

# Legal Torque

## Who are you working for : your family or your creditors?

- Catherine Bormans -

**A**ny form of business involves risk – risk that through factors outside your control (for example - a terrorist attack in the US, change in legislation, the collapse of a major client) the business goes broke. If your business does become insolvent, then unless you have taken steps to protect your personal assets, you could lose everything – including the family home.

You work hard to acquire your assets but do you also work at protecting those assets from creditors? The law recognises that individuals may take steps to protect their assets. Asset protection is about providing a fence at the top of the cliff rather than an ambulance at the bottom.

There are some fairly simple mechanisms that can be put in place to protect your personal and family assets from the risk of insolvency of your business.

### **Company Incorporation**

The first mechanism that most people use is to incorporate a limited liability company to operate the business. As a general rule, any debts that the business owes are owed only by the company. If the business fails, then creditors can only recover their debts against any assets owned by the company. Creditors cannot, as a general rule, bring any claim against the shareholders or directors of the company or against any of their personal or family assets.

However, the company structure is not bullet proof. The director of a company can have personal liability in respect of the company's debts in some circumstances, including:

1. Where a personal guarantee is provided by the director to a supplier. Many suppliers

require a director to sign a personal guarantee as a condition of extending credit to the company.

In this way, the very purpose of having the company is defeated, and the director has full personal liability for the debts of the company to that supplier.

2. If the director trades the company while it is insolvent or is guilty of reckless trading. Under the Companies Act, a director can have personal liability for debts incurred by the company at a point in time when the director ought to have realised that the company was going to be unlikely to pay those debts.

During the life of most businesses, there will be times when technically the business is insolvent and is unable to pay its debts when they fall due from its existing cashflow.

As the cases on this subject show, as a matter of practice it is very difficult for a director to know when the company should stop trading, and when the director might be being exposed to personal liability for the company's debts by continuing to trade. In addition, the natural instinct when a business is in difficulty is to try to trade out of the position so that creditors can get paid.

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The problem is, if the company goes into liquidation, then a liquidator or creditors

may be able to bring a claim against the director and against the director's personal assets to meet the debts that the company can't pay.

In these ways and others, the protection of your personal assets that the company structure is designed to provide, is in practice often defeated.

### **Trusts**

A simple way to overcome those "loopholes" is to set up a trust and have that trust own your personal and family assets, including your family home.

In this way, if the individual has liability under a personal guarantee or for reckless trading in the event of the company's failure, creditors cannot touch or bring a claim against the assets that are in the ownership of the trust. If the family home is owned by the trust, then even if the individual goes bankrupt, creditors cannot touch the family home.

Essentially how a trust works is that if you are the person setting up the trust (settlor), you hand over assets to another person (a trustee) to look after for a third person (the beneficiary). The trustee is responsible for looking after the assets in the trust in the best interests of the beneficiaries. There is usually a trust deed which sets out the rules of the trust. There are also laws regarding the responsibilities of the trustees.

Legislation contains rules concerning how old the trust must be before it is immune from attack from creditors, and also concerning how the trust must be set up and administered. The protection of assets put into the trust is in general terms not absolute until at least two years after ownership of the assets is properly transferred to the trust.

There is also a restriction on how much of the value of an asset can be transferred to the ownership of a trust, which in general terms is \$27,000 of value per individual or \$54,000 in value per couple per year.

As well as protecting your assets from creditors, a trust can have other advantages. In particular:

- A trust may offer tax savings.
- A trust may provide protection if capital gains or death duty is introduced.
- Trust assets may be exempt from asset testing for residential care subsidies or other welfare benefits.
- A trust can be set up for a specific purpose, for example, for the education of named persons. The money in the trust then cannot be used for any other purpose.

### **Summary**

To protect your personal and family assets from the risk of your business failing, it is crucial that you operate the business through a limited liability company, and that your personal and family assets are transferred into the ownership of a trust.

It is also crucial that these steps be taken now. If these steps are delayed until the business is suffering financial difficulty, then it will be too late - the transfer of ownership of assets into the trust will not be valid or effective.

We are able to assist you in formulating the best business and personal asset ownership structure for your particular circumstances. We can also ensure that the structure is put in place efficiently and effectively, and that it is administered in a way to ensure that your personal and family assets enjoy the maximum protection from the risk of your business failing.

You work hard to acquire your personal and family assets and home. You owe it to yourself and your family to take these simple steps to protect those family and personal assets from the risks associated with your business.

For further information please contact **Catherine Bormans** on telephone **09 915 2412**, email **cmb@fmlaw.co.nz** or visit our website **www.fmlaw.co.nz**

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