



Personal Financial Planning and Business Preservation Planning – Reducing the Personal Impact of a Business Collapse

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Depending on the nature of a business enterprise different personal implications may apply to a Business Principal in the event of collapse of a business. What follows is an overview of the implications that could occur for a Business Principal in the event of a collapse.

Understanding the Business Enterprise

The collapse of a business has an obvious impact on the wealth of Business Principals. If a business is operated by an individual or by partners, the impact is direct and immediate.

Not only does failure of the business wipe out the value of equity the individual has in the business, it also leaves the Business Principals potentially directly exposed to personal claims for all liabilities of the business.

This could result in judgements personally awarded against the Business Principal. The ultimate effect is that unless the Business Principal has sufficient resources to pay out all debts of the business, the Business Principal will be personally liable.

The situation for a partnership is even worse. Under partnership law, each partner is liable to all creditors for all debts of the partnership. This means that the wealthier partner ends up meeting a disproportionate share of the liabilities. While he will generally have a claim against his co-partners who have under-contributed, if they do not have sufficient means, as is usually the case, this legal right will not result in him actually obtaining money from them.

The impact of a corporate collapse, which is the more common situation, is more complicated. On the face of it, there exists far greater protection for the shareholders and directors against attack on their personal assets. However, there are many, many traps for the unwary which need to be understood.

This principle of protecting the shareholders and directors from any claims made against the corporate entity is still the cornerstone of corporate law. Inroads into breaching the principle of the shield of the 'corporate veil', have been made on several fronts through several different statutes and



the common law. In addition, quite apart from the issue of shareholders and directors hiding behind the corporate veil, there are many other issues which emerge from a corporate collapse.

A business prevention plan must take into account the implications that could arise from a business collapse and also in the timing of a business collapse.

Notwithstanding the corporate veil, getting this wrong can have a dramatic negative impact on the personal wealth of Business Principals.

That is to say at the best of times, the business landscape can change quickly and, unpredictably. In a recession, particularly a major one, the environment can change dramatically and in ways which are often impossible to properly plan for. For example, a business may rely on two or three major customers for 80 per cent of its revenue. Such customers may easily end up in trouble themselves and without warning effect your customers business.

This may then have a domino effect on other major customers. Within the space of weeks, a sound, profitable business maybe fighting for its life. Fifty per cent of its ongoing demand could evaporate and the business may be left with significant bills owned by customers which may never get paid.

Such a scenario may not be unrealistic. If a business receives more than 15 per cent of its regular revenue from one customer or a group of related customers, it faces an unacceptable risk, even in non-recessionary times.

Understanding the scenario that is likely to unfold if a business suffers a sharp, serious downturn or a cataclysmic event, such as liquidation of a major customer who owes the business substantial monies which are being relied on to pay pressing creditors, is crucial.

Prevention Planning must allow for the contingency of failure. Planning for that failure must start immediately. In the bushfire analogy, waiting for the flames is too late. Planning for the worst possible contingency (that is, liquidation of a business) must be undertaken whilst businesses have the time and the fortitude to deal with the issues.

By understanding the likely impact, pre-emptive steps can be taken to ameliorate the effects on the personal wealth of the shareholders and Business Principals. Understanding the likely scenario will allow the Business Principals to make the correct decision in relation to timing of the cessation of trading.

There is the right time to stay and fight a bushfire and there is a time to go.

Likewise, there is a right time to defend an ailing business and there is definitely a right time to walk away from it. By being pre-emptive and by getting the timing right, the impact on the personal wealth of the shareholders and directors will be greatly lessened.

In any corporate collapse, there is an unavoidable loss of wealth arising from the fact that the value of shares in the corporate entity will be reduced to zero. What can be



salvaged, to a degree, are the claims which may otherwise arise from the future shock of the collapse.

Furthermore if a Business Principal does not understand the nature of their own enterprise, and its implications of a contingency such as a financial collapse then in event of a contingency such as death the odds are that the Legal Personal representative will not understand the problems of the business and otherwise sound financial business may collapse through nothing more than lack of knowledge.

Financing the Business

For practical purposes, most private business entities obtain debt from two sources; either a loan from shareholders or loans from a bank. If shareholder loans are to be repaid by the corporate entity, this process must be planned carefully in advance. Obviously, this can only be carried out if there are sufficient liquid funds in the corporate entity to enable this to be done.

If repayment of shareholder loans may leave the business in an insolvent situation or they may be later held to be a preference payment or a related-party transaction, the repayment may ultimately be set aside by the court on behalf of the later-appointed liquidator. Not only may the monies have to be repaid, but in certain circumstances the directors could be personally liable for losses suffered by other creditors arising from that repayment.

