Insolvency Aspects of Asset Protection

Business Structuring should include legitimate tax reduction strategies.

But it shouldn't only be about that.

It should also focus on Asset Protection, and should preferably be undertaken before times get tough (ie prior to insolvency). This is because:

1. Assets of the business or its directors will not be protected at the very time such protection is needed the most (eg insolvency or liquidation); and

2. Options for Asset Protection to be undertaken during insolvency are more limited. For example, insolvency limits the manner in which assets can be transferred, quite justifiably to protect creditors and ensure they are not deprived of assets (or the proceeds of sale of assets) that they would otherwise have access to in a liquidation.

Accordingly, it is important that directors are pro-active about asset protection; it should commence from the outset and be reviewed regularly, even whilst the business is solvent, including:

1. Start up;
2. Trading;
3. Growth;
4. Succession; and
5. Insolvency

Some of the consequences of a failed business are well known (eg director liability for insolvent trading), but others are less well known and are sometimes overlooked in asset protection strategies.

Some of those lesser consequences include:

1. **Holding company liability for insolvent trading.** Not only can a director (or de facto director or shadow director) be liable for insolvent trading, but so too can a holding company be liable for the insolvent trading of its subsidiary. That is, the holding company can be held liable for the debts of a failed subsidiary, in circumstances similar to insolvent trading. See s588V Corporations Act 2001 (Cth). Accordingly, if the "asset holding company" (ie the company who owns the assets) is also the holding company of the trading subsidiary, the level of protection achieved by separating the assets from the trading subsidiary is eroded in a liquidation of the subsidiary.

2. **Drawings and wages.** In order to avoid having to pay tax on wages, shareholders (with a director in the company) often take "drawings" which are effectively loans by the company to the shareholder which are classified/converted as dividends when profits are determined. Of course, if the company is insolvent then there is likely to be no profit, and therefore no dividends. That means the drawings cannot be classified as dividends, and the shareholder must repay the whole of the drawings as a loan, as opposed to having only paid a percentage of it in tax if it was taken as a wage.

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3. **Director's injecting funds into the company without obtaining security at the same time.** Proper security (over real property or under the Personal Property Securities Act) may elevate the director/shareholder to the front of the queue for repayments, and may also avoid unfair preference claims. Many directors/shareholders have "propped up" their businesses by borrowing monies against their home (for example) and then injecting them into the company. Without security, at best the director/shareholder is an unsecured creditor and if the company enters liquidation, the director/shareholder will:

    a. If there are other secured creditors, have less chance of recovering any of the director/shareholder's loan from the company, given that unsecured creditors rank after secured creditors, after liquidator's fees, after priority creditors (eg employees), and after 'circulating' secured creditors. Then (if anything is left) unsecured creditors participate for their fair share of the remainder of assets in proportion to their debts (known as pari passu).

    b. If the company had re-paid some of the debt to the director/shareholder when the company was insolvent, the director/shareholder may be at risk of a claim by the liquidator to claw back those re-payments as an unfair preference.

Good lawyers can separate assets from some risk. Great lawyers can separate assets from risk and work together with a client's accountant to determine a strategy which accounts for where on the scale of protection -v- tax minimization a client's current needs are and future needs dictate.

Only in that way, will a client be able to make informed decisions, armed with the ability to adapt as needs be.

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