Supplement 5

Exposures for Directors

Protecting your Business in the year ending 30 June 2019

It is clear this has so far been the toughest year since the global financial crisis.

With the mining boom well and truly over businesses need to start preparing now.

The affects of a looming trade war are unclear making the business environment more turbulent.

Although Australian households carry record debt levels, household savings rate continues to rise, which is having a large effect on the retail sector. Corporate insolvencies remain at record highs.

Suggestions to protect your business in 2018/19:

1. **Pay down debt:** Reduce gearing levels by protecting working capital and selling non-core or surplus assets.
2. **Strengthen your balance sheet:** Consider selling non-core assets or divisions or surplus assets. Also weigh up sale or leaseback options for property and other assets.
3. **Diversify:** Streamline the business or add service lines to diversify your customer base
4. **Reposition:** Develop your business' unique point of difference. Invest in R&D and innovation rather than price cutting your way to market share. Scrutinise your product range and cull unprofitable lines.

Consultants have developed key stress testing questions for directors including:

- What if credit markets seize up (again) and we can't roll over our banking facilities?
- What effect will China's slowdown have on revenue? What is our new break-even level?
- What would be the effect on revenue and earnings if we lost a major customer?
- How is cash flow affected if our customers take an extra 10 to 15 days to settle?
- Could there be a breach of banking covenants? How would we respond to financiers' concerns?
- What changes will we require to our banking facilities and what will our bank's attitude be to an increase in lending?
- What overheads will we reduce and what capital-expansion plans will have to go on hold to preserve cash?
- Are sales or production levels too low to remain viable?
- Is a merger or strategic partnership needed to maintain critical mass? Who would we approach? Is our business ready for such a process or will we need six months to prepare?
- Are we able to be willing to approach private equity as a means of strengthening our balance sheet or to fund a merger or acquisition?

Director's Penalty Notices

This legislation was passed by the Government in July 2012.

- In addition to liability for PAYG withholding amounts, directors are personally liable for their company's unpaid superannuation guarantee charge.
- A new director is not liable to a director penalty for company debts that existed when they became a director until 30 days after they became a director.

- In addition to estimating unpaid PAYG withholding liabilities, the Commissioner can estimate unpaid superannuation guarantee charge.
- The Commissioner may also serve a copy of a director penalty notice on the director at his or her tax agent's address.
- Where 3 months has lapsed after the due day, the director penalty is not remitted by placing the company into administration or beginning to wind it up.
- New directors are not subject to these restricted remission options until 3 months after they become a director of a company, rather than 3 months after a debt arose.
- In addition to these defences, a director that becomes liable to a director penalty for not causing its company to comply with its superannuation obligations is not liable to a director penalty if the company treated the SGA Act 1992 as applying to a matter in a way that was reasonably arguable, and the company took reasonable care in applying the SGA Act 1992 to the matter.
- Where a company has failed to pay PAYG withholding amounts to the Commissioner, the Commissioner has a discretion to reduce a director's entitlement to PAYG withholding credits relating to withholding payments made by the Company.
- Company directors and their associates who are entitled to a credit attributable to a payment by a company that has failed to pay amounts withheld under PAYG withholding to the Commissioner, can be liable to pay PAYG withholding non-compliance tax.

In the May 2018 Federal Budget from 1.7.2018 been extended to debts for GST, luxury car tax and wine equalisation tax.

Tips for Company Directors under the new regime

If you are about to accept a position as a company director:

- Ensure that, as part of your due diligence that you cover the company's PAYG, superannuation guarantee and GST obligations. A new director will become liable to a director penalty if, after 30 days of joining the company, the company still has not discharged its obligations.
- Companies should review their PAYG and superannuation compliance procedures to ensure there are no risks identified, such as incorrectly classifying employees as contractors or incorrectly calculating their superannuation obligations.

Director Penalty Notices – Latest Developments

Recently the ATO issued a DPN subsequent to a company going into liquidation.

Arguably this was contrary to:

- The explanatory memorandum for the law changes presented to the Parliament
- The stated policy objectives
- The intention of the Act

This involved a director who allegedly was instructed by the ATO, in or about July 2012, to report all outstanding PAYG withholdings for his company.

The director complied and determined a large PAYG debt was owing to the ATO since 2005. As a result of the debt, the director placed his company into liquidation in September 2012.

At the time he placed his company into liquidation, a Director Penalty Notice had not been issued.

Subsequently, on 29 January 2013, 5 months after his company had been placed into liquidation, the ATO issued a "Lock Down" Director Penalty Notice covering all BAS lodgements outstanding more than 3 months past the due date.

While it is open for the director to seek redress through the administrative appeals mechanisms, it appears this director is personally liable for his company's tax debt.

Implications for other directors

The advice remains the same – always lodge BAS returns on time!