Guarantees

Claims from a bank against directors, and possibly

shareholders, constitute one of the greatest risks of attack on the personal wealth of a Business Principal. This generally comes about through personal guarantees and linked securities. Unfortunately many businesses obtain credit and finance businesses on an ad hoc basis as the business need arises. In many situations directors provide guarantees without even realising that they have done so.

Furthermore in many situations a Business Principal may have provided a corporate guarantee to another entity without the Business Principal not fully even appreciating the fact that it has done at the time or it has been forgotten. A priority task is to review all guarantee documents. In many instances many Business Principals do not have a register of guarantees and do not keep the guarantees all in one file.

This task will involve unearthing documents which may be many years old. There is normally no time limit on a personal guarantee. They do not expire and they do not come to an end simply because there has been a change in shareholding or a change in directors. A common misconception is that when a person ceases to be a director or an active director, they are no longer liable under guarantees provided.

This is definitely not the case. There will, in most cases, be personal guarantees for all equipment leases and corporate hire purchase agreements. Application for credit to major suppliers will invariably be accompanied by the provision of personal guarantees. In many cases, the wording of the guarantee will be embodied in the credit



application form itself and the directors may not have even been aware that they were providing a guarantee by signing the application, unless they read it carefully.

Bank Documentation

In many instances Business Principals pay very little to Bank documentation. As such Bank documentation can be particularly troublesome. In many instances the initial loan will have probably been varied many times, securities would have changed and limits would have changed. In order to determine the liabilities of the guarantors, it is crucial that the entire set of documents be collated.

This usually only becomes an issue when a business collapses and the bank then seeks to obtain judgments against the guarantors. The bank will have their set of documents in the correct order and their lawyer will have no trouble in determining who is liable and for what.

When action is taken against the guarantees, Business Principals often do not have access to any documents as they are often incorporated with the documents retained by the liquidator. Although this can be overcome through the court process of discovery, at that stage it is far too late to have taken pre-emptive action. Business Principals should therefore carefully collate all Bank and finance documentation.

When all guarantee documents have been collated, the next step is to prepare a schedule and allocate a potential dollar amount to each guarantee which, in the worst-case scenario, may apply. When all fellow directors fully understand the

potential exposure they have to all personal guarantees, pre-emptive steps can then be taken to reduce the exposure.

Care must be taken to ensure that these steps do not result in repercussions from related-party transactions, preference claims and potential insolvent trading. The plan would involve working through each item of exposure and developing a strategy for dealing with it. Furthermore planning should involve considering all planned and contingent events. For example, if guarantees have been provided by people who are no longer involved with the business entity, this would involve writing to the suppliers and financiers and requesting their guarantees be terminated.

This needs to be documented in a legally effective manner because if claims do arise later, solicitors for the parties seeking to enforce guarantees will be looking for every possible loophole. If there is exposure to several major suppliers who have the benefit of guarantees, request them to either release the guarantees or to limit the guaranteed amount to a set dollar sum.

If the supplier is not prepared to do this (and in the current economic climate, they may well be disinclined to do so), then look around for other suppliers who are prepared to supply without being provided with unlimited guarantees. In that case, start paying down the debt of the supplier with the guarantees (but not in a way which may amount to a preference payment).

Guarantees from financiers need to be reviewed on a situation basis. It is highly unlikely



that Banks and financiers will consent to release of guarantees. Available surplus funds should therefore be directed toward repaying facilities, equipment leases and corporate hire-purchase facilities at a greater rate than the minimum monthly payments provided for in the documents.

Loans to Shareholders and directors

The most common way that shareholders and Business Principals take funds from their business is by way of loans. Businesses tend to use the business chequebook as if it were their own personal chequebook. From it they may pay for school fees, holidays, draw out cash and pay most of their household bills. The less financially literate directors do not even realise that they are taking the money out as a loan.

Many don't understand the distinction between themselves and the business. To them, they are the business and the business is them. The business earned the money and are simply taking what they believe is theirs. However, their accountant will record all such payments as loans to the relevant directors or shareholders and this will be recorded in the books of the business.

In larger businesses, the process is usually more formalised but the underlying principles are the same. The business pays bills on behalf of the directors and this gets recorded in their loan accounts. While business is going well, this does not present a problem, although there are significant income tax implications from Business

Principals borrowing money which is never really intended to be repaid.

There are sound practical reasons for this practice.

It may well be the case that the business produces taxable profit which is not reflected in the amount of cash which builds up. This will be due to claiming non-cash expenses such as depreciation, investment allowance, general timing differences between one year and the next and also the fact that there may be carry-forward losses from earlier years. This will produce the situation where the cash profit exceeds the taxable profit.

If the business Principal were to take out their drawings as wages this may not provide an immediately useful tax deduction in the hands of the business because it may not have a taxable profit, while it may have to pay payroll tax and it will definitely have to pay Work Cover and the nine per cent superannuation levy on that amount. In the hands of the director, if the drawings are taken out as wages, he will have to pay tax on it; whereas if he takes it out as an increase in his loan account, it will not be subject to tax.

