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# HOW TO AVOID SABOTAGING YOUR LIMITED LIABILITY COMPANY OR S-CORPORATION

By  
**BARRY H. ZIMMER**  
**Zimmer Law Firm**  
**9825 Kenwood Road, Suite 201**  
**Cincinnati, OH 45242**  
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## INTRODUCTION

Limited Liability Companies have become the preferred way to own and operate a small business or to own rental or commercial real estate. Sub-Chapter S Corporations are also still common. There are sound reasons why LLC's and Sub-S Corps are so popular. One is to protect personal assets from liability for claims arising out of operating a business or rental or commercial real estate. Another is to protect business assets from personal lawsuits against the business owner.

A third reason is that the entity can be a "passthrough" tax entity, avoiding double taxation of income to a traditional corporation, known as a C Corp. The income of the entity and the deductions available against that income pass through to the owner(s) and appear on the owner's income tax returns. The entity itself does not pay income taxes. Thus, the owner(s) can get lawsuit protection of a corporation and also avoid double taxation of income (at the company level and the owner's level).

These business entities can be very effective for these goals. But many people unknowingly undermine their LLC's and S Corps and the results can be very costly.

This report discusses the seven most critical errors that can jeopardize or doom the asset protection benefits of your LLC or S Corp. The topics include the top 3 mistakes, failure to isolate sources of liability, choosing the wrong legal entity, forgetting the number one asset protection tool, and failing to understand the goals of asset protection planning. Taxation is not discussed in detail except as it relates to entity selection.

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### 1. Top Mistake #1: Not Finishing the Job

We often see people who own small businesses, residential real estate, commercial real estate, and equipment or vehicles used in business. They say that they own these assets in LLC's or S Corps in case of a claim or lawsuit. But when we examine their paperwork, we learn that the reality of their situation is sometimes different than what they think.

Setting up an LLC begins with filing a form with the Secretary of State. In Ohio, this filing is called the Articles of Organization. Ohio has made this step very easy by setting up the filing to be done online.

Unfortunately, many people start and stop the process with this filing in the mistaken belief that it is all that is needed to create an LLC and get lawsuit protection. This is not surprising in this do-it-yourself world where anyone with a computer or mobile device and a web browser thinks they can handle any legal or business task on their own.

To have a fully effective LLC that provides asset protection, the owner should also create and sign an Operating Agreement that defines all aspects of operations and governance of the entity. Assets must be changed to company ownership, member certificates or other proof of ownership should be created, bank accounts should be set up, a Taxpayer Identification Number should be secured in some cases from the IRS, a tax election should be filed, and usually a number of other steps peculiar to the business or industry should be taken.

Setting up an S Corp is a similar but more complex process. It starts with subscriptions for shares of stock and filing Articles of Incorporation with the Secretary of State, followed by a Shareholders Meeting, election of a Board of Directors, appointment of officers, and multiple other steps. Meetings of Directors and Shareholders must be held every year unless special arrangements are made otherwise to be a “Closely Held Corporation” available for Ohio companies.

If these formalities are not completed, the company is not fully formed — whether it be an S Corp or LLC. This could be a fatal error if there is a future claim or lawsuit.

If your company is sued and the creditor attempts to collect on his court judgment against the company by seizing your personal assets, you may think that the claim stops at the LLC or S Corp. But if you have not completed the formalities of setting up your entity fully and correctly, courts may not allow you to shelter your assets and hide behind the veil of the LLC or S Corp. If you have not respected the business entity set up rules, then you should not expect a court to respect the entity either. Your personal assets will not be protected.

If you have made this mistake, the solution is to promptly complete all steps in setting up your company. Consult a qualified lawyer to be sure that you have not left any details unattended. What you do not know can hurt you later. There is no website or document creation service that can substitute for the wisdom, skills and experience of a lawyer.

If you are just now starting your company, do it the right way from the start. Consulting a qualified lawyer is the most prudent way. Although do-it-yourself forms are available cheaply over the internet, DIY planning is risky and misses the most valuable factor when it comes to asset protection planning – the advice, experience, insight, and support of a qualified lawyer.

## **2. TOP MISTAKE #2: IMPROPER OWNERSHIP OF ASSETS**

This mistake is not as common as mistake number one but it can be fatal. To get LLC or S Corp protection from lawsuits, the business assets you seek to protect must be owned by the company.

For real estate, the title of the property must be changed to the company through a new deed. If there are renters, the lease agreements must be assigned to the company. Ownership of hard assets such as equipment, machinery, and vehicles must be changed to the company. The property and casualty insurance coverage must also be changed.

It is surprising how often people overlook one or more business assets and forget to transfer them to their entitle. If you operate your company while the supposed business assets are still in your personal name, it will be a difficult sales job to convince a court that your personal assets should not be reachable by company creditors, or that a court judgment cannot be collected against your company's assets.

### **3. TOP MISTAKE #3: NOT RUNNING YOUR COMPANY CORRECTLY**

It is a cardinal rule that business expenses are paid from the business and personal expenses of the business owner are paid from the owner's personal accounts -- if you want your LLC or S Corp to protect your personal wealth. If you use your company to pay your personal bills, you are inviting a plaintiff's lawyer to "pierce the veil" that would be available via your S Corp or LLC. That means your personal assets are exposed to loss to satisfy lawsuits against your company, and your company assets are exposed to satisfy lawsuits against you personally. Or even worse -- you could lose control of your company if you are sued personally and the court allows the plaintiff to "pierce the veil". If you mix business and personal expenses in the company's books, you will have a tough job to convince a court that you and your business are separate and not just alter egos of each other.

