A Business Owner's Guide to Asset Protection from Creditors

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A goal of many business owners is to obtain some protection from creditors for the business owner and his or her family. This article will provide a general overview of some of the issues likely to be encountered and strategies that may prove useful in meeting this goal. Planning years before problems arise is crucial; if you already have creditor problems, it is mostly too late. As a general rule of thumb, planning action should be taken four or more years before any expected problems are on the horizon; more than 10 years is best, given certain provisions of the Bankruptcy Code.

Planning for asset protection needs to take into consideration a number of legal issues arising under state and federal statutes and common law such as fraudulent conveyance theory (transfers for less than adequate consideration or to hinder, delay, or defraud a creditor; four-year statute of limitations, generally), preferential transfers (unfair payment of antecedent debt of a debtor in bankruptcy), spendthrift and self-settled trust theory (restrictions against setting up trusts to benefit yourself), bulk sales act (applicable in some states, but not Utah anymore, relating to sales of businesses with inventory), bankruptcy law, tax reporting and compliance rules, general fraud rules (which may result in liability for fraud, or denial of a bankruptcy discharge), and special statutes such as antiracketeering laws like the federal RICO and the state little RICO laws. There are also criminal laws (*e.g.*, bankruptcy crimes; Crime Control Act of 1990; Money Laundering Control Act; tax crimes; etc.) and contempt of court rules to consider.

The only planning worth doing is planning that can be fully disclosed. Asset hiding, equivocation about ownership, or similar gambits can lead to very serious consequences and must not be used. Also, asset protection planning needs to be coordinated with tax and estate planning, and with business succession planning.

Although the applicable rules are complex, there are some strategies that can be effective. The three basic strategies are described in this article, along with some ideas that may be helpful to business owners in implementing the strategies. However, not every idea will be desirable or effective for every business owner and their use should be carefully considered by the business

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owner and his or her counsel in the light of other important goals of the business owner. The importance of the business owner's having competent legal and accounting advice cannot be over emphasized. This article presents a high-level overview. Each idea has benefits and detriments and has numerous details involved in implementation, and not every possible idea is presented. A business owner will need guidance to make appropriate plans.

Strategy No. 1 - Avoid, Limit, or Cover Personal Liability.

A business owner should try to reduce the claims that can be made, and cover the risks that cannot reasonably be eliminated. Some suggestions are:

A. *Always carry adequate liability insurance*; this may include general public liability, professional errors and omissions, officers and directors, umbrella coverage, product liability, etc. Homeowners' insurance and automobile insurance generally do not protect with respect to business use of the property without a special endorsement. Consult with a knowledgeable insurance broker about needed coverage. Some business owners, such as physicians or other medical professionals, without coverage often find it hard to obtain employment, hospital privileges, payor contracts, and similar revenue sources. Similar problems could exist in other industries as well. Try to assure that the misrepresentations or other wrongful conduct of another business owner or official toward the insurer does not result in loss of coverage for everyone else.

B. *Try to avoid or limit personal guarantees*. For example, if you must sign a guaranty, try to limit it to a maximum amount or percentage (such as pro rata with other guarantors). If there are more than one guarantor, have a contribution agreement among the guarantors to establish, as among themselves, the proportionate obligation of each; the per-capita (by heads) allocation otherwise generally used by courts may be very far off from the proportionate share of each guarantor in the business.

C. *Consider the use of liability limitation provisions in contracts*. Such provisions may include a waiver of subrogation (*e.g.*, if the loss is an insured loss under someone else's insurance, the insurance carrier won't come after you), nonrecourse (be sure to limit "bad boy" exclusions), indemnity (*e.g.*, with the business or other owners), stop-loss (*i.e.*, caps on various obligations), reduced standards of care (to the business or other owners), and similar agreements or terms. Obtain waivers and releases of claims in appropriate circumstances (*e.g.*, as people leave the business or employment, or settle up, etc.).

D. *Be careful of responsibilities undertaken*. Some areas of concern include positions as ERISA fiduciary, board of director member (whether for a business or for a nonprofit organization), managing member, general partner, trustee or other fiduciary (such as a personal representative, guardian, conservator, or attorney-in-fact under a power of attorney), payroll responsibility, etc. These often cannot be completely avoided, but insurance or indemnity agreements may be available to help cover risks. If a position is undertaken, find out the legal duties that go with it and carefully meet those duties.

