Asset Protection – Bankruptcy

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Talking about ***real people's*** *experiences*

Asset Protection – Bankruptcy

Agenda

- Introduction and Overview
- **Part One:** Scope of Asset Protection
- **Part Two:** Protecting Individuals
- **Part Three:** Protecting the family home, super, life assurance and monies for damages and compensation
- **Part Four:** Taking a holistic approach to Asset Protection
- Summary and close

Defining Asset Protection

*To protect **assets** and*
the ability to build assets

Guiding Principles

- ***Importance of timing –*** *Asset Protection strategy must change with your circumstances to maximise its benefit*
- ***Taking a holistic approach –*** *Asset Protection should look at the lifestyle and family of the business owner to protect their interests*
- ***From little things big things grow***
- ***Keep it simple*** *– A simple asset protection strategy can be more effective than a complicated asset protection strategy*
- ***An asset protection plan is a journey, not a destination***
- ***The suit must be cut to fit the person***
- ***Manage for success and the fallback position*** *if financial adversity should occur*

PART ONE

Scope of Asset Protection

Scope of Asset Protection

Assets not protected by the legislation

Assets protected by legislation

Assets accumulated by other entities

Assets that can be accumulated in bankruptcy

The Changing Bankruptcy Environment

Bankruptcy is very different to what it was in the 1970s

Terminal **Resuscitation**

Benefits of Asset Protection

- Reduce unnecessary exposure
- Improve outcomes in the future, a blip and not a crash
- Limit the severity of the fallback position if financial adversity should occur, improve health outcomes and less reliance on government for financial support
- Shorten the recovery time

How to Approach Asset Protection

Asset Protection should be...

- Addressed long before it's needed
- Understood, lived and part and parcel of how the business is run or the company is operated
- Continually updated as and when circumstances change

Assets **not** protected by legislation

- Examples of assets not protected by the legislation include:
  - *Plant and equipment, the family home, caravan or boat*
- The business opportunity is an asset that's not protected
- Protect assets by managing business to avoid financial adversity
- Common observations – available funding is not coordinated with the operation of the business. The sweet spot of the business is not known.
  - Management's ability is generally lacking causing the business to stumble into financial problems. Management have no idea on how to track the business back to safe ground
  - It is common for business to overtrade
- In balance, track to opportunities and navigate around traps. Not overtrading and navigating around the traps is asset protection. E.g.: directors guarantee directors penalty notices

Need to know where the rocks are to enable the person to jump from rock to rock to get safely across the stream

Assets not protected by legislation

- Common comment we receive
  - "We have cashflow problems, but we think we will be okay. We are spending more on marketing to get more business and improve our cashflow"

- When we seek to turn a business around, we will commonly:
  - Decrease the size of the business to reduce working capital funding requirements
  - Realise surplus assets and inject the funds into the business
  - Source and inject funds from an external source e.g: Mum and dad
  - Compromise with creditors to make it achievable to pay money to creditors

From little things, big things grow...

Assets not protected by legislation

- Negotiate to reduce the amount to be paid to creditors and coordinate for creditor payments to be paid over time from trading surplus (generated free cash flow) and not from working capital of the business.

  - Overtrading is to trade the business at a level beyond the funding ability of the business. Increasing sales makes the problem worse. Repaying creditors from the working capital and not profits also makes the problem worse
  - The lack of funding understanding also extends to funds being depleted by money being spent on the wrong things e.g.: excessive lifestyle
  - Poor culture can inhibit a business
  - A good businessperson will navigate a business safely past obstacles to seize the opportunity and generate profits for distribution and by operating the business within its sweet spot

Assets not protected by legislation

Overtrading can put other assets at risk

Real life example:

A couple owned a house jointly and the business was operated solely by the husband.

They wanted to expand the business and sought to borrow from the bank.

Bank required additional security and the spouse provided her half interest in the house.

The business failed and house was lost.

Assets protected by the legislation

- Debtors of a business are not caught by the bankrupt estate
- Monies accumulated in a regulated superannuation fund over time are protected without limit
- Equity in a vehicle is up to $8,550. This amount is regularly adjusted for CPI.
- If car is sold, this amount is also protected.
- Tools of trade up to $3,950
- Household furniture and effects

Assets accumulated by other entities

It is common for businesspeople to be advised to operate their business with a company to help protect the businessperson if financial adversity should occur. However, companies are more to **protect the director from an unforeseen event rather than financial problems**.

