Liability Protection in 2012

By Dennis F. Gorman, Esq., CPA

Business and investment assets are subject to varying degrees of attack by creditors. Understanding the actual protection which your assets enjoy (or don't enjoy) is important during these difficult economic times. While I am unable to cover all of the various aspects regarding choice of entity, e.g., income tax implications, the cost of formation and annual maintenance, uses regarding estate and gift tax planning, I will review the creditor protection aspects of the most commonly used entities.

First, having no entity i.e. operating a business as a sole proprietorship or owning investment assets in one's own name affords virtually no protection from the claims of creditors. Thus, if the enterprise/investment asset generates its own liability i.e. lead paint suit regarding real estate or auto accident by a sole proprietor's employee, the owner is fully exposed individually to any such liability. Furthermore, the assets of the enterprise/investments are subject to the claims of the owner's other creditors, e.g., the owner's guaranty of a child's auto loan.

INHERITANCE TRUSTS

If we self settle trusts for our own benefit, in general, the assets are not protected from the claims of our creditors. If, however, someone else establishes a trust for our benefit the assets are generally protected from the claims of our creditors provided the trust is properly worded.

An increasing number of parents are now extending the remainder distribution ages for their children's ultimate inheritances in order to protect the assets from the claims of potential creditors, divorcing spouses, etc. Also, "super creditors" have emerged under federal law. For example, the SEC and IRS are favored creditors under federal law and special drafting is required to protect beneficiaries of a trust when these agencies are potential creditors of a beneficiary.

REALTY TRUSTS

Nominee realty trusts were commonly used to hold title to investment real estate. Unfortunately, the trustees, beneficiaries and in some cases both, are subject to potential liability stemming from the assets held by the subject trust. Furthermore, creditors of the beneficiaries of a nominee realty trust may attack the assets of the trust with a little effort.

CORPORATIONS

Corporations insulate the owners from liability stemming from the business operations. However, the owner's stock in a corporation is subject to the claims of the owner's other creditors. While multiple shareholders of a closely held corporation typically have share cross purchase agreements to keep the stock within the ownership group, the value attributable to a shareholder's stock is subject to the attack by the shareholder's outside creditors.

LIMITED PARTNERSHIPS

Limited partnerships were traditionally the best creditor protection vehicle before the advent of limited liability companies (LLC's). Limited partners are not subject to liability with respect to the business operations or investment assets of the limited partnership. Unfortunately, the general partner of a limited partnership (who manages the enterprise) is subject to liability. For this reason, corporations were often formed to act as the general partner to eliminate liability to the ultimate individuals who own the general partnership interest. This created a complicated expensive corporate structure. The limited partnership shares are also protected from the claims of any third party creditors of a limited partner (i.e., outside creditors are unable to go to court and seize the limited partnership shares to satisfy an outside obligation). The "charging order remedy" is the only one available to the creditors of a limited partner i.e. if and when any profits are distributed out to the limited partner a court may intercept such payments and turn them over to a third party creditor of the limited partner.

LIMITED LIABILITY COMPANIES (LLC'S)

After the IRS issued a favorable tax ruling to LLC's in the late 1980's, LLC's began to make traction in the US for both business and investment property use. LLC's afford the owners (members) the same liability protection as a limited partner of a limited partnership i.e. protection from any liability stemming from the business venture/investment asset. At the same time outside creditors are not able to seize the LLC shares rather the "charging order remedy" is the sole remedy. Thus, today LLC's are the state of the art creditor protection vehicle (in my view). There is no need for a corporate general partner since the statute is clear that all members enjoy this protection.

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