

Why Don't Accountants and Lawyers Say the Same Thing? Accountants, Lawyers and the Elephant in The Room©

By Donald W. Hudspeth of the Law Offices of Donald W. Hudspeth P.C.

In the parable of the Blind Men and the Elephant the blind men each touched different parts of the elephant, so each had a different idea and description of what he had learned. A similar situation may arise in the context of business representation where the lawyer's advice may seem to conflict with the accountant's advice, and vice versa. In my experience this conflict is more one of objective, perspective and focus than a true clash of ideas.

With the lawyer, for example, the business client seeking limited liability and asset protection may very much want and need a limited liability company (LLC), corporation or trust to limit company related claims to the company and not the personal owner(s). To the lawyer a business having an LLC (or corporation, and sometimes a trust) is a no brainer.

But for the accountant, if the owner is the sole owner of the LLC the LLC will be disregarded for tax purposes, so there seems to be no reason to spend the time and money on the LLC and an operating agreement, etc. As for the trust, an asset protection trust is irrevocable and taxed like a corporation, so the trust will typically pay more in taxes than the individual. Tax-wise the client with an asset protection trust may be worse off than before. Thus, the accountant may not recommend it.

In each case, as you can see, the lawyer and accountant are talking "past each other" because each analyzes the cost and benefit of the LLC, corporation or trust in light of their job and objective, from their own point of view and their own criteria of what's important. **A. Personal Liability¹.**

If a creditor has, say, a \$50,000 judgment against the individual(s) doing business personally under the trade name Hog Dog Express it may seize the "company" assets because the company and its owner(s) are one and the same. The creditor can take the, say, \$500 in cash in the Business Owner dba Hot Dog Express bank account. And, it can sell the hot dog cart (which, say, cost \$5,000) for \$500.00. Applying the \$500 in cash and \$500 received for the cart the creditor has received \$1,000 against a \$50,000 debt. After this liquidation of the business assets there will still be a \$49,000 judgment against the individual. And that judgment will stay as a lien of record and a debt owed it is paid, settled, or discharged in bankruptcy.

¹ These points are also made and discussed in my article "Asset Protection and Succession Planning, Examples and Checklist for Business Owner" available at azbuslaw.com/Publications/Articles.

B. The Hot Dog Stand LLC

1. Claim Against the LLC

In contrast to the above, assume that instead of doing business personally as a sole proprietor or partnership the client has a hot dog stand doing business as Hot Dog LLC. This means that a trade creditor or customer buying a hot dog would only have a claim against the LLC, not the LLC owner (i.e. “member.”). Using the above facts, the company LLC, not the business owner member, would owe the \$50,000 to the creditor.

2. Claim Against the LLC Owner.

Assume a creditor has a claim or judgment against an LLC “member” (what the LLC owner is called) on a personal credit card debt. And, assume the member’s assets are held in an LLC. In that case when the creditor attempt to execute the judgment² against member’s assets the creditor can only get a “charging order” against the LLC. A charging order is a right granted by the court to seize distributions made by the LLC to its members.

What is important here is what the charging order does not allow the creditor to do. Unlike the case of execution against corporate stock, in which case the creditor may execute against the shareholder’s stock and in effect become the company owner and pay itself, the creditor of an LLC member can only be paid if and as the member is paid a distribution³, which could be never. This means that if and only if the LLC pays a distribution of net profits to the owner (i.e. member) then the creditor is entitled to claim its portion of that payment. Under a charging order the creditor may get nothing anytime soon because the LLC member(s) may choose not pay themselves distributions and instead take money in other ways. They can pay themselves as Managers or borrow funds from the LLC. Metaphorically, the creditor is outside the company’s “castle walls” rather than inside. This gives the debtor leverage in negotiation because the business owner LLC can tell the creditor “We do not have any personal assets. Thus, there are no assets for you to seize or collect from. We are not required and do not intend to pay distribution to the member(s). If you want money, then you will need to discount the debt or provide terms of payment. (the “No Assets Speech).”

3. The Special Case of Licensed Professionals

Changing the example for the moment, consider a physician who is facing a million-dollar malpractice claim. Assume that the physician has substantial assets but that the assets are held by LLC’s (or asset protection trusts, discussed below). In the face of a claim the physician may give

² The execution of judgment is the act of getting an officer of the court to take possession of the property of a losing party in a lawsuit, called the judgment debtor, on behalf of the winner, called the judgment creditor, sell it and use the proceeds to pay the judgment

³ Generally, payment of profits to the members, who are paid and taxed as partners. Distributions can also be a return of capital.

the No Assets Speech and assert the claim is uncollectable because the physician is “judgment proof.” The claim is against the physician personally but the physician owns few assets personally. All of the assets are in LLC’s or trusts. This greatly limits or prevents completely the claimant’s ability to collect damages against the physician.

C. The Hot Dog Stand Corporation

1. Claim Against the Corporation

Assuming the client has a corporation, instead of an LLC, say, in the name of the Hot Dog Inc. then a trade creditor or customer buying a bad hot dog would only have a claim against the corporation, not the corporation’s owner (i.e. “shareholder”). Using the above facts, the company corporation would owe the \$50,000, not the shareholder.

