

Asset Protection for Physicians and High-Risk Business Owners

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CHAPTER FOUR

When to Use a Corporation

The first consideration in structuring a sound asset protection plan is deciding which form of entity should be used to operate your business. The possible choices include general and limited partnership, sole proprietorships, trusts, limited liability companies, and corporations. Each has different legal characteristics, tax attributes, and asset protection features. The right combination is based upon the nature of your business, whether you will have outside investors, the degree of liability protection needed, and which entity creates the greatest tax benefits.

Many physicians use a Professional Corporation (PC)—an entity with special features, determined by the state where the practice is conducted. In this chapter, we will examine the advantages and disadvantages of a corporation and see how it fits in with the overall plan we will develop.

Corporations are a form of business organization permitted by law in every state. A unique feature of a corporation is that it issues shares of stock. A share of stock entitles a shareholder to vote on the election of a board of directors, which is charged with the overall management of the corporation. The board of directors elects the officers—the president, secretary, and treasurer, who are authorized to conduct the day to day business of the corporation. Many states permit a single individual to serve as sole director and to hold all of the corporate offices.

One of the unique features of a corporation is that it is intended to have a perpetual existence. The death of an individual director or officer does not terminate the existence of the corporation. Instead, the corporation carries on indefinitely until it is dissolved by a vote of the shareholders.

A corporation is legally formed and begins its existence upon the filing of Articles of Incorporation with the Secretary of State of the state of incorporation. You can choose to incorporate in any state you wish. It is not necessary to incorporate in the state where your business is located. A disproportionately large number of corporations are formed in Delaware. Most large public companies are incorporated there. Delaware has encouraged corporate formations by adopting laws that favor incumbent officers and directors against attack from dissident shareholders, has a long history of decided court cases interpreting its corporate law, and has no state income tax. These are attractive features to consider when choosing a state for incorporating. Nevada is another state without corporate income tax, and its laws are also designed to actively encourage new corporations.

Limiting Personal Liability

The primary distinguishing feature of a corporation is the so-called *limited liability* of the officers, directors, and shareholders (the "principals") of the company. In a properly organized, maintained, and capitalized corporation, the principals have no personal liability for debts of the corporation. If a corporation breaches an obligation or causes injury to a third party, only the corporation and not the principals are legally responsible. If the corporation does not have sufficient assets to satisfy the liability, the creditor is not entitled to seek satisfaction from the personal assets of the principals. This feature is distinct from other businesses operated as sole proprietorships, partnerships, or trusts. In those cases, the owner, partner, or trustee, respectively, has *unlimited liability* for debts incurred in the business.

Professional Corporations

The problem for physicians is that personal liability for malpractice cannot be limited by using a corporation. Regardless of whether you conduct your practice through a PC, you will not be shielded from any claims asserted for injury to a patient. If you lose a case, any amount not covered by your insurance will be satisfied from your personal assets. With jury awards of \$3 million and up occurring with some regularity—your entire net worth is on the line with every patient you treat. *We will see that if you cannot legally shield yourself from liability—the proper strategy is to protect what you own from a potential claim.*

Although the PC won't protect you from claims by a patient which you treat, it can be used to defend against the negligence of a partner. If your practice is organized as a general partnership, you are legally responsible for any injury caused by your partner. Even if you don't do anything wrong, you are liable for the actions of your partner. But using a PC limits your responsibility to only those acts committed by you or your employees. You are not liable for injury caused by a "partner" in your medical practice. For those in practice with other doctors, the PC creates a necessary degree of liability protection.

Effect of Personal Guarantees

Anyone doing business with a corporation may require that the principal of the company give a personal guarantee of a corporate obligation. In simple terms, the person signing a guarantee promises to pay the corporation's debts if the corporation is unable to do so. For example, if you wish to lease office or retail space for the business, the landlord may request a personal guarantee of the lease obligation. If the corporation fails to make its payments on time, the landlord can then collect directly from you. In this manner, a personal guarantee eliminates the benefits of the corporation's limited liability.

Similarly, vendors sometimes will not sell, and banks and other lenders often will not lend to a family corporation without a personal guarantee. To the extent that guarantees are provided, an individual owner will have personal liability for these contracts, and the corporation will not provide protection from these obligations.