Ten Tips for all Directors on how to minimise your risk of being personally liable for company debts

The ATO have ever increasing powers and right now the they are increasing its use of Director Penalty Notices (DPNs) for unpaid PAYG tax and superannuation debts. The ATO have adopted this strategy since the new laws were passed in July 2012.

It is predicted by Irish Bentley Lawyers that DPNs will become one of the ATO's main collection tools.

Directors of companies with arrears need to take prompt action to avoid or mitigate personal liability and should:

1. Be Proactive, no reactive

2. Conduct due diligence to ascertain the PAYG, superannuation and G.S.T. liability position before accepting the office of Director. New directors can be deemed liable for debts incurred before their appointment after as little as 14 days (according to a decision handed down by the Supreme Court).

3. As the consequences of delay can be irreversible, act quickly and proactively. The legislation surrounding taxation law and insolvency law contains many "deeming" provisions. Do not delay in getting advice to take steps to minimise your personal liability or rescue the company.

4. Ensure your ASIC details are up to date to provide an address for service that is monitored by a professional. DPNs and other notices only need to be posted to the address listed with ASIC and it is not enough to prove you did not receive it.

5. Get Director's Insurance. Insurance is available to limit the exposure. Talk to your lawyer or insurance broker about your insurance options. In doing so, consider getting a second opinion.

6. Consider a payment plan and get advice on whether you should seek for the remission of GIC and penalties.

7. Seek advice as soon as possible. Taxpayers and directors seek advice when it is too late because they do not understand the consequences that flow from late reporting, delay, or the fact that statements made to the ATO can be used as evidence against them. The ATO do not take notes of every discussion you have with them, so always be very careful if tax and superannuation debts cannot be paid then specialist advice should be sought immediately and can save you significant money and avoid prosecutions.

Disclosures made to the ATO should be carefully framed to avoid potential exposures for insolvent trading.

Directors are automatically personally liable for PAYG and superannuation contribution liabilities that are unpaid and unreported for three months. The personal liability accrues irrespective of the ATO issuing a DPN. The DPN just crystallises the date the personal liability is to be paid. You may be able to avoid personal liability if you act quickly so you must seek advice on the DAY that you receive the DPN. If in doubt, get advice because the consequences of delay can be irreversible.

Directors can be called on to repay the ATO for payments clawed back by liquidators for unfair preferences. Please note that advisors are at risk of a claim from their clients if they don't inform them of the director's statutory indemnity to the ATO under section 588FGA of the Corporations Act.

8. Borrow money to pay the tax debts via a loan dedicated to paying the tax debt. It is (generally) better to borrow money elsewhere to pay tax debt, than to pay the general interest charge. Any interest paid on a loan taken to pay tax, is also deductible, so ensure the loan is stand alone to simplify the deduction.

9. Report on time. Ensure that you lodge the company BAS forms and Superannuation Guarantee Charge Statements on time. Do this even if you cannot pay them. This protects the directors from personal liability.

10. Consider your other options under the insolvency sections of the Corporations Act. If your cash flow situation seems hopeless because the debts have climbed too high, then there are provisions set out in the Corporations Act which can be utilised to rescue your business and company by reaching a suitable arrangement with creditors. There are options other than liquidation. You should seek help from an insolvency practitioner who also has experience in tax matters as they understand how to negotiate with the ATO during any creditors' meeting, and they understand the policy considerations that need to be satisfied.

The Australian insolvency laws are built around the theory that it is better to rescue a business, then to destroy it, due to the investment in goodwill, business systems and the desire to keep the company employees employed. Where possible these provisions should be utilised and you should seek advice from an experienced insolvency practitioner about your options.

Asset Protection – Protect your Assets

Prior to becoming a Director (or at least before a Company incurs liability), you should take steps to protect your personal assets (e.g. your home) so that such assets will not form part of the recovery process, should the ATO (or any other person/entity) obtain an adverse judgment against you (or the Company).

Before becoming a Director, carry out due diligence on the Company's PAYG taxation and superannuation liability. The Supreme Court has held that new directors can be deemed liable for Company debts incurred before their appointment after as little as 14 days.

Consider the Company repaying a debt via a payment plan. If the Company cannot pay its outstanding debt, the ATO (or other creditors) may accept payment under a realistic payment plan however in doing so, you should ensure that the Company does not make any admissions as to being insolvent or other liability.

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 execution of personal guarantees by directors has become commonplace and essential today if one wanted to continue in business. This means that directors of a 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 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 a director and the company. A liquidator can 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 protective instruments 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 amount of ambit of their operations. 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 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.

D & O insurance 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 as 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.

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

Steps directors take 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 your asset protection purposes. This needs to be undertaken when you are solvent. The insolvency laws only capture transactions, where 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. This step is less effective given recent bankruptcy law changes and caution should be exercised.

2. It may well be preferable to 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. Superannuation funds have over the long term provided one of the best returns when compared to the stock market and property.

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.

