

A frequent cause of personal financial difficulties is the failure of a business and the attendant business-related liabilities personally owed by the company owner. These individuals must often file for bankruptcy or make a proposal to their creditors as result of business-related debts.

There's Always a Second Chance - Creditor Proofing Tips for Business Owners

Debtors completing their bankruptcy/proposal often wish to start up another business sometime in the near future. The expected question then arises: how can they creditor-proof themselves in the event that their new business fails? Here are some ideas:

1. Consider incorporating the business. Incorporation will provide the owner with a level of creditor protection - most of a corporation's obligations are limited to its assets so this structure can provide protection for personal assets. This structure also has income tax benefits, which will not be discussed here, (this subject warrants its own article which will be published at a later date).

2. Always pay statutory debt on time, specifically:

- Payroll source deductions;
- Goods and Services Tax collected;
- Provincial Sale Tax collected; and
- Employee wages and vacation payable.

In Ontario (and in certain other provinces), corporate directors can be personally responsible for these debts, notwithstanding that the business is incorporated.

3. If the owner is using his or her own funds to invest in the company, it's advisable to do so in the form of a loan to the company secured by a charge over the assets. A lawyer should ensure that the proper documents are prepared and that the security interest is properly registered. In the event the company fails, the security interest will have a priority over all unsecured creditors with respect to realizing on the company assets.

If the loan is not properly documented and registered, the owner may become an unsecured creditor waiting in line to be paid with all the other creditors in the event of business failure.

4. Consider acquiring personal assets in a spouse's name or a family trust. Such assets do not form part of the transferor's bankruptcy estate and are therefore not subject to claims of estate creditors.

5. If the company owner is putting away money for retirement, consideration should be given to investing in RRSPs that are exempt from claims; for example, segregated funds. The distinction between segregated funds and mutual funds is that segregated funds are insurance contracts. The Ontario Insurance Act provides that:

"where the beneficiary of the insurance contract is a spouse, child, grandchild or parent of a person whose life is insured ... the rights and interests of the insured in the insurance money and in the contract are exempt from execution or seizure..."

Therefore, insurance products held in RRSPs will be exempt from seizure by creditors.

6. If one can avoid doing so, personal guarantees of a company obligation should not be given to suppliers or a landlord unless it is absolutely necessary.

Conclusion

With some foresight (what's the worst that can happen, and how do I avoid it?) and careful planning using the applicable initiatives outlined above, one can create an effective creditor-proofing strategy that will enable the company owner to ready him or herself if things don't go as well as expected.

Creditor proofing is best undertaken at the start of a business venture - when there are few assets and no claims outstanding. By the time a claim occurs, it may be too late to move assets beyond the reach of creditors.

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Starting Over

Personal Financial Difficulties is an overview rather than a complete analysis. Before applying any of these suggestions, consult your Fong and Partners Inc. advisor.

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