

**Protecting the Future
Asset Protection, Succession Planning and Health Care Directives
For Business Owners©**

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Introduction

The Coronavirus brings to the forefront the need for a will or trust, medical power of attorney and health care directive. The economic impact of the pandemic raises issues of asset protection and succession planning for business owners. Because I have previously written about asset protection and succession planning¹ this article is intended as more of a checklist of items to discuss with us in consultation.

I. Asset Protection

Asset protection is a huge topic by itself and the topic of other articles. Here are some things you can do:

A. The LLC Operating Agreement.

The operating agreement may include custom asset protection (read “anti-creditor”) provisions.² These include:

1. No mandatory distributions that creditor would take under “charging order.”
2. Non-pro rata distributions; that is distributions could be made independently of ownership “percentage interest. For example, three members own 1/3 each as a percentage interest, but one member may receive more, say 50%, or receive less, say 10%, of company profits. Note this may require “special allocation” allowance from IRS.
3. The LLC is manager-managed such that members are not involved in management activities or have any right to terminate manager(s).
4. Dissolution or sale or spin-off of assets only by unanimous approval of Manager and Members.
5. No transfer except by unanimous approval,
6. Purchase of interest upon bankruptcy, divorce or death.

¹ Asset Protection and Succession Planning at azbuslaw.com/Publications/Articles. Also check out our Blog.

² A corporation shareholders agreement may include a variation of some of these provisions.

7. Poison pill, i.e. the right of company or member(s) to buy out creditor who is seeking to attach the LLC interest. (This works best in judicial foreclosure). Attachment³ trigger right to buy and buy-out price of say 1X net worth times member's percentage interest (attached by creditor).

8. Members may not withdraw from company or reacquire contributions already made.

9 Family members only.

B. Asset Protection by Holding Company or Trust

1. Holding company management corporation with management agreement between holding company and the subsidiary corp. or LLC under which the holding company will manage the business or property. Payments to the holding company for the management services remove monies from the subsidiary operations company which is likely to be the defendant in some action. For example, the hair salon whose employee injures a customer. The customer could sue the salon, but the monies could have been paid out to the management company

2. Holding company owning operating assets and leasing them via an equipment or other lease to the operating subsidiary. In this case – which is the opposite of the case above -- the holding company hold the asses and receives lease payments for their use. In this case neither the assets nor the monies are subject to execution because they are held by the holding company.

3. Asset Protection Trust. Unlike the trusts used for estate planning an asset protection trust is irrevocable. Its protection comes from the fact that the grantor can longer control the trust and usually the trust is for the benefit of the beneficiaries (spouse or children) not the grantor.

4. Domestic Asset Protection Trust (DAPT). The DAPT goes the standard irrevocable trust one better by being formed and holding assets in certain states which have the necessary statutory framework. Last count there were 14 states which allow such trusts. These include Alaska, Nevada and South Dakota. (We typically use South Dakota.) In a nutshell DAPT states have passed legislation saying, in effect, we do not recognize the judgments of other states. You cannot execute a judgment against assets held by our state DAPT. DAPT's raise a number of constitutional issues, like comity.⁴ But to my knowledge no such statute has been

³ "Attachment" is pre-judgment remedy typically used in a collection suit by which a creditor seeks to seize certain property pending later favorable case outcome. The immediate effect can be to prevent the business from operating which is an extremely powerful and effective creditor's remedy. However, the creditor must post bond to protect the debtor from illegitimate seizure or weak legal claims.

⁴ The legal principle that political entities (such as states, nations, or courts from different jurisdictions) will mutually recognize each other's legislative, executive, and judicial acts.

ruled unconstitutional and the cost of challenging the trust would deter all but the most ardent creditors.

C. Asset Protection by Transactions

1. Sell accounts receivables for cash, typically to the holding company or owner. The buyer pays the cash to the selling operational company. The cash is then used to pay salaries, loans and operational expenses. The bills are paid but the defendant operational company has little cash.

2. Create company loans and leases payable to the holding company or owner. This removes funds from operations thereby making the operations company less attractive for collection action. And, payments on loans and leases are not payroll, so not subject to payroll taxes. This works best for corporations but can work for LLC's too in certain circumstances.

a. Note: As profits from a company, whether paid as salary, dividend or distribution are taxable, while loan payments received are not, it may serve the investor to loan the company money and take proceeds as loan repayment rather than profit.

3. Security interests in the operations company assets which put the holding company or owner or other third party ahead of other creditors and as a secured party.

4. Because (and assuming) the above transactions are for reasonable return value they are not voidable or fraudulent. And, if the payments are not a function of ownership (but sale or debt) then they are not subject to constructive fraud claims by state corporation and LLC statutes.

5. Loans and lease payments should also be free from self-employment tax claims so long as the company is not in the business of leasing assets or making loans.

6. The tax advantages of the above are less clear for a "single member" LLC (which could include the husband and wife as a single member). The reason is that for tax purposes with a single member LLC the entity is disregarded. This means that the company and the owner are not treated as separate parties but basically as one and the same. Thus, the owner could be subject to self-employment tax. All of the above transactional protection devices should be discussed with your accountant, especially if you are a single member LLC.

a. One way to "cure" the above problem is to have another owner. Even a family member, with a nominal, say, 2% interest, would make the company a multimember LLC; thus, avoiding the problem. This structure can have other benefits as well, e.g. to challenge an alter ego claim.

D. Asset Protection from Partners and Employees – the “Wolf Inside Your Door”

We may not immediately think of the company’s organization and operations documents as “asset protection.” But, in practice more money may be taken, assets diverted and opportunities stolen or missed by the company owners, management and staff than by or to an outside creditor. Here are some of the more important documents.