Two observations:

1. Company is successful and the person becomes bankrupt due to extra-ordinary event that has nothing to do with the company. Shares in the company are owned by the bankrupt causing assets of the company to fall into the bankrupt estate.

OR

2. Company is unsuccessful, and the person becomes bankrupt due Director Penalty Notice, personal guarantees, insolvent trading claim, security provided to lenders.

Assets accumulated by other entities

- For other entities to work they must be managed to avoid director and shareholder financial exposure.
- It is not uncommon to see a young couple buying a house jointly and operating a business with both acting as directors and each owning a share in the company. Risk management in this example does not exist.

Issues for them to consider:

- House title (joint tenant or tenants in common)
- Only one as director
- Company shareholding – who owned by?
- Limit the need for more than half the house to be needed for operating the business
- Bank borrowing
- Wills
- Life assurance

Assets that can be accumulated in bankruptcy

- Savings from wages in bank account, accruing interest
- Monies accumulated in a regulated superannuation fund
  - Employer contributions and contributions by the individual when enabled by the super legislation
- Able to propose a Part IV scheme to access business opportunity
- Able to trade a cash business during bankruptcy within legislation requirements
  - No limit on amount of income that can be earned
  - Own name
  - Credit limit of $6,624, adjusted for CPI

Bankruptcy vs. Debt Agreement

Context – January 2023 Sample

Bankruptcy	
Business-Related	34.3%
Non-Business	65.7%
Debt Agreement	
Business-Related	4.1%
Non-Business	95.9%

Debt Agreements – Overview

- Major creditors expect significant debt repayment
- Repayment arrangements over three years unless house involved, then five years
- Debt agreements should not inhibit the persons ability to live satisfactorily
- Debt agreements vs. Part IV Composition
- Part IV recapitalisation of bankruptcy and composition tailor mode to address the specific business opportunity and give creditor a better outcome

Bankruptcy vs. Debt Agreement

- Bankruptcy – recapitalisation for quicker financial recovery
- Debt agreements oversold – work best with smaller debt and when used to address cash flow issues
- Debt agreements over five years can be used as another option to save the family home
- For a Debt Agreement to work, the repayment arrangements must be affordable

PART TWO

Protecting Individuals

Using a company to protect the businessperson

- Only the businessperson should be director – not the spouse as well
  - Spouses' assets should not be exposed to the business
- The businessperson must see the company as a separate entity and not as themself
  - Asset protection benefit of the company is mitigated if the director owes the company money
- Intermingling of finances of the various entities undermines the asset protection strategy, loan accounts, antecedent transactions etc.

Security over company's assets to protect the Director

- Director should have registered security over company's assets to protect directors' personal exposure for the company.
  - Personal guarantees provided for the company
  - Tax debt exposure
  - Loans to the company
- This may not be possible if the company does not have the assets or needs borrowings from bank to fund the business
- Suggestion, better protection for director if business is kept smaller and can secure its assets to protect the director
- Directors' security to be registered. Personal Property Securities Register (PPSR)

Director's personal guarantee

- A blank cheque – **very dangerous**
- Keep a record of all personal guarantees given
- Apply a dollar limit to each guarantee (to know total financial exposure)
- Apply an expiry date to each guarantee (to limit each guarantee to a time frame)
- Personal guarantees create a direct path for the company's debt from the company to the director

Director’s liability for the company’s tax debt

- Directors can become personally liable for the following company taxes and obligations
  - Goods and Services Tax (GST)
  - Pay as You Go (PAYG)
  - Superannuation Guarantee Change (SGC)
  - Luxury Car Tax (LCT)
  - Wine Equalisation Tax (WET)
- If the unpaid PAYG, GST, LCT or WET was reported to the ATO within three months of the due date, then when the director receives a DPN, personal liability can be avoided by putting the company into Liquidation, Administration or appointing a Small Business Restructuring practitioner within 21 days of the DPN being served.

