



## Entrepreneurs: Protecting personal assets

If you're one of the many Canadians who currently own or are planning to start a small business, you're likely aware of the many risks you face as an entrepreneur. One area of risk that many small business owners often overlook, however, is how to protect their personal assets from professional liability. Most business owners, officers and directors don't realize that their personal assets may be at risk from creditor claims in the event that their business encounters financial troubles.

In fact, a study<sup>1</sup> confirms that three out of four Canadian business owners have not taken adequate steps to protect their personal assets from professional liability. The same study reveals that the majority of respondents were unaware that simple,

cost-effective investment products are available to help protect their personal assets in the event of financial trouble within their business.

### **THE STORY OF BRIAN AND MARGARET**

Brian recently celebrated his 40th birthday. He is the owner of a small construction company that specializes in building high-end houses in the Halifax area. Looking back over the last 12 months, he realized he'd had a pretty stressful year.

Brian's had a pretty good run until recently. The housing market had been booming and his business had grown considerably along with his reputation for good work. Yet Brian's last project finished 13 months ago and it had taken this long to sell the two properties. The cost of financing the project had nearly wiped him out as the total number of interest payments had cost him far more than he had anticipated. After all, the majority of the houses he'd built in the past had sold in under a



<sup>1</sup> "Small-business owners face personal-asset risks by overlooking investment protection", *Canada News Wire*, March 6, 2001

month. The problem with this project had been the location of the plot that he had purchased, which, while beautiful, had turned out to be a little too far out of the way for many of his prospective buyers.

Brian's wife, Margaret, owns her own business designing customized mirrors and is doing quite well. If it hadn't been for Margaret's business having a good year, they may have had to dip into their personal savings to pay the interest on Brian's business loan. It had been a close call and a powerful reminder of the risks Brian faced in his line of business. Yet he figured that as an entrepreneur, risks like these came with the territory and the only thing he could do better next time was to be more careful when it came to selecting locations.

Margaret wondered if there was something else they could do to help protect the savings they'd built together over the last 10 years.

## THE MEETING

When their advisor, John, met with them for their annual portfolio review, he couldn't help but notice that Brian was a little quieter than usual. John asked Brian if there was anything on his mind and Brian responded, "I'm not sure what to say, John. I've had a tough year and I've had to use up all my free capital to sell those last two houses I built. If they had stayed on the market much longer I would have had to sell off some of our investments just to pay the carrying costs. It was a close

one. It's a good thing that Margaret had a good year and could help me with the payments."

John listened carefully to Brian's predicament and then asked Margaret how her business was doing. Margaret responded, "I had a great year this year — much better than last year. But you never know in my business. One year I can't keep up with all the orders, the next I'm laying off staff. The custom finishing business is pretty fickle, so you have to plan for the bad years as well. That's why we've tried to save as much as possible when times are good. But I have to admit, Brian's situation this year kind of scared me. To think we'd saved up all that money over the years and we almost had to turn around and use it to cover the carrying costs for Brian's business. I guess when the times are good you tend to forget just how exposed we are as entrepreneurs to business risk."

John nodded in agreement and replied, "Yes, entrepreneurs like you two really have to plan for the tough times like Brian experienced this year. But beyond saving a little extra in the good years, I believe I have a solution for you that can put some of your fears to rest."

Until now, Brian and Margaret had been investing the majority of their savings in mutual funds. The investments had done quite well, having averaged around 10 per cent compound annual return over the last 10 years. They were quite happy with the rate of return, as it fit in with their long-term financial plan.





John continued, "I'm going to suggest you two consider switching your mutual fund assets into segregated funds that can offer the same growth potential as the investments you already own. Segregated fund investments may provide a number of additional benefits that are not available with mutual funds. For example, segregated funds contain an insurance component that allows you to designate a beneficiary. The significance of this is that as long as you invest your savings in good faith and not for the immediate purpose of avoiding creditors, if one of your two businesses were forced to declare bankruptcy, your personal assets have the potential to be protected from creditors."

Brian spoke up asking, "How does it all work?"