Protection from Tort Claims

Except for professional malpractice cases, when the source of the lawsuit is a negligence claim or a claim arising out of the employer-employee relationship, the corporation can be an effective device. We have previously discussed how an employee's negligence may be imputed to his employer. If your secretary injures someone while she is picking up your lunch, you are likely to be responsible for the damages. However, if the secretary is an employee of a corporation, the corporation, but not the officers or directors, will be liable for the injury. This is also the case generally for employee claims of discrimination or wrongful termination. Any such lawsuits will be filed against the corporation as the employer. The principals of the company will not usually be held personally liable for these types of activities.

Protection from Customers

When the corporation *sells* goods or services (other than professional services), liability for these activities will usually be limited to the corporation. A buyer of goods (as opposed to a seller) typically does not require a personal guarantee as to the quality of the product. If the product is faulty or someone is injured by the product, the corporation will be liable but not the principals. If a corporation supplies services, such as contracting or repair work on a house, only the corporation would be liable for faulty services. A corporation provides a useful shield against personal liability in connection with the sale of products or services. When a corporation *buys* goods or services, liability for payment will also be limited to the corporation, unless the principals have signed a personal guarantee of the obligation.

Eliminating Double Taxation

The way corporations are taxed provides some interesting and challenging planning decisions. A corporation is a taxpaying entity. That is, it must file an annual tax return and pay taxes on its income. If those earnings are distributed to a shareholder, this distribution is treated as a *dividend*, which is then taxable to the shareholder. The effect of this is that corporate earnings are taxed twice—once at the corporate level and once at the shareholder level, when the earnings are distributed in the form of dividends.

The problem of double taxation may be eliminated in one of two ways. First, the corporation can pay out as salary an amount equal to its net earnings. This is called *zeroing out* the corporation. As an example, a medical corporation might have a profit of \$100,000. If this amount is paid to one or more of the officers of the corporation as compensation for services, the corporation will get a tax deduction for this \$100,000 in salary. That will reduce taxable income to zero, and no federal income taxes would be due. The \$100,000 is included in income, and the tax is paid by the recipient. This eliminates the problem of double taxation.

The Internal Revenue Code imposes certain limitations on this technique by allowing a deduction to the corporation, only if the amount of compensation paid to a particular individual is "reasonable." The salary cannot be excessive based upon the actual services provided by the individual. There have been thousands of cases litigated by the Internal Revenue Service on this issue, and no firm rule has developed. Basically, if the salary is comparable to that received by others in similar businesses, it is unlikely that there will be a challenge from the IRS.

If you attempt to pay salary to your children or your grandmother without any services performed by them, the deduction could be disallowed as unreasonable. If the salary is disallowed as unreasonable, this amount is added back to the corporation's income and a tax is assessed on this income. Also, the amount which was distributed is treated as a dividend to the recipient and is taxable to that individual. This produces a double tax on the same income and is clearly a disastrous result.

Using S Corporations

The second method for eliminating double taxation is the use of a device called an *S Corporation*. This is a type of corporation specifically provided for in the Internal Revenue Code. An S Corporation is treated differently for tax purposes than a conventional corporation (which is known as a "C Corporation"). If elected by the shareholders, an S Corporation will not be subject to tax at the corporate level. Instead, all corporate income is included directly in the income of the shareholders. There is no need to zero out the corporation with salaries since corporate income is now subject to tax only once, at the shareholder level. Additionally, if the corporation has a *net loss*, that loss can be used by the shareholders to offset other business income.

In order to qualify, the stock of an S Corporation must be held by thirty-five or fewer individuals and all shareholders must consent to the election. An S Corporation has all of the lawsuit protection features of a C Corporation. If unreasonable compensation is an issue or the corporation is expected to show net losses, an S Corporation would be a useful planning technique.

Piercing The Corporate Veil

The lawsuit protection features of the corporation will be available only if the integrity of the corporation as a separate and distinct entity, apart from the individual, is respected by a court and by the Internal Revenue Service. In matters involving a lawsuit by an injured party, especially if a corporation has no significant assets, the plaintiff will attempt to convince the court that the corporate entity should not be respected and that the principals of the company should be personally liable. In these cases, the plaintiff is attempting to *pierce the corporate veil* in order to obtain a judgment against the principals, who may have personal assets sufficient to satisfy a judgment.

There are many reported cases on this topic, and the outcome is usually determined by whether the corporation carries out its business and looks and acts the way a corporation should. If the principals treat the corporation and hold out the corporation to third parties as a separate and distinct entity, the court will usually uphold the status of the corporation and will not find personal liability. However, if various corporate formalities are not consistently observed, the corporation will be disregarded and the individuals may be held personally liable.

