How Business Owners Can Legally Protect Their Business and Personal Assets

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Introduction

1. **For every business owner it is critical to look at ways they can protect both their business as well as their personal assets by setting up the right business structure and procedures within that structure.**

But there are practical things business owners can do to minimise their risk?

Before we commence talking about what we mean by asset protection and working out what we want to achieve by putting asset protection structures into place, we need to understand that there is risk in running a business as there is in life and that sometimes you cannot help bad luck

There are however practical ways to limit liability from the above risks by taking steps to minimise the risk of being sued or attacked.

For example:

- **Implementing cash flow systems**
- **Safe workplace systems**
- **Undertaking continuing professional education if you are a service provider;**
- **Implementing proper manufacturing processes if you are a manufacturer of goods;**
- **Additionally all business should obtain adequate insurance cover such as WorkCover, Public Liability, Professional Indemnity Insurance and so on;**
- **Directors and officers liability insurance.**

2. So what is asset protection?

- **Protection from what? It is important to remember that businesses can be subject to attacks or risk from any number of sources, both externally and internally.**
- In terms of external attacks, when business owners consider risks from which they might need protection most will respond by listing off attacks by:

- **Creditors;**
- **Clients or customers for breach of contract or negligence;**
- **Attack by clients or customers for negligence;**
- **Public risk; and**
- **Product liability.**

Most do not consider the following equally important often internal risks:

- **Attack by employees (ie industrial action);**
- **Fraud (including employee fraud);**
- **Other business partner’s actions;**
- **Failure or marriages/relationships; and**
- **Death or critical illness or incapacity of an individual business owner.**

3. What do we really mean by asset protection? What do we hope to achieve by implementing asset protection structures and procedures?

What you should aim to do is separate or quarantine assets be they business or personal, especially personal, from risk:

- **We want to be able to quarantine business owners from business risk (for example by separating the business structure from the business owner whom I call the at-risk individual);**

- **We want to be able to quarantine business assets from personal assets (for example, making sure one's private or family wealth is protected from the failure of the business and the sale of any business assets);**

- **We want to be able to quarantine business assets from business risk (for example, by having one entity own the business assets and another entity as the trading entity);**

- **We want to be able to quarantine the risk of one business from the risk of another business (for example, by making sure that different businesses are run by separate and different entities);**

- **If we can, we want to be able to reduce assets (or equity in assets) held by at-risk individuals (eg by transferring them to a non-at-risk spouse or other entity (eg trust or superannuation);**

- **We want to be able to minimise the impact of other risks such as marriage breakdown, fraud, workplace accidents, death or incapacity by taking out insurances or having secure documentation in place such as Binding Financial Agreements, Buy Sell Option Deeds which I will touch on later.**

4. Business structures

When most people consider their asset protection position they look at this in terms of their business structure and not much more beyond this.

Most people would be aware that there are several business structures generally used to operate businesses. The most commonly used structures for businesses are:

- **Sole proprietorships**
- **Partnerships**
- **Companies**
- **Trusts (unit trusts or discretionary trusts) often with a company or corporate trustee**
- **Other structures:**
  - **Joint Venture**
  - **Associations**

- **Superannuation**

Fairly recent ABS surveys indicate that legal organisations used in Australia are broken down in the following proportions:

Companies – 30%

Sole proprietors – 30%

Partnerships – 20%

Trusts – 20%

There's a huge number of businesses in Australia, well over 90% of which would be classified as small business. Before the GFC there was consistent growth across most of the structure types, except for partnerships which have experienced decline each year.

Interestingly but perhaps understandably entry rates are highest for sole proprietors and trusts followed by companies and Partnerships. On the other hand, exit rates are highest for sole proprietors.

Also interestingly survival rates have been consistently higher for Trusts and Companies, while they have been lower for Sole Proprietors and Partnerships.

To determine the best structure for your client's business you should look at:-

- The purpose of the business, its likely duration and the types of assets the business will acquire;
- Taxation consequences;
- Organisational and governance issues (eg who does what, who gets the profit, who has the liability);
- Liability issues which we're focussing on in this seminar;

- Establishment and maintenance costs;
- Funding issues that is how will initial capital be provided and how finance can be raised moving forward;
- Ability to admit new investors or business owners (to allow for future growth);
- Succession issues (exit strategies for owners, stability of structure in the event of disability of death of owner – eg might dissolve a partnership);
- Simplicity of the structure (it is important for the business owners to be able to understand and manage the business properly, as it is for their accountants, financiers and investors and so on).

5. **Sole Trader**

The advantages and disadvantages of running a business as a sole trader

A sole proprietorship is a structure whereby the individual carries on the business in their own name.

It is the simplest and cheapest structuring option. This option is most often used by veyy small businesses that don't have employees (eg cleaners, or contractors etc).

There are:

- low establishment costs (limited to a business name (if any) and obtaining an ABN (if necessary) and any licences etc)
- low ongoing administration costs, with simple accounting

Other features are that:

- The **individual owns the assets of the business**, and makes contracts with customers directly.
- This structure has a limited life ie if the sole trader dies or becomes incapacitated, the business may come to an end.
- The sole trader will have limited access to finance if the business grows since he or she will not be able to raise finance from the public and is limited to everyday sources such as finance companies, mortgages of property etc.