1. Operating or Shareholders Agreement stating fiduciary duty of LLC Managers and Members and Corporation Directors, Officers and (in a close corporation) the Shareholders. In a nutshell having a fiduciary duty means that one cannot act out of self-interest to the detriment of the company or other owners. No self-dealing.
2. Operating or Shareholders Agreement with strong non-competition, non-solicitation and confidentiality provisions.
3. Key Employment Agreement with strong non-competition, non-solicitation and confidentiality provisions.
4. Other employee Employment Agreement with strong noncompetition, non-solicitation and confidentiality provisions.
5. Independent contractor agreements which protects the particular “slice” of custom product or service provided. Independent contractors are by definition doing business in the industry and for other clients, so one may not have blanket non-competition or non-solicitation agreements in the independent contractor agreement. But, for example, if the contractor is a software developer developing customized security software for your security company, you may protect that software developed especially for you by having the contractor agree that that information is confidential and the same customized software will not be provided to another customer.

Some of these rights may only exist or be protected if a written agreement contains them. But protecting the company is the ultimate form of asset protection.

E. Asset protection by Sales, Service, Supply and Maintenance Agreements

1. Clear statement of work or specifications
2. Warranty to do that work (only) and meet specifications
3. Disclaim all other warranties express or implied by law
4. Limit remedies. No third-party claims for damages like lost profits. Limit award to amount received.
5. Specify law and jurisdiction

6. Arbitration, perhaps, to keep the matter private. Arbitration is not public.

F. Personal Asset Protection

1. Homestead Exemption

2. Retirement plans, insurance

3. LLC for second home, or investment property

4. Irrevocable trust

a. Note: estate trust not provide asset protection

5. Domestic Asset Protection Trust (DAPT) to take advantage of state law protecting trust assets

b. Note: professionals like doctors, lawyer, architects, engineers, accountants need # 4 or #5 trust because LLC or corp. not protect against malpractice which is personal claim.

c. Note: trust like #4 or #5 also protect high net worth individual against personal claims for fraud, negligence, etc.

6. Trust (#4 or #5) as co-owner with individual of “sunny day” and “rainy day” LLC’s. (This we would have to explain.)

II. Succession Planning

A. To Family

1. By Last Will & Testament if heir take owner place in ownership and operation of the business.

2. Buy-Sell Agreement specifying that:

a. spouse: in divorce the spouse agrees to sell shares to company or remaining owners at predetermined price formula
b. heirs: in succession heir(s) agree:

(i) to accept both voting and financial interest and assume the grantor’s position, presumably of ownership, management and control, in the company or

(ii) sell shares back to company or remaining owners at predetermined price formula

c. Purchase upon death could be funded by insurance. Share redemption insurance paid by the company or cross-purchase purchased and paid for by the corporate shareholders or LLC members. (Cross purchase steps up basis for shares which can reduce tax on subsequent sale.)

3. Trust (Trustee) hire or continue management of the grantor's interest in the company. Could be:

a. Estate Trust if asset protection not an issue

b. Irrevocable Trust or

c. DAPT if asset protection as well as succession are important

B. Problems of Family Succession

Transferring the business to a family member may be a dream come true for both the parents and the child. But this transfer can be fraught with challenges, including

1. The parents' unrealistic expectations of commitment, performance and success.
2. Low standards or goals of the child or heir.
3. If the heir is not already working in the business then what may be a fatal lack of knowledge and experience, if not also aptitude.
4. Existing, perhaps longstanding family issues that have nothing to do with the business and get in the way of effective communication.
5. The heir's desire for a special deal with below market price and exceptional terms.
6. Perhaps permanent damages to the family relationship if the heir is not suited or motivated to run the business as it should be run and the business fails.

C. To Co-owner

1. Any of the above-stated options IIA1,2,3, but typically the parties would use a company buy-sell agreement with price formulas. Selling to a co-owner has the advantage of the purchaser's present and thorough knowledge of the business.

D. To Key Employee.

1. The employee may be groomed for succession, so will be ready when the time comes. Again, there may not be the knowledge gap which an heir new to the company would experience.
2. Key employee may not have funds to buy business so crates need for seller financing.

E. To a Known and Approved Third Party

1. Sales Contract to sell owner's share in the company to the third party upon owner's death, disability or other triggering event signed by the other owners.
2. Option to buy to third party. With written approval and consent of other owners.
3. Right of first refusal for terms equal to terms to family or co-owner successor. Again, with written approval and consent of other owners.

F. List Company for Sale

1. Agreement of all company owners in place now that upon death or other specified event(s) to list the company for sale in the open market, and upon its sale to divide the proceeds.

III. Health Care Directives

A. Medical Power of Attorney

1. The medical power of attorney grants the power to make decisions about your medical care when you are unable to, e.g. serious accident or illness. It says *who* can make the decisions.

B. Healthcare Directives

1. The healthcare directive consists of your answers to a series of questions about your medical care if you are unable to make the decision yourself. This is the *what* of medical care.
 - a. Common questions are whether you desire to be put on life support, and to what extent, e.g. forever or when recovery unlikely.
 - b. By answering such questions yourself in advance you take the onus off your family to make such decisions.
 - c. Limiting futile care also preserves the estate which otherwise may be drained by the medical care.

C. The Will

1. While not a healthcare directive in our firm the Will, Medical Power of Attorney and Healthcare Directive are done together at the same time.
2. The will may be combined with a trust or buy-sell agreement as discussed above under Asset Protection and Succession Planning.

Last Word.

The time needed and cost to do these critical documents are surprisingly small. And, with current technology most of the work described here could be done by Skype or by phone.