E. *Obtain indemnification* agreements from the business organization through which you do business, and from any other co-guarantors on obligations. It is best not to rely solely on the legal theories of contribution, exoneration, or equitable or implied indemnification.

F. *Follow a compliance plan* to ensure compliance with the various industry rules the violation of which can create devastating liabilities. For example in the health care industry there are antiself-referral, antikickback, false claims act, and other anti abuse rules. Any government contractor will be subject to the false claims act. Environmental standards exist as well for just about every industry. Accounting and securities law matters are key concerns for public companies. The failure to have and oversee a compliance plan (*e.g.*, on financial reporting) has been a basis for personal liability for directors and managers.

G. *Avoid self dealing* transactions or obtain appropriate board or shareholder or member consents to any such transaction, whether in the business or with respect to a not for profit tax exempt organization. There are also strict rules prohibiting certain transactions by or with pension or profit sharing or other ERISA employee benefit plans and tax-exempt organizations.

H. *Be careful who you use as an agent*, whether as an employee or otherwise (including family members running errands), because you may become liable for the agent's misconduct which will be deemed yours as well; or if the agent is the agent of the organization, you may be found liable if you negligently supervise the agent.

Consider outsourcing risky matters to independent nonagents, such as common carriers or contractors.

I. *Avoid nondischargeable obligations*, which may remain your personal obligation despite bankruptcy, or cover them before others where appropriate. These obligations may include back taxes, family support, student loans, breach of trust, wrongful conversion or taking of assets from another, etc.

J. *Be careful about family liabilities* which may be imposed on you, such as obligations for family necessities, retail theft by a child, use of your boat by a minor, etc. Normally, you are not responsible for debts of a spouse or other family members, but there are some exceptions. Also, sometimes inherited assets may have hidden tax liens associated with them.

Strategy No. 2 - Have Obligations or Assets Belong to Another.

The concept is that if you don't owe it, you don't have to pay it, and if you don't own it, your creditors can't seize it. Yet the assets can be available to protect persons in whom the business owner has an interest, such as family or the other business owners with whom he or she co-owns the business or professional practice.

A. *Conduct your business through an organization allowing limited liability*. Corporations (with or without the S-election for tax treatment), including professional corporations where appropriate, or limited liability companies, are excellent choices for this purpose. The differences between them for tax, employee benefit plan, and general estate planning can be significant, however, and will determine the choice between them. The Articles, bylaws, or operating agreements should in either event contain liability limiting provisions to protect officers and directors or managers and members.

Limited partnerships are not very useful for a professional practice or a service organization, although they can be quite useful for holding investment assets, including assets that may be leased to the practice or business. Limited liability partnerships in Utah only help protect against malpractice claims, not most other types of claims, and may have some usefulness; but a limited liability company would usually be a better choice. Avoid sole proprietorships and general partnerships. (General partnerships between organizations which already have limited liability may be alright.) Business trusts are too uncertain for general use at this time.

Business organizations with limited liability protect business owners against losing their other assets, such as homes and outside investments, in case the organization is held liable. This is very useful protection against a variety of obligations, including the dramatic possibility that another business owner, for example in a professional practice or service organization, is sued for malpractice and thus the organization is sued, too. The organization will also protect against contract claims not guaranteed by the business owner, against tort claims (*e.g.*, accident claims) where the business owner is not personally negligent or otherwise at fault, and against certain tax and statutory obligations of the business.

B. *Take steps to avoid liability where an entity can't protect you*. Business organizations won't protect against certain obligations, however, such as one's own personal negligence or wrong doing, personal guarantees of organization obligations, responsible person liability for federal or state tax withholding from payroll or for state sales taxes, preformation activities, and postsuspension or postdissolution activities not limited to winding up.

Further, subscription obligations to purchase stock or membership interests in the organization itself, obligations to meet capital calls, or fiduciary obligations and other obligations of the business owner to the organization itself will be enforceable against the business owner by the organization and thus will also be enforceable against the business owner by the organization's creditors in case of the insolvency of the organization. Understand the obligations and duties you owe to the organization and the other owners of it.

