



Asset Protection Considerations for Business Owners

By: Ryland F. Mahathey, Esq., CPA, LL.M and Brad Milhauser, Esq., LL.M



Many business owners devote much time and energy “working in” their business to improve business operations and profitability; however, they often neglect to “work on” their business by not addressing certain asset protection issues. Business owners, particularly those owning their business in corporate form, should consider the following: 1) how to own C corporation or S corporation stock to minimize exposure to creditors, an “outside” asset protection issue; and, 2) whether to implement several basic business agreements designed to protect and even enhance business value from the “inside” of the corporation.

Stock Ownership

Generally, a creditor of a corporate shareholder may seize the shareholder’s stock and thus have the same management and liquidation rights as the debtor shareholder. Charging order protection (described below), normally applicable to limited liability entities, does not apply to S corporations or C corporations. S corporation owners may have additional concerns if a creditor is an ineligible S corporation shareholder thereby causing the corporation to lose its S election. As a result the corporation will be treated as a C corporation and exposed to double taxation.

A business owner who owns S corporation or C corporation stock should consider the asset protection benefits of converting or merging the corporation to a new Limited Liability Company (“LLC”). There are several limited liability organizations that can protect business assets from the personal liabilities of the owner. However, entities such as limited partnerships, or limited liability limited partnerships, are treated as partnerships for federal tax purposes and therefore cannot own S corporation stock; whereas, an LLC electing to be taxed as a corporation may.

Generally, the asset protection benefit of an LLC is a judicial remedy as known as a “charging order” which protects the owner’s interest in the LLC from his or her personal

liabilities. If a creditor obtains a charging order, the creditor is limited to the rights of an assignee of a membership interest in the LLC. If a distribution is made from the LLC, the creditor is entitled to receive a proportionate distribution. However, the creditor has no voting rights and thus, cannot force a distribution, liquidate the LLC, or otherwise manage the business.

With proper planning, both C corporation and S corporation owners may be able to avail themselves of the LLC asset protection benefits by converting the corporation to an LLC taxed as a corporation. Generally, such conversions are treated as nontaxable “F” reorganizations under IRC Section 368(a)(1)(F). However, potential income tax consequences and individual state law considerations should be carefully evaluated. For instance, C corporations considering conversion should analyze potential exposure to the “built-in-gains tax” under IRC Section 1374. Also, the strength of the charging order protection provided by an LLC varies depending upon state law.

Business Agreements to Protect Value “Inside” the Business

Among the basic business agreements or legal documents that should be considered by business owners to protect business value include a Non-Compete and Confidentiality Agreement, Buy-Sell Agreement, and perhaps even a Deferred Compensation or Bonus Plan for key employees.

Few events can sap the value of a small business like a key employee or associate leaving the business and starting a similar enterprise, especially if such an employee departs with trade secrets, confidential information or even customer lists. Business owners should require their employees to sign Non-Compete and Confidentiality Agreements to prevent this from occurring. If the terms of such an agreement are considered reasonable under state law, the agreement should be enforceable.

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A Buy-Sell Agreement is another key document that if properly structured, funded, and updated will protect the value of both the exiting and remaining business owner's interest in the business. The Buy-Sell Agreement accompanied by proper planning should provide the exiting owner a fair value for his or her ownership interest and provide the remaining owner a means to purchase the exiting owner's interest without depleting the business of cash flow and its value. A Buy-Sell Agreement is designed to establish a predetermined and agreed-upon business value (or method of arriving at the value) at the occurrence of certain trigger events such as the death, disability, voluntary or involuntary termination, or retirement of a shareholder or partner.

It is crucial that planning be done to ensure there are sufficient funds available to implement the buy-sell provisions when triggered. Funding at an owner's death with life insurance may be the easy part. More problematic may be how to buy-out a departing owner's interest in the event of disability, retirement or voluntary termination, especially if a portion of the business' cash flow must be devoted to that purpose. Further, once in place a Buy-Sell Agreement should periodically be updated to reflect changes in the business value and the owners' objectives.

Finally, business owners should consider putting into place a deferred compensation or bonus plan designed to reward key employees who meet certain performance targets. A properly planned deferred compensation or bonus arrangement can serve two purposes which will work toward protecting the value of the business. First, the plan should be designed so that employees are rewarded for achieving benchmarks that not only protect but increase the business value. Second, such agreements, for example through gradual vesting schedules, should place "golden handcuffs" on valuable employees by making it difficult for a key employee to leave the business and forfeit certain benefits.

A detailed discussion of the aforesaid legal documents is beyond the scope of this article. The point here is that when considering asset protection strategies for business owners, protecting the internal value of the business through a few important but often overlooked documents can be just as important as the legal wrapper placed on the

ownership of the business. It should also be noted that implementing such agreements not only protects the value of the business but also enhances its value and makes the business a more attractive target to a potential buyer when the owner eventually exits.

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