2. Claim Against the Shareholder Personally.

If the creditor has a claim against the business owner (again, say for personal credit card debt) and the business owner has a corporation instead of an LLC, then by law the creditor can execute its judgment against the debtor-shareholder’s stock to in effect become the owner and use the company income or assets to pay itself. In this case the creditor is “inside the castle walls.” For this reason, all other things being equal, an LLC is better for asset protection than a corporation.

Comment

The LLC is better than a corporation in the defense against personal claims against the business owner. Still for any trade debt, say for hot dog supplies, or personal injury claim, e.g. a bad hot dog, the claim is against the company not the company owner, whether the company is an LLC or corporation. If there is no LLC or corporation, then the claim will be against the sole proprietor or partners individually, who will be personally liable. That is a tragedy because, as you can see from the above examples there is a \$49,000 difference in what the creditor has a

reasonable chance to collect from an individual versus an LLC or corporation. Having an LLC or corporation for asset protection has extreme value.

The public policy underlying this is we want people to start new businesses. This helps themselves, their employees, their vendors, their customers and the economy. But, if the person or family has to risk everything to start a business, there is a good chance they won’t do it. And, that hurts practically everybody.

Going back to the point about the accountant and lawyer focusing their attention on “different sides of the elephant,” almost always the lawyer would recommend incurring the cost of a corporation or LLC and doing other legal work. However, we have had cases where the client had little money and as yet no assets or income to protect. In that case the money might be better spent on equipment, inventory or supplies rather than a legal entity. In this latter case it might make sense for the accountant to advise the client to keep those minimal funds. In any case the rationale

for such advice is understandable. That being said we would advise the client to complete the organizational and operational legal work as soon as possible.

The Asset Protection Trust.

As discussed above in section B (3) on the Special Case of the Licensed Professional, doctors, lawyers, accountants, engineers and other licensed professionals are personally liable for malpractice, i.e. negligence. These professionals may have LLC's, corporations or Sub-S corporations for their practice, e.g. Jones Medical Office LLC. This will protect them from personal liability for *trade* debt. But as the practice negligence is done personally the malpractice claim is against the professional personally. As lawsuits may be for \$1,000,000 +/- the doctor or lawyer is a "sitting duck" for personal injury or malpractice claims.

Except perhaps in extreme circumstances such a fraud, assets in an irrevocable asset trust are not subject to a creditor's seizure and liquidation. The effect of the irrevocable Asset Protection Trust is to allow the professional to accumulate assets for the benefit of the trust beneficiaries, most often (assuming careful drafting) the spouse and children.

The Domestic Asset Protection Trust (D.A.P.T.)

The ultimate asset protection trust is the so-called Domestic Asset Protection Trust aka D.A.P.T. As of this writing 14 states have statutes allowing the creation of the Domestic Asset Protection Trust. Exaggerating, a D.A.P.T. is like an offshore trust in the United States. The particular state statute will say, in effect, "we do not recognize your judgment from another state so you cannot collect it here." Obviously, this is an extremely powerful asset protection device. The doctor, lawyer or other professional may consider the D.A.P.T. a great way to preserve income and assets for the family.

However, again returning to my point about the "different sides of the elephant," the accountant may balk at the \$10,000 to \$20,000 cost for these irrevocable or foreign state trusts as well as the higher level of taxation as a corporation. The D.A.P.T. is taxed at corporate rates. Given the tax is "today" and the legal claim is "tomorrow or never" the accountant may prefer to focus on the present and known savings in expense and taxes. Again, this is a rational approach, whether or not one agrees with it.

Most likely it depends on the cost-benefit ratio of the particular client situation. As 80% is better than nothing paying taxes at a corporate tax rate of, say, 20% is better than having the assets seized and liquidated. A physician with a \$1,000,000 estate and for whom an LLC or corporation provides no malpractice liability protection, \$20,000 may be incredibly reasonable. And, if the professional waits until there is a claim it is too late.

Conclusion

The moral of the story here is not to ignore your accountant or attorney. To the contrary the accountant's or lawyer's advice may be critical for reasons not unlike those stated above. The

objective is to be fully informed. The client should seek full information and advice from the accountant and the lawyer and perhaps a financial adviser. With this information the client can weigh the points of view, as well as the costs and benefits, to make an informed decision. That is the goal of legal representation. It is not the lawyer's (or the accountant's) role to dictate or decide, but to inform and advise. The ultimate decision belongs solely to the client.

My practice and advice to my clients is to render to the accountant what is the accountant's sphere of knowledge and to ask and recommend that the accountant leave the legal work to the attorneys. This optimizes the knowledge and experience provided to the client. In this way "both sides of the elephant" are accounted for and protected.

The Professional's Expertise

As a side note it is not unusual for an accountant to do legal work, e.g. an LLC, and not do or recommend an operating agreement. This can be disastrous in the case of later "partnership" disputes. And, operating agreements are now legally required in Arizona.

Likewise, a lawyer may handle a business asset sale or stock redemption without considering or even being aware of the substantial tax consequences of decisions made. Taxes can be the "tail that wags the dog" in the business sale, so it is critical to have a qualified accountant's professional tax advice in these transactions.

Complicating and amplifying these concerns is the ever-increasing level and pace of knowledge in business and the professions. As a result, it is a challenge for even experienced business persons or professionals to be current on developments in their industry or practice area. It follows then that one has no business tipping their toes into the bailiwick of another profession. That is a recipe for bad client outcomes and possible malpractice.