One of the major problems with the corporate format for small businesses is that as a matter of course the shareholders, officers, and directors will be named in any lawsuit against the corporation. The plaintiff will attempt to pierce the corporation or will argue some theory to make the defendants responsible. In a significant number of these cases, when there is a judgment against the corporation, the court will disregard the legal protection of the corporation and will hold the defendant shareholders, officers, or directors liable.

Much of the practical protection offered by the corporate form is rendered meaningless by these cases. Sometimes the protection is upheld, and sometimes it is not. This lack of certainty makes business planning—and sleeping at night—difficult. Since the shareholder will almost always be named as a defendant in the lawsuit, even if he is ultimately successful, the attorney's fees and the costs of defense can be financially ruinous.

There are two solutions to this problem. If you are a principal shareholder or officer/director of a corporation, use a proper asset protection plan to shield your personal assets from the potential liability associated with the corporation. Alternatively, use a Limited Liability Company (LLC)—instead of a corporation to conduct business. We will discuss the LLC in detail, but for now, you should know that an LLC cannot be pierced like a corporation and the members cannot be named in a lawsuit for failure to follow any formalities. It provides the protection against liability associated with the corporation but avoids many of the pitfalls. When considering the best asset protection strategy for your situation, determine whether the LLC is an appropriate form to conduct your business activity.

If you are using a corporation, you must pay attention to formalities which the courts have determined to be of particular significance:

Corporate Bylaws. The corporation must adopt a set of bylaws, which provide a written statement of how the internal affairs of the corporation will be handled. The bylaws set the time and place of regular shareholder meetings and meetings of the board of directors.

Corporate Minute Book. The corporate minute book contains a written record of actions by the shareholders and directors of the corporation. At a minimum, there must be annual minutes reflecting the election of directors by the shareholders. Any significant corporate activities, including corporate borrowings, purchases, and the payment of compensation to officers, should be properly reflected in the minutes of the meetings of the directors and shareholders.

Stock Ledger Book. The corporation must maintain an accurate stock ledger book. This book shows who has been issued stock certificates and the amounts received by the corporation for the issuance of its stock. The stock ledger book contains an up-to-date record of the names and number of shares owned by each shareholder.

Conducting Business in Corporate Name. When doing business with third parties, the officers and directors must make it clear that they are acting on behalf of the corporation and not in their individual capacity. Correspondence should be sent out under the proper corporate letterhead, and contracts should be entered into only with the corporation as a signatory. Unless the documents clearly reflect that a transaction is entered into on behalf of the corporation and all necessary agreements are entered into under the corporation's name, the corporate entity will not survive a challenge in a lawsuit.

Bank Accounts. Corporate bank accounts and accounting records must be separate and distinct from the individual. A corporate bank account cannot be treated as if it were the account of an individual officer or director. Corporate income and assets must be separately accounted for on the books of the corporation. One of the biggest mistakes made by clients is that they feel free to move money and property back and forth between themselves and their corporation without properly accounting for such movement in the records of the corporation. This is a fatal mistake, and under these circumstances, the corporate entity will be disregarded by the court.

Protecting Corporate Assets

We must also consider the issue of protecting the assets of the corporation. The corporation, as an entity operating a business, is in the front line of attack for litigation from every conceivable source. If the company loses a lawsuit, all of its assets are available for collection. Because of this, a sensible asset protection strategy must be adopted for the corporation as well as for the individual. As a rule, to the extent practical, you do not want the corporation to hold any significant assets. You do not want a corporation to build up a substantial net worth only to see everything wiped out in the event of a lawsuit.

Real Estate and Equipment

Assets, such as real estate and equipment, should never be held by the corporation. These assets should be held by another entity—a Family Limited Partnership, LLC, or a trust—and leased back to the corporation at a reasonable rent. Since the property will be leased, rather than owned, the assets will not be available for collection by a creditor of the corporation.

Surplus Cash

The corporation should never hold any surplus cash. You would be amazed at how often clients proudly tell us that they have accumulated \$1 million of cash in a Merrill-Lynch CMA account. This is pure madness. Only amounts necessary to pay immediate and foreseeable obligations should remain in the corporate account. Any surplus should be loaned or paid out as salary or some other type of distribution. The last thing you want is a fat pile of cash available for the taking.

Inventory and Accounts Receivable

Certain types of property can't be conveniently held outside of the corporation. Assets, such as inventory and accounts receivable, will undoubtedly cause tax and accounting difficulties, unless they are maintained in corporate form.