This option is however the riskiest way to carry on business, since all of the individual's assets (regardless of whether or not they are personal or business assets) will be exposed to any claims made against the business. Similarly the business assets are also exposed to the risk of the individual's personal debts.

However, even if you are a sole trader and determined to stay that way, or you are a professional adviser of one, it is possible to adopt some asset protection by:

- **Obtaining insurances sufficient to cover them for the types of claims that might arise eg public liability, professional indemnity insurances etc;**
- **Undertaking other asset protection structuring eg by having a non-at risk spouse, or other entity (such as trusts or superannuation) hold all substantial assets (although this may not be good succession planning or asset protection from a Family Law perspective).**

6. Partnerships

The advantages and disadvantages of running a business as a partnership

A partnership is where two or more individuals or other legal entities carry on business together with a view to profit.

Partnerships are again relatively simple structures, with low establishment and administration costs. They can be informal partnerships (eg between a husband and a wife in business) which are then governed by the provisions of the *Partnership Act* or can be formalised by a documented Partnership Agreement (which may override certain provisions in the partnership legislation).

The partners will have full control of the business but generally must make decisions jointly.

The partnership is not a separate legal entity.

Except in the case of a limited partnership partners face unlimited personal liability.

Partners like individuals in the sole trader set up are personally liable for all liabilities and claims against the business and accordingly all assets by each partner personally (whether or not those assets are used by the business) are exposed to the business risks.

In fact, the potential liability of a partner is even greater than the liability of a sole trader, since partners are jointly and severally liable for the debts of business, actions of other partners (except limited liability partnerships) and claims made against the business.

However, even if you are in a partnership and not motivated to change it is possible to adopt some asset protection by:

- Obtaining insurances sufficient to cover each partner for the types of claims that might arise;

- Each partner undertaking other asset protection structuring eg by having a non-at risk spouse, or other entity (such as trusts or superannuation) hold all substantial assets.

7. Companies

The advantages and disadvantages of running a business as a company

Companies are clearly **the most commonly used business structure.**

This means that the company owns the assets.

A company structure provides limited liability to its shareholders (provided they do not provide personal guarantees for finance or as part of supply contracts) however if the shareholder becomes bankrupt or insolvent the shares held by it will fall into the hands of the trustee in bankruptcy or administrator, liquidator or receiver.

Companies are generally governed by their Constitutions or the replaceable rules and Corporations Law (with some exclusions) and are subject to regulation by ASIC, with annual reporting (and possibly annual audit) requirements etc. Incorporation and ongoing administration costs can be expensive.

Directors have the day to day control but have a duty to act in interests of the shareholders. Any majority shareholder has ultimate control of company (because of the shareholders' right to remove and replace directors).

Directors have onerous duties and responsibilities and can be personally liable for debts incurred by their companies:

- If they trade while insolvent.
- If they have provided personal guarantees to financiers or suppliers; and
- Under the director penalty regime whereby a director can be personally liable for the full amount of the tax liabilities of the company.

However, despite the exposure of directors and shareholders to claims it is possible to adopt some **asset protection by:**

- **Obtaining insurances sufficient to cover directors and office holders for the types of claims that might arise;**

- **Each director undertaking other asset protection structuring eg by having a non-at risk spouse, or other entity (such as trusts or superannuation) hold all substantial assets;**

- **Ensuring that the shareholders are non-at risk individuals or entities (even if controlled by the directors), so that the shares do not fall into the hands of trustees in bankruptcy.**

- **Entering into Shareholders Agreements (which I call the business pre-nup) (to document how the company is to be managed, how the company is to be valued on entry or exit of business owner, how the rights of minority shareholders are to be protected and to ensure proper dispute resolution procedures are documented);**

- **Entering into Buy Sell Option Deeds to document what is to happen in the event of death or disability of a business owner or controller.**

8. The advantages and disadvantages of family trusts

There are many types of trusts known in the law but today we're going to talk about the most common form of express trust known as the family or **discretionary trust**.

Discretionary trusts are generally used as a vehicle for protecting private assets so we will focus on these rather than unit or hybrid trusts.

Discretionary trusts are called known by this name because the trustee has complete discretion on how to distribute income and capital of the trust to various beneficiaries set out in the trust deed, as amended from time to time.

They are usually used for running a family business where by the assets of the business are held by the trust, the trust operates the business and the income earned by the business is distributed between the family member beneficiaries.

Discretionary beneficiaries generally have no legal entitlement to the assets or income of the trust.

Trusts are governed by the terms of their trust deeds, the common law, equity and the *Trustee Act*.

They are the Rolls Royce of business structures and therefore the most expensive to run.

The trust itself is not a legal entity, rather it is the trustee that has control and holds the property for the benefit of the beneficiaries.

It is the trustee and not the trust which is ultimately attacked or sued, however usually the trustee will have a right to an indemnity from the trust assets or from the beneficiaries of the trust if they have consented to the breach of trust.

Trusts are one of the more complex structures used in business structuring. They are often not properly understood by clients, financiers, suppliers or even accountants.