Also, personal liability may be imposed by piercing the corporate (or limited liability or other organizational) veil in cases of abuse, thin capitalization, failure to follow formalities, commingling of assets, etc. Thus, although it is often useful to finance the business using debt rather than stock or membership contributions, there should be sufficient equity to cover reasonably anticipated uninsured obligations. Separate accounts and bookkeeping for the organization must be scrupulously maintained. Annual meetings, annual report filings, and other organizational formalities must be complied with. It is best for the business owner to be able to affirmatively demonstrate respect for the organizational form of the business organization, even where the organizational form has relaxed standards of formality.

Special statutory provisions may ignore the business organization and create personal liability under certain circumstances, such as Multi Employer Pension Plan Amendments Act ("MEPPAA") concerning underfunded union or industry pensions, or various provisions of state or federal environmental legislation, or various fraud and abuse rules. Organizational officers who participate in discriminatory conduct or unfair labor practices may be held liable as if they were an employer under a number of labor and antidiscrimination laws. There have been cases holding officers personally liable for violations of such acts as the Fair Credit Reporting Act even when acting for the company. Shareholders who also have a controlling position have been held responsible for a company violation of copyright. These are examples; the general principles behind such cases may apply to other laws as well.

Fiduciary responsibilities under ERISA or other law are personal and usually nondelegable. Consider using the limited exceptions to ERISA fiduciary duties for plan investments through use of a self-directed plan. Avoid any sort of self-dealing with such plans. Also, if you are involved in any position of responsibility (including as a primary donor) with a charity or foundation, avoid self-dealing and conflicts of interest with them as well. Similarly, with other fiduciary positions: understand your duties and avoid conflicts of interest.

Even apparently little things can be important in avoiding liability for the organization's obligations. For example, always use your title with the corporation or other organization when signing company checks, otherwise such checks are, in a number of states, personal checks even if the company name is in the upper left hand corner of the check.

The stock or partnership interest or limited liability company interest itself will be subject to seizure or, in the case of a partnership or limited liability company, to a charging order by creditors; however, where there are at least two owners, the underlying assets of the business organization may be insulated and a stock or company interest seizure or partnership or limited liability company charging order may not provide much to a creditor, while the business itself may continue, at least as long as there are other owners involved.

Use caution in making distributions to shareholders or members or redeeming shares or interests to ensure the entity is and remains solvent. Obtain adequate authorization for transactions with the entity where there may be a conflict of interest.

Have good accounting and legal advice available, and use it.

C. *Protect the business organization and its assets, too*. The business organization itself will become liable for certain obligations so that even if the business owner is not personally liable, the business owner could nevertheless lose a great deal if the organization were to lose all its assets to, for example, a malpractice claimant who obtained a judgment against another business owner in the professional practice or service organization and, as will always be the case, against the organization, too. Thus, planning needs to include not just the assets of the business owner but also of the business organization. Many of the ideas set forth in Strategy 1 above will apply here, as well.

The organization needs protection from the creditors of its owners, too. This planning starts the minute you start to consider which form of business organization to use. Some forms of organization are better than others at preventing the business or its assets from falling under the control of an owner's creditor. Single-owner corporations or limited liability companies are vulnerable because control over them (and their liquidation) can be obtained by the creditor of the owner. In Utah, for multimember organizations, a limited liability company is often a better choice than a corporation because even the creditor of the majority owner will not end up in control of the business or generally be able to force a liquidation against the will of the other owners. (Tax and other issues should be considered, as well, in choosing a form of organization.)

It is often best to keep buildings, major equipment, software, patents or other key intellectual property, and other significant assets out of the business operating group itself. These assets can be held by management service organizations, or by family limited partnerships, limited liability companies, or trusts, and leased or licensed to the practice or operating organization.

It is also often best to isolate separate operations or investments in separate organizations. These can be brother-sister organizations with substantially parallel ownership or can be held in a parent subsidiary group. Parent-subsidiary groups while being useful as a general asset isolation tool, generally are limited in their use for a professional practice due to legal restrictions or professional rules of ethics that require the stock of professional corporations to be held by licensed practitioners; similar restrictions may apply to limited liability companies. If a corporation with an S-election is used, there are strong limits under tax law on the use of parent-sub groups.

Certain accounts receivable (but not, *e.g.*, Federal governmental, Medicare or Medicaid accounts) may be factored or other assets pledged to organizations controlled by family members or may be pledged to the business owners to secure compensation arrangements (although this may accelerate some income for tax purposes), loans or other credit arrangements, or distribution rights from the organization.

