

**SIXTEENTH ANNUAL
SOUTHERN SURETY AND FIDELITY CLAIMS
CONFERENCE**

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**BUSINESS STRUCTURES FROM THE SURETY'S
PERSPECTIVE:**

LOCKING IN INDEMNITY AND COLLECTION RIGHTS

PRESENTED BY:

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OVERVIEW OF ENTITIES

- Proprietorship
- Corporation
 - C Corporation
 - S Corporation
- Partnership
 - General Partnership
 - Limited Partnership
 - Family Limited Partnership
 - Registered Limited Liability Partnership
- Limited Liability Company
- Trusts
- Professional Entities
 - Professional Corporations
 - Professional Associations
 - Professional Limited Liability Companies

EACH ENTITY AND ITS USE

Proprietorship

- Individual ownership and operation of business
- Income and loss reported on Schedule C of Form 1040
- Unlimited liability of Proprietor
- Creditor potentially has recourse to all of Proprietor's assets
- Debtor's protection
 - Community property (Spouse's share may not be subject to certain liabilities)
 - Property partition between spouses (Spouse's share may not be subject to liabilities)
 - Invest in exempt assets (In Texas, homestead, \$30,000 Personal Property, cash value of life insurance and annuities and retirement plans)
 - Contribute assets to trusts for children
- Creditor's Protection
 - Understand in what form proprietor's assets are held
 - Make spouse liable, e.g. guarantee
 - Agreement from proprietor not to transfer assets outside the reach of Surety

C CORPORATION

- Shareholders own the stock and elect directors
- Directors govern in accordance with bylaws and appoint officers who run the day to day business
- Protects Shareholders from liability arising at corporate level (“Inside Out Liability”)
- Creditors of a shareholder could take stock of corporation to satisfy judgment against shareholder
- Debtor’s protection
 - Corporation’s assets are subject to claims of creditors
 - Shareholders not personally liable unless they sign guarantees. Even shareholder/guarantors may find protection by community property, property partitions, investing in exempt property and contributing to trusts
- Creditor’s protection
 - Take steps to make sure debtor is liable
 - Check with Secretary of State to make sure corporation is in good standing and to identify the Board of Directors
 - Require written consent or resolution of the Board of Directors authorizing the liability and/or the signatory to the liability
 - Recourse against corporation’s assets
 - Recourse against unprotected assets of shareholder/ guarantors
 - Understand form in which assets of guarantors are held

S CORPORATION

- Exactly the same as a C Corporation for all state law purposes
- For Federal income tax purposes, it is a flow through entity, i.e. income and loss flow through to the shareholders
 - Shareholders may use losses in start-up years
 - Avoids double taxation, i.e., tax at corporate level on earnings and at shareholder level on dividends
- Useful when business is sold so that only one level of tax is paid on sales proceeds
- Protects Shareholders from “inside out” liability arising at corporate level
- S Corporations are the same as C Corporations for state law purposes
- Debtor’s protections and creditor’s protections are substantially the same as in the case of a C Corporation

GENERAL PARTNERSHIP

- Formed by agreement (written or oral) between two or more partners
- Each partner is liable for all the obligations of the partnership
- Each partner has “apparent authority” to bind the partnership and thus subject other partners to liability
- Because of unlimited liability, a general partnership is not commonly used by individual partners
 - Used if partners are entities
 - Used if partnership business is conducted by other entities such that business liability will not affect the partnership, e.g. a holding partnership
- Debtor Protection
 - Use entities as general partners
 - Take protective action as in sole proprietorship (partition property, invest in exempt assets, transfer in trust)
- Creditor Protection
 - Require resolution of the directors or managers of each general partner entity which authorizes entity as general partner to cause general partnership to incur liability
 - Seek guarantees of owners of general partner entities
 - Understand how guarantors’ assets are held

LIMITED PARTNERSHIP

- Agreement in writing by one or more general partners and one or more limited partners
- General partners have unlimited liability for partnership obligations
- Limited partners are liable only for what they have contributed and what they have agreed to contribute.
- Flow through entity for Federal income tax purposes
- Not currently subject to Texas Franchise Tax
- Debtor Protections
 - Judgment creditors cannot seize a limited partnership interest to satisfy judgment. Creditors can get a charging order entitling them to distributions with respect to the partnership interest, if, as and when made
 - Creditors refer to a limited partnership interest as an “ugly asset”
 - Creditors may never get distributions because payments of the judgment debtor are made in the form of salary or something else
 - Creditor may receive a K-1 subjecting creditor to tax on its allocable share of partnership income (Note: Income without Payment)
 - Used most often with a single purpose entity, usually a corporation or limited liability company, as general partner so there is effectively no unlimited liability
- Creditor Protection
 - Require resolution of the directors or managers of each general partner entity which authorizes entity as general partner to cause general partnership to incur liability
 - Limited Partnership judgment creditor has recourse to partnership assets
 - Seek guarantees from limited partners secured by assets other than limited partnership interests