Estate Planning

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 suitable trust structure to prevent any inheritance potentially becoming available to your creditors on 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, in many instances insolvency was unforeseen and could not have been prevented especially in the prevailing volatile economic conditions and accordingly being prudent about one's 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 and with due care.

Roche v Deputy Commissioner of Taxation (2015) WASCA 196

This recent decision demonstrates what a director may be required to do to discharge personal obligations for company taxes.

Division 269 of Schedule 1 to the *Taxation Administration Act 1953* (Cth) (Act) imposes duties on directors of a company to cause the company to comply with its obligations to pay on or before the due date:

- PAYG in accordance with sub-division 16-B and division 268 of schedule 1 of the Act; and
- The superannuation guarantee charge (SGC) in accordance with Part 3 of the *Superannuation Guarantee (Administration) Act 1992* (Cth).

Section 269-15(2) provides that a director ceases to have that duty on the day the company complies with its obligation to pay, on the day an administrator is appointed to the company, or on the day the company is wound up.

Section 369-20 makes a director personally liable for the amount unpaid by a company, if the director fails to carry out that duty.

Section 269-35 provides various defences to a penalty personally imposed on a director.

Mr. Roche was a director of Fuel Tank and Pipe Pty Ltd (FTP). During various periods between 1 June 2011 and 28 February 2013, FTP withheld PAYG from its employees and officers but failed to pay those amounts to the Commissioner of Taxation as required under sub-division 16-B in schedule 1 of the Act.

On 2.08.2013, Roche received a director penalty notice (DPN) pursuant to section 269-25 of schedule 1 of the Act, requiring payment of the amount unpaid by FTP.

On 23.08.2013, an administrator was appointed to FTP. On 24.09.2013, FTP was wound up.

On 7.11.2013, the Commissioner of Taxation commenced proceedings against Roche to recover the penalty and sought summary judgment.

Judgment was entered against Roche.

Roche appealed maintaining he took all reasonable steps to ensure the directors caused FTP to comply with its obligations (section 269-35)(2) of schedule 1 to the Act).

Roche maintained that from 2011 he had university studies and did not attend FTP premises or review its affairs on a day to day basis but discussed FTP's affairs with his father who was general manager from 2006 to 2012. He had quarterly meetings with his father and FTP's financial controller, during which he was given FTP cash flow projections, explanations of outstanding liabilities, expected expenses and expected revenues.

Roche contended that from advice received at those meetings, it appeared FTP would have enough funds to pay all its liabilities. Roche did not attempt to stop FTP from trading, maintaining he took all reasonable steps to ensure FTP complied with its obligations to pay PAYG and SGC.

In early 2013, Roche was advised by his father and the financial controller that FTP would need an equity injection to meet cost overruns. A proposed sale of shares in FTP to raise capital did not take place and subsequently FTP stopped trading and an administrator was appointed.

The defence could only succeed if Roche took all reasonable steps to ensure FTP paid all the required PAYG.

A director must prove that he or she took steps which were reasonable, having regard to the circumstances that the director, acting reasonably, knew or should have known.

The court held that the evidence that Roche submitted objectively fell short of what he needed to establish the defence.

This case demonstrates that to succeed in defending a penalty claim against a director under division 269 of Schedule 1 to the Act, on the grounds that the director took all reasonable steps to ensure the company was compliant with its obligations, a director needs to prove that:

- They have made enquiries as to the matters referred to above, including as to the payment, and the ability to continue payment, of all PAYG and SCG obligations; and
- They have reached the conclusion that payments have been made and would continue to be made, based on a reasonable belief.

Failing this, directors face the risk of personal liability and of course there are other relating to insolvent trading.

Mighty River International Limited v Mesa Minerals Limited (2015) FCA 462

In this recent Federal Court case, a hostile minority shareholder was allowed to inspect the records of the company. This part of a long running dispute involving the development of a manganese mining project in W.A. The minority shareholder, Mighty River International Limited (Mighty River), applied for an order to inspect the books of Mesa Minerals Limited (Mesa) under s247A of the *Corporations Act 2001* (Cth). The purpose of the inspection was to establish whether Mesa was leasing assets to third parties on noncommercial terms contain to the shareholders' best interests. Mesa argued that the application was not made by Mighty River as a member of the company with a genuine concern to protect its investment or by reason of any concern at all as to the use of the port rights. Mesa suggested Mighty River's intention was to conduct itself as a de facto director of Mesa by demanding information and participating in decision making that is properly the province of Mesa' board.

However, the Court was satisfied that Mighty River was acting in good faith and for a proper purpose as required by s247. Crucially the existing documentation provided by Mesa to shareholders did not give enough information on the issue, and in view of the drawn-out hostilities it was reasonable for a minority shareholder like Mighty River to seek more information to inform itself of these matters.

The Court did not take the view that Mighty River was involving itself in the company's management nor did the Court take the view there was checklist criteria to be met, given the issues involved the Court could well exercise its discretion under s247(A)(i).