The existence of loans to shareholders and related parties constitutes a major risk to parties in the event of the eventual liquidation of the business. The reason is that the liquidator will have the obligation to call those loans in. If the loans are not repaid, the liquidator will then make a commercial decision as to whether or not it is worth taking action against the shareholders personally. If the liquidator forms the view that the shareholders have



sufficient assets, he will definitely take action personally against the shareholder. If the shareholder doesn't pay the amount of the judgment, it is then likely the liquidator will initiate bankruptcy proceedings action against him.

Loans to shareholders therefore significantly increase the personal exposure of directors and, to a lesser degree, shareholders.

It is no longer a simple matter of making a decision to 'let a business go', accepting that the value of shares held in the business are now worthless and that loans made by shareholders to the business are probably worthless and then walk away, leaving the creditors losing most, if not all of what the business owes them.

Australian Taxation Office

The Australian Taxation Office takes the view that money withheld from wages of employees to cover their Pay As You Go (PAYG) deductions and monies recovered from customers to cover GST added onto their invoices really belongs to it. The business is acting as its agent in processing these transactions but the money collected in each case belongs to the ATO.

A common issue for failing corporates relates to remittance of Group Tax and GST. Generally, business tax is not an issue because during the dying days of the business, it generally makes losses rather than profits. Apart from their other obligations, Business Principals have a separate obligation to the ATO to ensure that the business pays to the ATO the amount deducted from wages and GST collected.

In the event where this does not occur, the Business Principals are obliged to arrange for the business to enter into an arrangement for payment of that amount with the ATO and if this does not occur or if the arrangement is breached, then they have an obligation to either ensure the appointment of a voluntary administrator of the business or arrange for liquidation of the business.

The obligation to remit the taxes remains with the business.

However, there is a process whereby the ATO can serve a notice on the directors called a Director's Penalty Notice. In the event where the directors don't take action within 14 days by either arranging for the business to pay the tax, to enter into an arrangement, or to go into administration or be petitioned for wind-ups the directors then become personally liable. The liability is an amount equivalent to the amount that the business failed to pay.

The Business Principals may therefore have no effective defence to this claim. However, if a director tried to ensure that the business complied but it was beyond the Business Principals power to force compliance, then there may be a defence.

Furthermore if the business has in fact paid its tax obligations then goes into liquidation, and the liquidator is successful in obtaining a refund from the ATO of part or all of the monies paid to it, as a preference payment, the directors at the time the payment was in fact made to the ATO will become personally liable. This may apply to a



director who resigned several months prior to the date the business went into liquidation.

Smaller enterprises tend to survive for longer than they should by using monies which should be remitted to the ATO to fund their struggling cash flow. This is a dangerous path to follow as it carries a high risk of ultimate bankruptcy for the directors. If the ATO does not recover the amounts demanded from the directors, they may take action to recover. After they obtain judgment, their practice is to proceed directly to bankruptcy.

Insolvent Trading

Claims for insolvent trading are made pursuant to provisions of the Corporations Act. These provisions make direct inroads into the principle of the corporate veil and result in the directors being personally liable for losses incurred by the business from the time it continues trading after it has reached the point of being insolvent.

The Corporations Act has a broad definition of director. It includes not only those who are formally appointed and whose details are recorded in the ASIC registry for the corporate entity but also includes people who otherwise act as a director. 'Insolvent trading' is easier to define than to prove. It occurs when a business is unable to pay its bills as and when they fall due.

To prove insolvent trading requires specific evidence) usually from a forensic or other specialist accountant who has reviewed the books and records of the business covering the period in question.

Evidence which supports the notion of insolvency includes details of a significant increase in creditors the corporate entity paying overdue creditors by instalments, cheques issued by the business bouncing the business having judgments taken out against it and not satisfying those judgments in full, a Statutory Demand being served upon the business and the business not taking action to deal with it) failure to remit tax liabilities to the ATO, failure to make superannuation contributions falling behind in payment of wages.

The directors of insolvent corporate entity generally know when the corporate entity is insolvent, or at least they should know. It is no defence for a director to claim that he did not know what was going on or did not have access to the books and was not kept informed about the activities of the business. A director, has an obligation to be informed and to know what is going on. If anything is unclear, the Director must ask questions.

Insolvent trading claims are initially made by the liquidator. The liquidator can simply make a claim on the directors for the amount of losses incurred by the business from the date he believes it became insolvent until the date of liquidation.

If the liquidator does not make a claim and follows up with legal proceedings, it is then open to any creditor to claim directly on the directors for the full extent of their losses.