FAMILY LIMITED PARTNERSHIP

- The so-called Family Limited Partnership or FLP became popular as:
 - An estate planning tool, i.e. to transfer wealth at minimum gift and estate tax costs
 - A method of protecting assets from creditors

- An FLP is another limited partnership for purposes of Texas law but may have additional provisions
 - Additional provisions to prevent creditors from reaching the assets of the partnership (“Spendthrift”)
 - Provisions giving the general partner nearly absolute control over the partnership

- Debtor Protection
 - Same as Limited Partnerships
 - Judgment creditors cannot seize a limited partnership interest to satisfy judgment. Creditors can get a charging order entitling them to distributions with respect to the partnership interest, if, as and when made
 - Creditors refer to a limited partnership interest as an “ugly asset”
 - Creditors may never get distributions because payments of the judgment debtor are made in the form of salary or something else
 - Creditor may receive a K-1 subjecting creditor to tax on its allocable share of partnership income (Note: Income without Payment)
 - Used most often with a single purpose entity, usually a corporation or limited liability company, as general partner so there is effectively no unlimited liability

- Creditor Protection
 - Same as Limited Partnerships
 - Require resolution of the directors or managers of each general partner entity which authorizes entity as general partner to cause general partnership to incur liability
 - Limited Partnership judgment creditor has recourse to partnership assets
 - Seek guarantees from limited partners secured by assets other than limited partnership interests

TRUSTS

- Trusts may be used to protect assets
- The Settlor or Grantor establishes a Trust by transferring money or property to a Trustee to hold for the benefit of a Beneficiary pursuant to the terms of a Trust Agreement
- Very effective protection for the Beneficiary unless
 - Settlor and Beneficiary are the same---as a general rule, if the Settlor has the ability to get to the money so do the creditors
 - Because of the relationship of the parties, and the terms of the Trust Agreement, the trust in substance is another form of entity, e.g. a partnership
 - Spendthrift provisions are either absent or inadequate
- Properly utilized and drafted Trusts are very difficult for creditors to penetrate
- Debtor Protection
 - Well drafted trust agreement
- Creditor Protection
 - Determine if any assets transferred to trust are capable of being reached by creditors
 - Unless trust is a trust in which the Settlor and the Beneficiary are the same, probably difficult to reach trust assets

PROFESSIONAL ENTITIES

- Professionals may protect themselves from certain liabilities, including errors and omissions of other co-owners through the use of
 - Professional Corporations
 - Professional Associations (Physicians must use; others may)
 - Professional Limited Liability Companies

REGISTERED LIMITED LIABILITY PARTNERSHIP

- Designated by the letters “LLP” i.e. X Partnership, LLP
- Either a general partnership or a limited partnership under Texas law may become an LLP by registering and paying an annual fee of \$200 per partner
- An LLP must maintain insurance to cover errors, omissions, negligence, incompetence or malfeasance for which liability is limited (see below), or alternatively post cash, a letter of credit or a bond, in the amount of at least \$100,000
- Benefits of registration as an LLP
 - A partner in an LLP is not individually liable for debts and obligations of the partnership incurred while it is an LLP
 - A partner in an LLP is not individually liable for debts and obligations of the partnership arising from errors, omissions, negligence, incompetence, or malfeasance committed while the partnership is an LLP and in the course of the partnership business by another partner not working under the supervision of the first partner unless the first partner
 - Was directly involved in the specific activity or
 - Had notice of the errors, etc. and failed to act to prevent or cure
- LLP’s typically used by professionals, e.g. law firms, but may be used by others
- Debtor Protections
 - Debtor protected as above as general partnership or limited partnership as the case may be
 - Debtor protected by terms of statute
- Creditor Protections
 - Require resolution of the directors or managers of each general partner entity which authorizes entity as general partner to cause general partnership to incur liability.
 - The limitation of liability of partners of an LLP does not affect the liability of a partner by law or contract independent of the partner’s status as a partner

- Liability may be established by promissory notes, guarantees, etc.