If these types of assets are significant in value, one solution is to create liens which will have priority over subsequent creditors. For example, the owners of a business or professional practice can make loans to the corporation for working capital or other needs. As security for these advances, the corporation can give the owners, as collateral, a lien on corporate inventory and receivables. This security interest is called a UCC-1 filing under the provisions of the Uniform Commercial Code (UCC). The hoped for result of this UCC-1 filing is that the inventory and receivables will be protected. A judgment creditor would find that the equity in these assets is subject to the superior claim of the business owners and cannot be used to satisfy the judgment.

Multiple Corporations

If the business of the corporation can be divided into separate businesses, assets can be protected through the use of multiple corporations. For example, a single corporation may own and operate six medical clinics in different locations. If something happens at one of the clinics, giving rise to potential liability, the assets of the other successful clinics must be isolated from these claims.

A client of ours had four dental offices in different locations. All of the offices were held in one corporation. Business at one of the locations slowed down substantially. That clinic became a financial drain on the others, absorbing all of the available cash in the company. Eventually, the corporation had to file for bankruptcy, wiping out all of the equity that had been built up.

Our approach would have been to have each office separately incorporated. Then, if one location were to falter, it would not drag down the others. A judgment creditor of one corporation would not be able to reach the assets of the other companies. An extreme illustration of this is the taxicab company which separately incorporated twenty-six different taxis.

This strategy is also useful for a company that manufactures or wholesales different product lines. Companies in the pharmaceutical business face enormous potential liability for many types of drugs and medical devices. Several years ago A. H. Robbins was forced into bankruptcy by liability in connection with the IUDs it produced. Dow Corning had similar problems from the liability associated with the silicone breast implants. Whenever a particular product may be hazardous, using multiple corporations is an effective technique for insulating each separate product from liability caused by another.

Protecting Trademarks and Trade Names

Trademarks, patents, and copyrights are valuable assets which should not be owned directly by the operating entity. A separate company can own these assets and make them available through a form of a licensing agreement. The objective is to protect these assets in the event of a judgment against the corporation.

One of our clients was in the garment manufacturing business. His company sold primarily to the large department stores. This is always a dangerous business. A large amount of capital is needed to fill orders which are not paid until sixty or ninety days after shipment. A common scenario goes like this: An unusually large order is placed by a retailer, and the manufacturer uses all of its cash and credit to buy the materials and pay the workers to fill and ship the order. Then, ninety days later, before the manufacturer has gotten paid, the truck pulls up with the entire order returned. Since the value of the goods to the manufacturer is only a fraction of the invoice amount, the manufacturer is now out of business since it is out of cash and out of credit. The bankruptcy court and the creditors now attempt to seize and sell every asset of the company including any valuable trademark or trade name.

Our client engaged in the proper planning before these events took place. The trademark and the trade name were owned by a separate company. The new company (NewCo) then licensed the use of these properties to the corporation on a monthly basis. When the corporation ultimately filed for bankruptcy (because of the circumstances we just described), the trademark and trade name were safely protected in NewCo. Since it was these assets which contained all of the goodwill of the business, our client was able to successfully go back into business and establish a new company.

Using Corporations to Protect Personal Assets

Is a corporation a good strategy for shielding personal assets from potential lawsuits? This is a question which has produced needless confusion and misleading advice. There are many heavily promoted schemes—generally involving Nevada corporations—which claim to provide a myriad of asset protection benefits.

Our view is that the corporation is generally a poor choice as a vehicle to protect assets. It is clumsy, inefficient, and usually better methods will be available.

The source of the problem is that a judgment creditor can seize any shares of stock which you own. If you transfer assets to a corporation in exchange for stock, the creditor simply takes the stock certificates and becomes the owner of those shares. If he obtains more than 50 percent of the shares, the creditor is then in control of the company—and your assets. We will see that this result differs from the Family Limited Partnership or LLC arrangement where the creditor cannot get the right to vote or manage the entity and, therefore, cannot reach the assets held by the company. Since the shares of stock of a corporation are reachable by judgment creditors, a corporation will not provide a significant degree of asset protection, in the event of a successful lawsuit against you.

Some degree of asset protection can be accomplished if you move the shares into a protected position. For example, corporate shares can sometimes be transferred to an entity that provides necessary legal protection for assets such as a Family Limited Partnership (FLP), LLC, or a trust. But there are lots of rules and tax traps for the unwary. For instance, shares in an S Corporation cannot be held by an FLP or LLC. Also, only certain types of trusts are permitted shareholders. Hazardous and unintended tax consequences occur frequently with corporations, and so all transactions should be carefully planned and monitored.

