particular to land and has additional rights in relation to the land.

Not all liabilities are registered on the PPSR and on title searches however, as those registers will only show secured parties. An unsecured liability may still result in loss of assets if the liability crystallises and there are insufficient funds to pay the liability.

It is important therefore for your advisor to understand your exposure under any contracts you may have signed.

The liabilities can also be mapped as an overlay on the asset diagram. I like to use different colours to quickly indicate where the risks are.

Other Risks

The risk of separation of spouses should be considered. The Family Court has wide ranging powers to look beyond structures and treat assets held in them as part of the assets of a relationship. A properly drafted binding financial agreement can assist with planning around this issue.

The risk of someone passing away and leaving assets to a person that is bankrupt, or is in risk of becoming bankrupt, should also be considered. A testamentary trust is a useful structure here.

Making changes to asset holdings

Once you have mapped your assets and liabilities, you may wish to consider changing how assets are held.

The purpose of the change may include to have income and/or capital from assets be distributed in a more tax effective manner, for example to distribute the income to beneficiaries through a trust.

Careful planning is required however as the transfer of an asset can trigger:

- A payment of stamp duty;
- A capital gains tax event;
- A need to fund the transfer and therefore potential to incur new liability;
- Loss of control over the asset.

Assets should however never be transferred to defeat or defraud creditors. The reason being is there is legislation which allows a creditor or trustee in bankruptcy to claw back any transfers that were made with the intent to defeat or defraud creditors.

There is an obvious intention to defeat creditors where there are existing creditors, or where assets are transferred for less than (or for no) value.

It is important therefore to:

- get a valuation of the asset that you wish to transfer, and for the acquirer to pay that value;
- pay out any existing creditors from the proceeds received from the acquirer of the asset.

Cost of holding assets in structures

Another important issue is the cost of maintaining structures to hold assets. Apart from annual fees for companies, accounting fees for preparation of financial statements and tax returns, banking fees for business bank accounts, there are some concessions for holding assets in an individual's name that are not available for, or reduced for, assets held in an entity.

Special note on the primary residence

A primary residence has exemption from capital gains tax and state land tax. Careful consideration should be given to the value of these exemptions.

Acquiring assets in appropriate structures

As can be see it may be costly and risky to move assets from your own name to a structure. The best way to avoid this issue is to never acquire assets in your own name, but to acquire the asset in an appropriate structure. There are many different structures and the appropriate one for you will depend on your circumstances.

One temptation is to have assets acquired in the name of another person, for example your spouse or other relative. Whilst any person can be a trustee of a trust and hold assets on behalf of beneficiaries, it is important to document the trust. After all the word 'trust' carries several meanings and if your 'trust' in someone is undocumented and broken by them, it can be very difficult to establish that the asset was held on trust.

Get the right structures for you

There are a number of different structures which have different advantages and disadvantages. The structure can have fixed entitlements to income and capital such as a company or unit trust, or have flexibility such as in a discretionary trust. There are also hybrid trusts which have partly fixed and partly flexible attributes.

Ultimately your advisor should be able to explain to you why a particular structure is a good fit for you, as well as explaining the disadvantages, because after all, it is meant to be for the benefit of you and your family.

J R Paul Hunt is Managing Director of Moisson Lawyers, based in Sydney, and has expertise in start-up and high growth companies, both listed and private. Paul is currently an Advisory Board member for a number of technology and media companies, Chairman of Invideco Pty Ltd, and a member of Director Institute.