Director’s liability for the company’s tax debt

- If the unpaid SGC amount was reported by the due date (note: not within 3 months like GST and PAYG) then when the director receives a DPN, personal liability can be avoided by putting the company into Liquidation, Administration or appointing a Small Business Restructuring Practitioner.
- If the unpaid monies were not reported to the ATO within the abovementioned time frames, then when the director receives the DPN, liability cannot be avoided, **the director is automatically liable for the debt.**
- A director only has 21 days from when the DPN was issued to have the company placed into Liquidation, Administration or Small Business Restructuring Practitioner Appointed.
- **Talking to a practitioner is not enough, the appointment must have been made.**

Protecting Individuals

- Directors cannot be made personally liable for a company's income tax debt
- For a director to avoid the company's tax and super liabilities, they must have not only reported the liabilities within the required timelines but must not have traded the company while insolvent.
- If the company traded while insolvent, the director can be exposed for the liabilities the company incurred whilst insolvent. **Appointing a liquidator to avoid DPN liability may be a false hope.**

PART THREE

Protecting the family home, super, life assurance and monies for damages and compensation

Issues to consider for the family home

Things to think about…

- Only one life partner exposed to the business.
- Can get messy, issues to deal with like presumption of advancement and presumption of resulting trust.
- May be considered to be more straight forward for the house to be owned jointly – particularly when it is subject to a mortgage and the property may be needed as security by the bank for business borrowings.
- For properties jointly owned, need to look at title. Tenants in common / joint tenants.
- Asset protection is executed by separating assets between the business and non-business life partner.
- Relevant to consider how the family home is owned, joint tenants or tenants in common. The asset protection strategy will be undermined if the property is held as joint tenants and the non-business partner dies. The home will be solely owned by the business partner. Asset protection is then out the window.
- For asset protection consider family home to be held as tenants in common and for the non-business partner's Will to leave nothing to the business partner.

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Issues to consider for superannuation

- Funds accumulated over time in a regulated superannuation fund are protected and not caught by bankruptcy lump sum.
- Lump sum funds properly received from the superannuation fund once bankrupt are protected as are assets that are purchased with these monies.
- Superannuation funds also have an asset protection role to play for businesspersons near retirement age.
- If a bankrupt person is able to access a lump sum from the superannuation fund these monies can be used to protect/buy the family home or underwrite the retirement that the businessperson had always planned to achieve.
- Income from a superannuation fund is protected but subject to the income contribution provisions during bankruptcy. These monies cannot be used to buy assets which are not protected by the bankruptcy legislation. Must use superannuation lump sum monies for asset purchases to be protected.

Issues to consider for superannuation

- Income from a superannuation fund is protected but subject to the income contribution provisions during bankruptcy

No. of Dependents	After Tax Threshold Amount
0	$66,639.30
1	$78,634.37
2	$84,631.91
3	$87,963.88
4	$89,296.66
5 or more	$90,629.45

Issues to consider for superannuation

- For each after tax dollar earned in excess of the threshold amount, 50c is required to be paid to the bankrupt estate during bankruptcy.
- Assets cannot be purchased during bankruptcy from income, but surplus funds can be saved in a bank account.
- If a bankrupt person's spouse dies and the bankrupt person properly receives funds directly from the deceased's superannuation fund, then those funds are protected for the bankrupt person, Morris v Morris (Bankrupt) (2016) FCA. *Note: must be* bankrupt when the funds are received for the funds to be protected.
- Lump sum superannuation monies received prior to bankruptcy are **not** protected.

Examples of superannuation asset protection

- Ben was at retirement age and needed to file for bankruptcy due to his business becoming insolvent. Over the past 40 years, Ben had accumulated $1,300,000 in super. Once bankrupt, Ben used part of those funds to save the family home. He purchased his half interest in the family home from his bankrupt estate.

- Tom was at retirement age and needed to file for bankruptcy. Tom had $370,000 in super. Prior to becoming bankrupt, Tom used part of lump sum super monies to buy a 4WD and caravan to enable him to spend his retirement travelling around Australia.

- James was at retirement age but had $120,000 credit card debt. James rented his primary residence and had $150,000 in super. James filed for bankruptcy to clear the credit card debt and then received $150,000 from his super fund as protected money to provide financial security for his retirement.