Using Corporations for Financial Privacy

Conducting business in a corporation can sometimes create financial privacy advantages. The corporation is a separate entity for legal purposes. It is required to obtain a Federal Tax Identification number, which is separate from the Social Security number of the owner. Real estate, bank accounts, and other business interests can be legally owned in the name of a corporation.

The identity of the shareholders of a corporation is not required in any public filing with the state regarding the incorporation or maintenance of the company. In theory, at least, the names of the shareholders are private and evidence of your ownership is not available for public access. But there are many holes in this general principle. Companies with publicly traded shares are required to disclose the names of principal shareholders in regular reports to the Securities and Exchange Commission and various state regulatory agencies.

The identity of the shareholders of privately held companies must be maintained in a written record in the stock ledger book of the company which is as secure as the procedures implemented by the custodian of the corporate records. In addition, information about the stockholders of a private company may be developed by the database services through voluntary disclosure on credit and insurance applications, business and professional licenses, and other regulatory filings. Corporations must annually file, with the state, the names and addresses of corporate officers and directors. If you are listed as an officer or director, a database search will reveal this connection to your corporation. It doesn't matter which state you have chosen to incorporate in—Nevada, California, Delaware—every state has the same requirement and the information is publicly available.

Let's say that, in order to maximize your privacy, you have a friend or business associate serve as the sole officer and director of the corporation. Alternatively, there are companies and individuals who offer these services, for a fee, to newly formed or existing corporations, mostly in Nevada. They promise to follow directions and act as your agent with regard to the corporation. For convenience, we will call your "friend" Gumby. Gumby's name—but not yours—will now be recorded publicly. If he carefully executes all corporate filings and documents, your name will probably not show up in a search of the databases.

The more difficult privacy issue involves the matter of signature authority with regard to corporate assets. Who should be authorized to sign on the corporate bank account? Although the account itself is in the name of the corporation—with its own Federal Tax Identification number the law requires that the bank obtain the name and Social Security number of *every account signatory*. If you are a signatory on the account you must supply this information. Your name and Social Security number on the account then provides the link to you—exactly what you were trying to avoid in the first place.

You can eliminate this difficulty by having Gumby as the account signatory—but you have now created serious dangers for yourself. You have made Gumby the sole officer, director, and signatory for all corporate assets—presumably valuable to you or you wouldn't be going to this much trouble. In essence, you have turned over to Gumby much of what you own. As attorneys, we see so many risks and opportunities for fraud with this type of arrangement that we don't recommend it for our clients.

One of the largest companies supplying these services was recently raided as part of an IRS crackdown. Computers and files were seized, and criminal investigations are proceeding. Imagine the inconvenience of getting Gumby's signature on a check when he is operating from the federal penitentiary. If your goal is financial privacy, we will show you that there are safer and more efficient alternatives which will accomplish the desired result.

Summary

We have seen that the corporation can provide benefits by limiting the liability of business owners from particular sources of lawsuits. This general rule will not apply to physicians, dentists, attorneys, engineers, CPAs, and other licensed professionals. These individuals remain personally liable for acts of malpractice.

In other cases, a corporation will be especially effective in situations involving negligence claims and disputes with customers. However, lawsuit protection will be lost if the corporate entity is disregarded by the courts, a very real risk for most smaller companies. In attempting to preserve the sanctity of the corporation as a separate and distinct entity, proper minutes and accounting records must be maintained. Correspondence and contracts with third parties also must clearly establish that it is the corporation, and not the individual, which is conducting the business.

Because of the risk of being named as a defendant in a lawsuit against the corporation, the principal owners, officers, and directors should carefully protect their personal assets from this potential liability. Corporate assets can and should be protected through multiple entities and a variety of asset protection strategies to make the company an unattractive lawsuit target. If permissible, corporate shares must then be held by an entity such as the Family Limited Partnership, Limited Liability Company, or a trust in order to prevent a creditor from seizing the stock.

The corporate format poses a variety of issues regarding financial privacy. Although there are no public records of the shareholders of privately held companies, considerable information is available from insurance and credit applications and government regulatory compliance. Signature authority over corporate assets will also provide an easily discernible trail leading to your door. Gumby's services can be used to act as agent for signing on accounts and corporate documents, but they are notoriously unreliable and present significant dangers from fraud or other malfeasance. In the succeeding chapters, we will see how asset protection techniques can be used to solve many of these problems and to accomplish your important objectives.