John answered, "Provincial legislation can prevent creditors from seizing the proceeds of an insurance contract, as long as either an irrevocable or "family class"<sup>2</sup> beneficiary is named. Having said that, what we can do to make this work is transfer Brian's mutual fund assets into segregated funds and name Margaret as the beneficiary. We will do the same with Margaret's mutual fund assets and name Brian as the beneficiary. This way, if Brian's business encounters trouble again, his personal savings are protected. The same applies to Margaret."

"This all sounds too easy, John. Where's the catch?" asked Margaret.

John replied, "There's no catch. It really is that easy. In the past, segregated fund investments often came with generous benefits such as 100 per cent maturity and death benefit guarantees that added to the costs of purchasing these investments. These added benefits

were often seen as unnecessary for younger investors such as yourselves and that's probably why you've never heard of them before. However, recent developments in the marketplace mean that you can purchase a segregated fund with less comprehensive benefits at a lower cost. You still obtain the potential creditor protection you're looking for, but you no longer have to pay for all the bells and whistles you don't really need."

Brian spoke up and asked, "What about the performance of these investments, John? Our mutual funds have been doing pretty well and I'd hate to give up on performance in exchange for some added security that I hope we may never need."

John responded, "No need to worry, Brian. Many of the segregated funds I'm recommending you switch into are solid performers. In fact, some of the funds I have in mind you already own. They are simply the insurance version of the same fund. There are approximately 40 funds to choose from and all the major asset classes are covered. You'll likely recognize the names of the asset management companies who are managing these funds. And because the management expense ratio on these funds is comparable to most mutual funds, your investment performance won't be bogged down by higher fees."

"This is starting to sound like the ideal solution for us." said Margaret. "I guess the question is, when do we make the switch?"

John responded, "The best time to start is today. The reason for the immediacy is that in order to obtain the benefits of creditor protection, you need to start planning while both of your businesses are healthy.

<sup>2</sup> In provinces other than Quebec, a family class beneficiary would be any of the spouse, child, grandchild or parent of the annuitant. In Quebec, a family class beneficiary would be any of the spouse, descendants and ascendants of the policyholder.



Once a business is in trouble, it's almost impossible to start a creditor protection plan. It must be done while the business is healthy or new."

"Sounds good to me," responded Brian. "It would be nice to get this worry behind us."

"Before we sign the necessary paperwork," John continued, "there are a few more things I should tell you about segregated funds. For example, when you two are ready to retire, we can move your assets into a similar family of segregated funds that provide additional features and benefits that can provide predictable, sustainable and potentially increasing income during your retirement years. You may have the ability to switch into this other family of funds without triggering taxes such as capital gains."

"Tell me more," asked Margaret. "It's a new product that has been recently introduced to Canada. What is unique about these funds is that they feature a Guaranteed Minimum Withdrawal Benefit. In a nutshell, this benefit helps provide a predictable stream of income guaranteed not to decrease no matter how your underlying investments perform.<sup>3</sup>

The level of income can be sustained at least until you receive your principal investment back. In addition, if your underlying investments perform well, there is the potential to increase the amount of income you receive each year

and the total number of payments you receive while retired. It's an attractive solution for couples like yourselves since it allows you to continue to help grow your wealth while guaranteeing your principal investment."

"That sounds ideal," added Margaret.

"Now let's not get too far ahead of ourselves here," Brian said laughing. "We've probably got another 20 years before we need retirement income. But at least now we can rest assured that our retirement savings can be protected from professional liability until that time."

Brian and Margaret left John's office feeling a lot better than when they went in. Not only had they taken steps to protect their personal assets from the risks they faced as entrepreneurs, but they had done so at a minimal cost. What's more, the segregated funds their advisor had recommended to them had the same growth potential as mutual fund investments, which would help keep their financial plan on track. By taking the necessary steps to control risk now, they could be a lot more confident that their retirement savings would be there when they needed them the most.

Compliments of:

<sup>3</sup> Or until contract reaches maturity or upon death of the last surviving annuitant. Provided withdrawal thresholds are not exceeded.

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