

## Corporate Strategy + Insolvency

### ***Directors Duties – Asset Protection***

Company Directors are under a positive duty to ensure that the company does not incur a debt whilst it is insolvent or does not become insolvent by incurring that debt.

Accordingly Company Directors are becoming increasingly exposed to personal liability for business debts.

Further the execution of personal guarantees by directors have become commonplace and essential today if one wanted to continue in business. This means that directors of small to medium sized businesses have exposed themselves to personal liability by guaranteeing the debts of their companies. Demands on the directors will normally proceed when there is a default pursuant to a personal guarantee.

Since 1993 the Australian Taxation Office also has had its recovery powers for company debts extensively increased as the ATO can now place a penalty on directors equal to the tax debt outstanding for the company pursuant to Section 588 FGA of the Corporations Act. This provision allows the ATO to be indemnified by the directors for certain taxation liabilities of the company.

There are also Common Law and Contractual duties owed by directors that are governed by Case Law and their individual employment contracts.

The Common Law duty of care, skill and diligence stems from the law of negligence and the relationship of proximity between the director and the corporation.

Rules of equity also impose a number of duties on directors by virtue of the fiduciary relationship between directors and the company. A liquidator is able to bring proceedings for breach by a director of a duty owed to the company that but for the insolvency of the company, would otherwise be exercisable by the company.

So effectively corporate structures are not the protective instrument they once were to secure against commercial risk. It is more evident that directors are personally exposed in the case of insolvency. A more litigious society has made unforeseen claims more of a reality and consequently directors need to protect themselves and their assets from adverse situations.

### ***D & O (Directors and Officers) Insurance***

There may be little benefit to an insolvency practitioner or creditors in pursuing directors unless of course the directors are covered by D&O insurance giving the practitioner access to the funds of an insurance company.

There are however a number of standard exclusions from D&O policies which significantly restrict the ambit of their operation. These include:

- **prospectus-type liability exclusion** which will often be of importance to directors of companies who propose to embark on a public offering;
- **professional indemnity exclusion** which excludes cover for claims alleging a breach of duty other than the professional duties owed by a director;
- **insured versus insured exclusion** which excludes claims brought by one person covered by the insurance against another, including by the company against a director. This is a significant exclusion because a director's duties are owed to the company itself and actions thus brought by the company are a significant potential source of liability. Many D&O policies contain an exception to the insured versus insured exclusion. This is to prevent the manufacturing of a claim for example by the directors of a company breaching a duty and voting to sue themselves to get damages for which the company is insured.

D&O policies normally include an exclusion to extend cover to claims brought in the name of the company at the instigation of a receiver, administrator or liquidator.

***How useful will D & O insurance be in the context of insolvent trading claims?***

Section 199B and 199C of the Act provide that a company must not pay an insurance premium of the company against a liability arising out of conduct involving a willful breach of duty. So long as the D & O policy excludes such claims from its ambit a company is able to take out effective D & O insurance for its directors and officers.

Section 199A prevents a company from indemnifying a director against liability incurred for a pecuniary penalty order or a compensation order under s1317H.

***What should directors do to protect their assets?***

1. Planning your personal asset structure is fundamental to preventing assets being disgorged by a liquidator of your company.
2. Structure ownership of your personal assets not only for taxation purposes but also for asset protection purposes. This needs to be undertaken when you are solvent. The insolvency laws only capture transactions, were it appears that they were executed when the person had or ought to have had knowledge of the insolvency of their company or themselves.
3. Directors should avoid having control of the entities that their assets are held in. One may still be held to be the beneficial owner of assets when it can be proven that one had control over the structure holding the assets.

***Solutions***

These solutions are by no means exhaustive but rather indicative of some of the strategies that may be employed. The application of these strategies will be dependant on the individual's circumstances.

1. Transfer property such as your residential property to a low risk party such as your spouse. Obviously your spouse cannot be a director of your company if this strategy is undertaken. Recent case law has determined that even directors who take no active role in their company's management cannot avoid insolvent trading liability simply by pleading that they did not understand their role and responsibilities.
2. Transfer property into a discretionary trust allowing your family to be the beneficial owners of your property. This mechanism also protects your property in the event you die and your spouse commences a relationship with someone else. That person may not be able to claim a share in the property subject to the trust as your spouse may not be the beneficial owner of the property. Bloodline Testamentary Trusts may be useful in such situations.
3. Placing contributions with a Superannuation Fund. Recently Funds have not performed very well with respect to deriving returns to contributors however superannuation funds have over the long term provided one of the best returns when compared to the stock market and property. In a recent High Court case it was held that superannuation contributions made before a person becomes bankrupt are unavailable for claw-back by the trustee in bankruptcy and therefore not recoverable by the bankrupt's creditors provided they were made as arm's length, commercial transactions. Placing such superannuation contributions with a recognised fund will satisfy the arm's length and commercial provisions.
4. Separate your trading entities from your asset holding entities. A basic example would be to place your assets in a discretionary trust such as your residential property whilst operating your business as a company.

### ***What about your inheritance?***

If you are entitled to receive an inheritance then in the event of your bankruptcy your inheritance will form part of your divisible assets amongst your creditors. Accordingly it is prudent to advise those who are proposing to bequeath property to you to set up a trust structure in order to prevent any inheritance potentially becoming available to your creditors in the event of your insolvency. Again in these instances a Bloodline Testamentary Trust is a useful tool.

Lastly as the saying goes "prevention is better than cure" is very appropriate in these circumstances. However experience has shown that in many instances insolvency was unforeseen and could not have been prevented especially in the prevailing volatile economic conditions and accordingly being prudent about ones financial affairs whilst solvent is becoming an issue we may all have to deal with.

### ***Conclusion***

Directors need to be aware of their duties and obligations of holding office.

Business by necessity carries commercial risk. Directors can, if they structure their affairs properly avoid losing all their assets if there is a commercial disaster. Although the above strategies protect directors in case of civil actions, there is no such protection from criminal actions. Directors must at all times ensure they are undertaking their duties diligently with due care.

**References:**

1. Directors' duties during insolvency, Hellen Horningston Lawbook Company 2001.
2. Cook v Benson [2003] HCA 36 (19 June 2003).
3. Deputy Commissioner of Taxation v Clark [2003] NSWCA 91