If (and this is a very big if) not inconsistent with other important goals of the business owner or the organization (such as protecting the group against the effects of a business owner leaving the group), good will, intellectual property, and, in a medical practice, patient files, might be owned individually with no noncompetition covenants on the business owner in order to prevent creditors of the organization from reaching the value of goodwill. On the other hand, noncompetition agreements, file retention, and intellectual property protection may be critical to the organization and it may not be desirable to have these key assets subject to an individual business owner's creditors.

D. *Give assets away or avoid receipt of assets*. Carefully structured family gifts can be a very useful tool. Stripping the business owner of assets available to creditors must be done only where it would not create a fraudulent transfer, for example, by rendering the transferor insolvent or by being done with intent to hinder, delay, or defraud present or future creditors. Sufficient assets should be retained to preclude insolvency. Stripping the owner of certain assets may be done through spousal gifts or other family gifts in or out of trust (there may be tax consequences) or through qualified disclaimers (assuming no pressing creditor problems). Naturally, it is important that the assets pass into the hands of someone with very little potential creditor risk.

Gifts in irrevocable trust of interests in a family limited partnership, a limited liability company, or a corporation may be especially effective for sheltering assets (including from the creditors of the persons to be benefitted) but retaining for the donor some significant control (but not so much as to create tax problems). For example, a family limited partnership or limited liability company could hold assets appropriate to the form of organization, such as buildings, equipment, life insurance, and investment assets of various kinds. Interests in these organizations can be given away to family members directly or through irrevocable trusts of various sorts. (Revocable trusts are useful for many purposes but provide no protection.)

A few states, including Utah, allow special irrevocable asset protection trusts to protect assets even where the trustor (the creator) of the trust may receive some benefits under it. This is in contrast to the general rule that where a trustor retains benefits in a trust his or her creditors may have access to trust assets. The conditions for and exceptions to such asset protection trusts differ from state to state. Utah's version is rather strong. Whether these sorts of trusts will be honored in other states is an evolving issue.

It may be possible to use foreign country asset protection trusts, designed to be tax neutral, in a jurisdiction with more favorable rules on fraudulent conveyance, spendthrift trusts, and similar issues. Foreign trusts are relatively expensive, complex, and create special tax compliance and other problems and must be used only with great care; however, they can make access to assets much more difficult for a creditor to obtain. The choices of the jurisdiction to use, the trustee to use, and the trust features to use will be critical. If the creator of the trust retains too many powers, he or she could end up in jail for contempt of court for not exercising those powers to repatriate the assets so creditors can seize them. On the other hand, if the wrong trustee in the wrong jurisdiction has control, the creator of the trust may be trying to enforce the trust before the same unfriendly foreign courts to which he or she intended to subject creditors.

There are risks with gifts in or out of trust, which include risks from the transferee's (recipient's) own creditors (including ex-spouses), the possible lack of trustworthiness of the trustee or grantee, etc. The business owner and other family members' (for example, parents) transfers may be structured to avoid an individual with potential problems (this may include the business owner himself or herself); however, the effect of the generation skipping tax should be considered on gifts to grandchildren or later generations. Also, the Bankruptcy Code's 180 day inheritance rule could bring inherited assets into the bankruptcy estate of a beneficiary and should be taken into account in planning.

Divorce happens, but marital agreements can be effective and should be seriously considered generally, but especially where the business owner transfers substantial assets by gift to his or her spouse or where control of a key business interest may be at stake. Special effort is needed to make these agreements enforceable. Also, ERISA qualified plan rights of spouses can't be waived before marriage; thus, any prenuptial agreement will need to be supplemented after marriage to take care of this where desired.

In even a strong marriage, consider keeping the assets of the spouse separate so claims against one won't compromise the rights of the other.

Strategy No. 3 - Invest in Favored Assets.

There are some assets more protected from creditors than others.

A. For example, *qualified pension and profit sharing plans are protected* against the business organization's (employer's) insolvency and are also protected from the business owner beneficiary's (employee's) creditors in the event of the business owner's own bankruptcy. They are protected by ERISA, the federal law of pensions and retirement plans. There may be exposure, however, if the plan only covers the business owner and the business owner's spouse (this may bring the plan account into the owner's bankruptcy estate, but an exemption may still apply) or if the plan fails an antidiscrimination test or other qualification requirement or if the plan is disqualified for engaging in a prohibited transaction or for some other compliance failure (this may bring the plan account into the bankruptcy estate and destroy the exemption). They also receive protection under the Bankruptcy Code as an asset which may be exempted, and traceable proceeds may continue to be exempt from creditors under state law in Utah.