Life Assurance Asset Protection

- When a person becomes bankrupt, life assurance or an endowment insurance policy will not vest in the bankrupt estate.
- This protection applies for the bankrupt person and his or her spouse or de facto.
- Proceeds from Life or Endowment Insurance received on or after the date of bankruptcy are protected and are not available to the bankrupt estate. Assets purchased with these monies are also protected.
- The Bankruptcy Act does not provide protection for policies for accident or ill health cover which also provides death benefits.
- Monies from a life assurance death payout received prior to bankruptcy is not protected and is available to the bankruptcy.
- The timing for when a person becomes bankrupt can be very relevant.

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Life Assurance Asset Protection

- Life Assurance may assist a person if bankruptcy and death should occur
- Bankruptcy provides protection for Life or Endowment Insurance Policies in respect of a person's life
- When a person becomes bankrupt, the Life or Endowment Insurance Policy will remain available to the bankrupt person. The protection applies for the bankrupt person and his or her spouse or defacto.
- Proceeds from Life or Endowment Insurance received on or after the date of bankruptcy are not available to the bankrupt estate. Assets purchased with these monies are also protected.
- *It is important to note that while Life or Endowment Insurance Policies in respect of a person's life are protected – death cover which is incorporated into an accident or ill health policy is not protected, the death payout is available to the bankrupt estate.*

Damages and compensation

- Bankruptcy provides protection for any right of the bankrupt to recover damages or compensation and monies that have been received for damages and compensation.
- This protection is for:
  - Personal injury or wrong done to the bankrupt, the spouse or de facto partner of the bankrupt, or a member of the family of the bankrupt.
  - The death of the spouse or de facto partner of the bankrupt or a member of the family of the bankrupt.
  - Monies received by the bankrupt (before or after they became bankrupt) in respect of such an injury or wrong or death of such a person.
- Protection travels to assets purchased with the compensation monies. It is important for financial records to be kept to evidence the flow of funds.
- The protection only exists while the person is alive. When the person dies, the protection is extinguished, and the monies are distributed in accordance with the will of the deceased.

PART FOUR

A holistic approach to Asset Protection

Asset Protection needs a holistic approach

Property

- Title, Joint Tenants **<u>or</u>** Tenants in Common
- Will
- Encumbrance on property for the business
- Title held by non-business life partner – what was the intention re: who owns the property and what evidence exists to support this position
- Title held jointly – Doctrine of Exoneration

Asset Protection needs a holistic approach

Trading Company:

- For DPN protection – lodgments required within required timelines
- On time lodgments will potentially be to no avail if company is being traded while insolvent to make the director personally liable
- If company is insolvent, director's personal guarantees may force the director into bankruptcy
- If director owes the company money – may force the director into bankruptcy

The speed of the Director's financial recovery

- The quicker the financial recovery, the quicker asset accumulation can resume
- Tracking through the insolvency as quickly as possible is relevant.
- Example: if company goes into liquidation, there is the potential that the liquidator will lodge an insolvent trading claim. Also, it is common for Director to not know who personal guarantees were given to.
- Director can put the company into liquidation and file for bankruptcy immediately after that.
- The bankruptcy will capture any future insolvent trading claim by the liquidator and personal guarantees that may surface in the future.
- Prior to bankruptcy debtors in bankrupt person's name are available to the bankrupt person.
- During bankruptcy the director can accumulate savings.
- In three years time, the director will be out of bankruptcy.
- If business opportunity arises, can propose a Part IV Scheme for creditors to consider.

Most common causes of business failure

- ***Overtrading***
- ***Excessive encumbrance***
- ***Lack of capital***
- ***Lifestyle before business – excessive drawings***
- ***Lack of business skills***

Example approaches to Asset Protection Strategy

- Chap commences trading as a sole trader. House jointly owned as Tenants in Common. House valued at $750,000 and mortgage of $350,000. Wife works as a teacher and told that she can borrow up to $400,000. Husband's equity in the property is $200,000. If the chap becomes insolvent, wife will need $550,000 mortgage to be able to keep the home. Wife's parents have said they will lend her $150,000 if needed. The asset protection strategy is to build up savings/equity in the house/share portfolio so as wife can save the house if business should fail.

Example approaches to Asset Protection Strategy

- Lady commences trading a company while husband works as an employed software engineer. They are protecting their home which is worth $1,600,000 and the mortgage is $800,000. They purchased the house as Joint Tenants 3 years ago. They do not want to lose the house. The husband is the main contributor to the mortgage payments. Husband has taken out a Life Assurance Policy for $1,500,000 to enable wife to pay out mortgage and address any financial liabilities of the company if he should die. Husband has commenced savings program to build up buffer of cash to help him protect the house if company should become insolvent. Wife has taken out Life Assurance Policy (owned by husband) for $800,000 to pay out the mortgage if she should die.

