DOES YOUR BUSINESS STRUCTURE PROVIDE ASSET PROTECTION?

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Business risk structuring

In the current economic climate, a common objective of business owners is to ensure that their business operations are structured appropriately, so that their personal wealth is protected from business risk and their business assets are protected from the risks of litigation or unexpected adverse events.

Business risk structuring focuses on:

1. Quarantining business risk from business assets (eg. by having one entity trading and another entity holding assets);
2. Reducing assets, or equity held in assets, owned by individuals that are 'at risk' (eg. by encumbering/borrowing against them or transferring assets to a spouse that is not 'at risk');
3. Minimising the effect of other risks (eg. fraud, workplace incidents) by taking out insurance or establishing other forms of documentation.

Protecting Trust Assets

Discretionary trusts, unit trusts and hybrid trusts are the most common forms of trusts used for private businesses. It is well established that one of the best ways to obtain asset protection is to have assets held by discretionary trusts and to separate those assets into different discretionary trusts, according to their nature. This is because a beneficiary of a discretionary trust ordinarily does not have an equitable interest in trust income or property which would not be exposed if a beneficiary became personally bankrupt.

In the case of *Australian Securities and Investments Commission In the Matter of Richstar Enterprises Pty Ltd v Carey (No .6)* [2006] FCA 814 (Richstar's case), the beneficiary effectively controlled the trustee and therefore had 'something akin to a proprietary interest'. There is some uncertainty in the current application of Richstar's case; however, in situations where an individual is a sole trustee, sole appointor/principal and beneficiary of a discretionary trust, it may be considered that the beneficiary effectively controls the trustee and therefore has a proprietary interest in the trust assets. This is why it is often recommended to have a company acting as trustee.

It is the trustee of a trust that is ultimately sued or attacked, however a trustee has the right to indemnify itself out of assets of the trust (provided that the trustee is not in breach of its fiduciary duties or has not acted fraudulently). The effect is that, if a creditor obtains a judgement against a trustee, then the creditor will stand in the shoes of the trustee and, under the indemnity allowed to the trustee, able to access the trust assets.

Protection of trust assets can be achieved by:

1. Establishing a corporate trustee with nominal assets (i.e. $2 share capital) to give a layer of protection if the business is sued;
2. The trustee, or directors of a corporate trustee, undertaking other asset protection structuring (i.e. having substantial assets such as their family home held by another entity or a spouse that is not 'at risk');
3. For discretionary trusts – structuring the trust carefully so that if the trust is holding assets of an 'at risk' individual, that individual does not have ultimate control (i.e. sole trustee and appointor/principal);
4. For unit trusts - ensuring that unitholders are not 'at risk' entities or individuals, so that the units do not fall into the hands of a trustee in bankruptcy;
5. For unit trusts - entering into a unitholders argreement which documents how assets are to be valued on entry/exit of a business owner and what will happen in the event of death or disability of a business owner).

Protecting company assets

Companies are the most common business structure. A company provides limited liability to its shareholders (provided that no personal guarantees have been given). Some people confuse limited liability with asset protection. Limited liability means that individuals are protected from the liabilities of the entity in which they have invested. Asset protection, rather than protecting individuals, protects assets from the misadventures of the asset owner.

This means that, if a shareholder becomes bankrupt, their shares in a company will fall into the hands of the trustee in bankruptcy. Directors also have quite onerous duties and can be held personally liable for debts incurred by a company in particular circumstances (eg. if a director gives personal guarantees or trades whilst insolvent).

Protection of company assets can be achieved by:

1. Company directors undertaking asset protection structuring (eg. by having a discretionary trust or a spouse that is not 'at risk' holding substantial assets such as the family home);

2. Ensuring that the shareholders are not 'at risk' entities (companies that are wholly owned by one or more discretionary trusts provide best asset protection);

3. Obtaining insurance sufficient to cover directors for the sorts of claims that may arise;

4. Entering into a shareholders agreement which documents how the company will be valued on the entry/exit of a business owner and what will happen on death or disability of a business owner.

Practical example

Jenny and Thomas Bakewell operate a drilling business through a company, of which they are both directors and shareholders. Jenny has given personal guarantees to lenders. They also have a family/discretionary trust which owns drilling equipment of significant value. Jenny is the sole trustee, sole principal and beneficiary of the trust.

They own other personal assets such as their family home in their joint names.

Potential issues:

1. Shares are individually held so if either Jenny or Tom becomes personally bankrupt, their shares will fall into the hands of the trustee in bankruptcy;

2. As Jenny has provided personal guarantees, a lender can go after her personal assets (such as her family home) if a business loan cannot be repaid;

3. If a creditor obtains a judgement against Jenny as trustee, then it will be able to access the trust assets;

4. It may be considered that Jenny effectively controls the trustee of the discretionary trust and therefore has a proprietary interest in the trust assets, which exposes the trust assets to risk if Jenny becomes personally bankrupt.

If you are establishing a business, it is important to consider at the outset whether the proposed structure is appropriate for your circumstances. If your current business structure is not appropriate, it is often possible to restructure your business, with minimal taxation consequences.