There have been many threats over the years to erode the power of trusts as an asset protection mechanism but there are still some processes that you can put into place to limit your exposure, including:

- **Establishing corporate trustees of any trust (to add another layer of protection for anyone suing the business) although this is not the complete answer because directors of a corporate trustee can still be held liable for the debts of the trust if the debts can't be paid out of the assets of the trust.**

- **Ensuring that the trustees have indemnity from the trust assets (specified in the trust deed) to protect trustees.**

- **Stucturing the trust carefully for example if the trust is being used to hold the assets of an at-risk individual, care must be taken to ensure that individual does not have ultimate control of the trust (ie ensure that the person is not the sole trustee, or sole appointor etc).**

- **Obtaining insurances sufficient to cover the trustee for the types of claims that might arise.**

- **The trustee (or in the case of a corporate trustee each director of that company) undertaking other asset protection structuring eg by having a non-at risk spouse, or other entity hold all substantial assets.**

9. How do business people protect their personal assets from their business partners?

When clients come to me seeking advice about structuring their existing new business, one of the last things they will want to focus on or spend money on, is documenting the internal arrangements for the business.

Like marriages, business owners rarely think or worry too much at commencement about what can happen to business or personal assets in the event of an involuntary parting of the ways.

The types of documents that new businesses should consider preparing at the outset are:

- **Shareholders, Unitholders and Partnership Agreements (sometimes called Stakeholders Agreements)** to document how the business will be managed (ie how decisions are to be made, how the business is to be funded, and what is to happen if a business owner dies, becomes incapacitated or decides to voluntarily exist the business). Company Constitutions or Trust Deeds are not sufficient to deal with these matters, or contain clauses in direct contradiction to the clients' wishes in these matters.
- **Buy-Sell Option Deeds** to cover involuntary exits of a business owner through death or disability.
- **Executive Agreements** setting out the terms of which business owners are to be employed in the business.

The benefit of having these types of agreements in place from a risk protection point of view is:

- clarity on the rights as between business owners concerning requirements to contribute to the liabilities of the business;
- clarity on the rights of the owners on winding up;
- having a fence at the top of the cliff (by way of insurance funded buy-sell agreements etc) can avoid the need for the ambulance at the bottom of the cliff ie business failure can result not merely from external attack but can arise simply as a result of a key business owner dying or becoming incapacitated.

10. Other issues business owners should be aware of in terms of protecting their assets

As I said at the outset, sometimes you can't help bad luck and in the hurly burly of working in a business and living a life things can get overlooked.

Time bombs may be lurking in your business despite what you may believe to be a pretty good asset protection structure.

- Loan accounts and unpaid present entitlements in a trust

  For example, internal **loan accounts** and **unpaid present entitlements in a trust** whereby you are owed money by your trust for whatever reason and the debts just sit there.

The problem with loan accounts and unpaid present entitlements is that they can undo much of the risk protection implemented by business owners and can expose the entity (and indirectly passive investors/stakeholders) to liability if the loans are called upon by an administrator or receiver for example if a director of a company takes steps to ensure that there are no assets in his or her personal name but has loan accounts in their name in associated trust entities or in the company directly, those loan accounts can be called upon by a trustee in bankruptcy if the director declares bankruptcy.

- Inter-entity loans

  Inter-entity loans can cause similar problems, for example, if you are operating 2 entities as a means of separating business assets from the business risk but the business operating entity lends the asset holding entity funds to purchase additional assets, then if the business operating entity is attacked and eventually wound up, the liquidator can call up the loan made to the asset holding entity. The asset holding entity will then have to either borrow money to repay the loan or sell the assets it was protecting from the trading risk to pay out the loan.

- **Another form of time bomb lurking in every corner of corporate Australia is the guarantee.**

Business lenders will usually seek security for any loans made to businesses (so that they have enforceable rights over the property secured and priority over other unsecured creditors for repayment).

Security can be in many forms including a:

- Registered charge (usually fixed and floating) over company assets.
- Registered mortgage over real property;
- Registered Bill of Sale over chattels; and

But critically by way of a bank guarantee.

The bank guarantee requires personal guarantees to be given by partners, directors of a company (or corporate trustee) or by trustees of a trust and in some cases by unitholders in unit trusts. These are usually part of the "standard conditions" of finance approval and as such are often overlooked by business controllers as something innocuous, however the giving of this additional form of security can undo much of the risk reduction strategies undertaken as the initial business structuring and risk minimisation structuring stage.

Then there are other guarantees which can be required by landlords or other third party creditors from corporate debtors. Business owners often forget to discharge these guarantees when they exit a business. Beware!

Conclusion

Business structuring with a view to protecting assets is a complex area of law which requires consideration of the business owner's present requirements and likely future requirements.

The issue of asset protection should not be considered in isolation but should be balanced with other requirements such as ease of operation, taxation issues, funding issues and succession issues. Ultimately you may be required to make a decision about which of those factors are more important.

It is an area in which business owners should consider joint consultation with their business, family and succession lawyer and experts in other areas such as accountants, superannuation experts, and even insolvency practitioners.