Generally, it is better for the creditors to provide funds to the liquidator in order to pursue the claim on the



directors because the liquidator has far greater access to the financial records and can provide the best accounting evidence for the reasons for the business going into liquidation and thus, in support of the claim.

Any business prevention plan must take into account the risks of insolvent trading claims being made on the directors. To do this effectively the mechanism must be in place for the directors to know when the point of insolvency has been reached. This information can only be provided by the provision of timely and accurate financial reporting. However, a major reason for many companies going into liquidation in the first place is the lack of adequate financial reporting and controls.

Many unprofitable corporate entities are able to survive during periods of buoyant economic times because there is enough margin within the system to cover over the weaknesses in the business management. It is during a recession, when the margin for error significantly reduces, that these inefficiencies come to light and can often prove fatal.

A business preservation plan must provide for a weekly report to be provided to the Business Principals, which sets out the crucial information needed in order to monitor financial trends.

Business Principals must receive details of all written demands received from creditors, listing any legal actions initiated against the business, details of any Statutory Demands received, details of any arrears owing to the ATO and arrears in payment

of superannuation obligations. Without this information, the business may well continue trading when it has gone past the point of solvency. At that point, unless the directors have a workable plan to inject funds by way of shareholder loans, increase in bank facility or sale of assets the business must commence discussions with an insolvency practitioner and consider appointing a voluntary administrator.

Preference Payments

The Corporations Act gives liquidators the power to reclaim certain payments made by the corporate entity during the period prior to the date of liquidation. For payments made to parties who are not related to the corporate entity, the relevant period is six months from the date of liquidation.

If the payment had been made to a party who is related to the corporate entity, this provision will extend for four years prior to liquidation. If the payment had been made with the intention of effectively reducing the amount of assets available in the corporate entity at the time of liquidation, the liquidator can trawl back for a period of up to ten years prior to the liquidation date.

These provisions are aimed to defeat attempts made by directors to protect their own interests over those of other creditors. For example, if the corporate entity had previously borrowed funds from directors, shareholders or other related parties and, at the time the business was technically insolvent, repaid those loans, the liquidator could then sue those lenders and seek an order for repayment of an equivalent



amount of money, if the repayment was made during the relevant defined period.

A roughly similar situation would apply if the business, at the time it is solvent, transfers assets to related parties for less than their real value at that stage. For example, sale of a business asset to a shareholder for \$50,000 less than its real value 12 months prior to liquidation would enable the liquidator to sue the shareholder for \$50,000.

A business preservation plan which incorporates a strategy to effectively remove assets from the business in a way which would be detrimental to the interests of other creditors or which would involve payment of invoices owing to related parties in preference to other creditors may ultimately prove to be reversible.

Unfortunately, when Business Principals start feeling the pressure, it is common to seek hasty advice from accountants and lawyers who are not really qualified to provide it. Carrying out transactions for the benefit of related parties which constitute voidable arrangements may well create a false sense of security by the Business Principals. If any related party transactions are contemplated, it is important that they be carried out only after obtaining advice from an experienced practitioner. Conversely any business that operates by issuing a small number of high dollar-value invoices must be aware of the potential for preference claims being made against it.

As a matter of course, when a liquidator is appointed, the liquidator will review all

payments made by the business in the preceding six months and will make claims for repayment on all recipients where the payment to them appears to satisfy the requirements for being preference payments. There are similar provisions in the Bankruptcy Act. Any transfers of property which have occurred within five years from the date of bankruptcy will be reviewed by the trustee.

In the event where any transaction has been for less than full value or where the purpose of the transaction has been to artificially reduce the value of the estate, the trustee has the power to reclaim the property or the value of the property from the recipient.

For example, if a bankrupt is joint owner of a house with his wife, the house has a value of \$500,000 and is subject to a mortgage of \$100,000, then the value of his share of the equity is \$200,000. If he transfers his interest to his wife for no money then the trustee has the power to seek an order for transfer of the interest back or otherwise to obtain an order that the wife pay him \$200,000.

Any payments made by the trustee within the period of six months prior to the date of bankruptcy will be reviewed by the trustee and, if he believes that a particular creditor has received a preference payment, then he has the power to sue that creditor for the value of the 'preference'.

The act of a corporate collapse can have serious consequences for the personal wealth of associated parties, quite apart from the direct loss arising



from the fact that the value of shares held by the shareholders becomes worthless and the value of any loans made by the shareholders or associated parties to the business are in all likelihood worthless as well.

There are traps for the unwary. If there is even a small chance that the Business Principals may lose control of the corporate entity in the future, the business preservation plan needs to take into account the potential traps and plan for them, well in advance, based on expert insolvency advice. An understanding of these pitfalls and an analysis of the possible

impact of them is required in order to make a decision as to when is the appropriate time to cease trading, as apposed to battling on and facing potentially greater personal losses.

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