Example approaches to Asset Protection Strategy

- Couple wanting to purchase a house and start a business. They sought legal advice from their solicitor on 1) buying their house and 2) starting a business. Solicitor advised that she could not guarantee house would not be viewed as jointly owned due to them starting the business at the time the property was purchased. They purchased the property in one partner's name and reduced the size of their proposed business to reduce the risk if the business were to become insolvent. The business went on to trade profitably and they have purchased another property in the name of the partner who owns the first property. The business is going from strength-to-strength and they are now in the position where they feel comfortable that they have sufficient equity that their home would be safe if the business were to fail.

Examples of how Asset Protection Strategies have failed

The chain is only as strong as the weakest link

For example:

- Wife sole director of company. House jointly owned. Husband's will does not leave the wife his interest in the family home. However, the house is held as Joint Tenants rather than held as Tenants in Common. The title is automatically passed on to the wife upon his death causing no Asset Protection for the family home.

- Wife is a director of a company, the company experiences insolvency problems. The wife makes sure that ATO lodgments occur within required timeframes to protect herself from a Director Penalty Notice from the ATO. However, she has continued to trade the company while insolvent. She subsequently receives an insolvent trading claim from the liquidator and needs bankruptcy to resolve the debt.

Examples of how Asset Protection Strategies have failed

- Compensation monies received following the unexpected death of the spouse. The monies are used to meet living expenses and spent on consumables. Subsequently saves a deposit for a unit and takes out a mortgage to buy the unit. Subsequently becomes bankrupt and loses the unit to the bankrupt estate.

- Elderly woman's husband becomes sick, company is placed into liquidation and the husband subsequently dies. Both husband and wife were directors of the company. Wife identifies that she will lose her house as it was provided to the bank as security for business loans. She withdrew her superannuation monies to buy a retirement unit. Then realises that she is unable to pay the company's guaranteed debts and files for bankruptcy. The newly acquired retirement unit is lost to the bankruptcy.
  It would have been protected if superannuation funds were accessed after becoming bankrupt.

The importance of timing

- Plan asset protection before there is a need
- Identify the problem and required timing of actions.

  For example:

  - Need to be bankrupt before accessing / receiving lump sum from superannuation
  - Need to be bankrupt before receiving compensation payment
- Identify how extraction from insolvency can be expedited to speed up financial recovery.

  For example:

  - To consider not waiting for the liquidator to lodge an insolvent trading claim before filing for bankruptcy.
- Company director to consider not resigning till company placed into liquidation – otherwise not able to protect self from ATO Director Penalty Notice (DPN).

The Asset Protection Strategy should change over time

1. ***House jointly owned***
    - Start business solely in one partner's name via company
    - Put life insurance and wills in place
    - Seeking to pay off house to increase spouse's equity share
    - Start super contributions as main focus is to pay house off
2. ***House jointly owned with significant equity***
    - Investment property
    - Life assurance remains in place
    - Wills not changed
    - Spouse has sufficient equity in family home and investment property to buy out family home if financial adversity occurs
    - Increasing priority to super savings
3. ***Couple getting older with focus increasingly on growing super balance to provide asset protection for assets and retirement lifestyle***
    - Super balance equal to or greater than the value of the house
    - If not, the value of the house sufficient to buy appropriate accommodation for retirement

Summary and Close

Summary and Close

- **Asset Protection** is an essential component of business
- For small business, a **simple** asset protection plan can be more effective than a detailed plan
- When financial adversity occurs, it is too late to then create an asset protection plan
- **Opportunity** is an asset
- The closer **Asset Protection** can be aligned to **Resuscitation**, the better it is for Australian Businesses

Revisiting the Guiding Principles

- ***Importance of timing –*** *Asset Protection strategy must change with your circumstances to maximise its benefit*
- ***Taking a holistic approach –*** *Asset Protection should look at the lifestyle and family of the business owner to protect their interests*
- ***From little things big things grow***
- ***Keep it simple*** *– A simple asset protection strategy can be more effective than a complicated asset protection strategy*
- ***An asset protection plan is a journey, not a destination***
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