Qualified plans are generally the best form of retirement program for creditor protection; they have protection under ERISA in every state, are entitled to bankruptcy exclusion or exemption without dollar limit or a showing of need, allow for the largest amounts of tax-favored retirement savings, and are relatively flexible. However, such plans contain strong spousal protection provisions, and they are still subject to tax claims, but they are one of the last assets seized.

B. *IRAs, including SEP-IRAs and Simples*, are not qualified plans but may nevertheless be entitled to be protected pursuant to an additional exemption under the Bankruptcy Code without a showing of need up to a $1 Million cap on IRAs other than SEPs and Simples (as adjusted from time to time) exclusive of qualified plan rollover contributions. They may receive some level of state law protection as well; this protection is rather good in Utah. Nonspousal inherited IRAs are not treated as true retirement funds because they have different distribution requirements not tied to retirement age. Using trusts for IRA benefits may be a better option for protection than naming an individual as IRA beneficiary. This issue raises concerns, as well, for spousal IRAs held as inherited IRAs and not rolled into the spouse's own IRA; for spouse beneficiaries, it would often be best to transfer the inherited IRA into the spouse's separate IRA. In addition, prohibited transactions or other failures of compliance may disqualify the IRA from tax benefits and this in turn may destroy any exemption.

To protect rollovers which have been made to IRAs from qualified plans, it is best to use direct, trustee-to-trustee, transfers rather than further rollovers when changing from one IRA to another.

Under the Bankruptcy Code, certain education IRAs and tuition plans may be exempted from the bankruptcy estate up to the tax contribution limits for the type of plan where contributed not later than a year before the bankruptcy petition, and not over $5,000 for each type where contributed not later than one year before and not earlier than two years before the petition. State law protection is less certain.

C. Another possibility is *to invest some funds in exempt assets* under state laws such as the homestead exemption (in Utah, $5,000 if not primary residence or $20,000 if primary residence; double these amounts per household where jointly held), insurance death benefits received by a spouse or dependent (to the extent necessary for support), or tools of a trade (up to $3,500; one car used in trade up to $2,500). Exempt assets are nevertheless subject to certain claims such as secured claims in particular assets, alimony, support, maintenance, one month's wages for an employee, state, local, and federal taxes, purchase money on a specific item, repair, etc. liens on a specific item, or special assessments on a specific item. Some states are more generous than others on exemptions although there will be limits in a bankruptcy situation. As you can see from the above dollar limitations, Utah is not one of the generous states. In some states (not Utah) certain annuities are exempt, but courts have found that sophisticated annuities are really investment contracts not subject to the exemption.

Under the Bankruptcy Code, the homestead amount will be reduced if the debtor transferred nonexempt assets into the homestead within 10 years with the intent to hinder, delay, or defraud creditors. Also, changing domicile to get a different state's more generous homestead (or other) exemption must be done more than 730 days (*i.e.*, two years) before the petition. Further, if the homestead was acquired in the 1215 days (*i.e.*, three years, four months) before the petition, it will be limited to $125,000 (other than for family farmers), but a rollover from a prior home acquired before that period in the same state is not so limited.

Some states (such as Michigan, but not Utah) recognize a tenancy in property between husband and wife, known as a tenancy by the entireties, which makes it difficult for creditors of one to get to any part of the property. Such a tenancy won't stop the tax collector, though.

A personal home is not exempt over the homestead limitation amount, but it nevertheless has certain special benefits. It is one of last assets seized for taxes and may not be required to be sold to qualify for certain governmental programs (*e.g.*, Medicaid), although it may be subject to a later claim for reimbursement of government benefits paid.

Some otherwise exempt assets are subject to certain claims, however, such as security interests, repair liens, alimony, child support, and taxes and governmental assessments.

The dollar amounts and other limits set forth in this article and the various rules described in this article will change from time to time and should be reviewed whenever planning is done. The point here is no to provide up to date advice, but is to provide an overview of how the issues can arise and some general strategies for dealing with them.

Start Now.

Although proper planning and implementation takes some time and effort, it may be very worthwhile if a calamitous liability were to be incurred. For planning to work, however, it must be accomplished well before a problem is known. There is, as the saying goes, no time like the present.