

A BETTER WAY

Protecting Business Value from Claims of Creditors

By **G. Timothy Leighton, JD, CFP® ***

As business owners create value and wealth for themselves as owners, they are often concerned about preserving that value in case things go wrong. For example, if someone sues the business, the owners don't want to risk losing their assets, inside or out of the business. Perhaps the "easiest" way to prevent that loss is not doing things that inspire lawsuits. Two other easy steps to take to avoid that result are to purchase various forms of liability insurance and to structure the business as a legal entity that shelters assets from some claims.

Liability insurance is a topic that deserves at least one article all on its own. Today's column focuses on the choice of entity and then touches on special assets that enjoy special protection under state law.

Business owners typically have multiple objectives to satisfy when choosing how to structure their enterprise. Some of the considerations include ease of operation and compliance, how the business will be taxed, how to transfer the business in the future and/or wrap up at the end of the business life, how to preserve privacy for the owners, and how to limit the liability of the owners along with minimizing exposure of assets. The most common forms of ownership structure are sole proprietor, partnership, corporation and limited liability organization. Again, each of these considerations could use at least one article to describe important aspects.

A key reason for choosing corporate or limited liability organization status is to limit the exposure to loss of the owners and their assets. Another way of saying that is that business owners often seek to cover their assets. Generally, the extent to which an owner faces a potential loss arising from claims against a business structured in either of these ways is whatever investment the owner has made in the enterprise. Now, the business owners must comply with various rules set forth in state law and other requirements in order to limit that liability exposure. And the owner must not deliberately hurt someone through the business or be so reckless that the owner might have personal liability for the action. But within those rules, then the enterprise generally would limit the risk of loss only to what has been invested in the business. Typically the risk exposure of a corporation or limited liability entity is not greater than the value of the assets in that enterprise. But personal assets outside of the business are usually not subject to the claims of creditors of that business when the business maintains the necessary formalities.

For business owners seeking even greater degrees of asset protection, there are at least two other strategies to consider. Such an owner should consider setting up a special kind of trust to hold the ownership interest of the enterprise. And the entrepreneur can also consider acquiring particular assets that have special protection under Illinois law (and the laws of several other states).

As part of comprehensive estate and asset protection planning, business owners often turn to trusts as vehicles to accomplish various planning objectives. Under appropriate circumstances, an entrepreneur aiming to manage risk strategically might set up an irrevocable

trust, with a trusted individual or institution serving as trustee, to be the actual owner of the stock or membership interest. There are also other complex structures, such as family limited partnerships. These structures offer additional layers of asset protection. There are trade offs, to be sure. Among other things, someone else other than the business owner becomes the legal title-holder of that asset, albeit for the benefit of the entrepreneur and/or other designated beneficiaries. There are costs involved in setting up and maintaining irrevocable trusts. But these instruments are powerful devices that can include so-called “spendthrift” clauses. These provisions can serve to reduce the potential access by creditors.

A business owner with flexible cash flow can also consider devoting some of that cash to acquiring and growing special assets that enjoy significant protection from claims of creditors. Certain life insurance policies and annuities are exempt from creditor access. Unless the owner has set up these instruments with specific intent to defraud those owed money, they are generally not subject to claims of creditors. State laws limit creditor rights in this way as a matter of public policy. This policy reinforces responsible behavior. The idea is that people are encouraged to provide for the needs of dependents upon untimely death of their providers. These laws are designed to help assure that those for whom insurance benefits are intended will actually receive insurance proceeds, whether or not the insured remains solvent. There are special procedures required to achieve this result, so like any complicated financial instrument, those interested in them should work closely with their professional advisors.

Business owners have many tools available to them to preserve enterprise value from the claims of those who seek to take something away from them. These tools range from basic decisions in organizing the enterprise to risk management tools along with complex legal and financial instruments. To determine and implement the appropriate combination should involve the entrepreneurs along with their professional advisors.

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