### **4. FAILURE TO ISOLATE SOURCES OF LIABILITY**

This is another very common mistake best explained by an example. Bill and Mary own and operate a small manufacturing business. They own the building where they operate their plant, delivery trucks, and some expensive machinery critical to their operations.

Bill and Mary created an LLC and transferred the real estate, the equipment, and the vehicles to the entity. They set everything up properly and kept all their business affairs separate from their personal affairs. They followed the rules. A few years later, they were sued by an unhappy customer. They disputed the lawsuit but the customer won a court judgment against their LLC. The plaintiff then proceeded to place a lien against their real estate, and started proceedings to seize their equipment to raise cash to pay their judgment. Next, they filed a foreclosure action on the real estate.

If Bill and Mary had set up four LLC's instead of one, then they would have been in a very different situation. One LLC would have been for ownership of the plant, a second for the equipment, a third for the vehicles, and a fourth would have been the operating entity. This isolation of each component of their business in separate LLC's would have protected each one from claims related to the other. A lawsuit against the operating company would not have put the equipment, vehicles, and real estate at risk. A lawsuit from a collision involving a company truck would likewise not put the operating company, equipment, and real estate at risk. The company would be in a much better position to negotiate a settlement to preclude a lawsuit or to pay a judgment at a reduced amount.

You do not have to be a business owner for this to apply to you. We commonly see people who own multiple investment properties and hold them all in one common LLC or S Corp.

Each piece of real estate should be owned in a separate LLC. That isolates each valuable asset from exposure to claims arising out of another assets, and compartmentalizes your assets.

## **5. CHOOSING THE WRONG LEGAL ENTITY**

Corporations that make a Sub-S Election (S Corps) protect company owners from personal liability for company obligations. That's what is described as "keeping the inside creditors in". Only the assets of the S Corp that is sued will be at risk. Personally owned assets are safe.

What if you own a business that is organized and operates as an S Corp, and you get sued personally for an unrelated matter. Does the entity also keep the "outside creditors out" of the company? Or is your company exposed to risk from plaintiffs who have a court judgment against you personally?

If someone has a court judgment against you on a personal claim, then all your personally owned assets would be at risk to pay that claim. So, if you owned 1000 shares of Procter & Gamble stock, for example, the creditor could use court proceedings to seize that stock and sell it to pay your debt.

Your stock in your small, closely held S Corp business is at risk just like your P&G stock would be. A creditor armed with a court judgment can actually take your shares in your company through court-sanctioned proceedings under the law that allow creditors to get lawsuit judgments paid with the assets of the judgment debtor. If you are the majority or sole shareholder, that could include firing you as an employee, selling your company assets, or dissolving the company to raise cash to pay your debt on the lawsuit judgment. It could mean collecting dividends (profits) from the company in your place.

Thus, there is no outside creditor protection from an S Corp. That makes that entity less attractive than an LLC from an asset protection perspective. But there may be tax related and other concerns that make an S Corp a better fit case to case. Is it necessary to sacrifice outside creditor protection of a business in order to get those S Corp advantages?

The answer is that an LLC is a pass through entity if there is one owner, meaning that income and deductions pass through to the owner's personal 1040 just like a sole proprietorship (a business operated personally and not as an LLC, partnership, or corporation). If there is more than one owner of an LLC it can elect to be treated like it is an S Corp or a general partnership for income tax purposes. This is a relatively easy process done with the IRS. Talk to your CPA about the pros and cons and how to make the election.

This fact is one more reason why LLCs have overtaken S Corps in popularity since the 1980s. You can get all the tax benefits of an S Corp, inside creditor protection, and outside creditor protection through an LLC. There is no other entity that offers all three benefits in Ohio.<sup>1</sup>

## **6. FORGETTING THE NUMBER ONE ASSET PROTECTION TOOL**

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<sup>1</sup> A Limited Liability Partnership in Ohio is a variation on an LLC, and if properly structured can provide inside and outside creditor protection.

Setting up an LLC or S Corp for your business or investment real estate does not mean that you can ignore prudent business practices. A prudent business owner will insure his or her business from all foreseeable risks, and layer on a personal umbrella liability policy for personal assets in addition to auto and home insurance. The S Corp or LLC is still prudent even with insurance in place because not every risk in business is insurable. Plus, claims can exceed policy limits, and policies can unintentionally lapse. Coverage can be denied if there is a question as to whether the loss is within the policy.

If a claim is covered by insurance, then the lawsuit protection of your business entity and all the other issues mentioned above are never called into question. An LLC or S Corp combined with insurance is extra safe.

## **7. FAILING TO UNDERSTAND WHAT ASSET PROTECTION WITH AN LLC/S CORP IS REALLY ABOUT**

Some people believe that if they get personally sued, their LLC owned business or property is totally immune from paying a judgment against them for a lawsuit not related to the LLC. It is true that the assets of the company will be protected from the holder of a legal judgment against the company owner(s). However, the LLC owner(s) will be frozen from the company's property and from cash distributions of profits.

Asset protection planning for business and property owners involves "inside liability claims" and "outside liability claims". Planning for inside liability claims relates to lawsuits arising from the business or property of the LLC. The creditor can only collect against the assets of the entity, not the owner's assets or other business entities. For example, a tenant in an apartment building sues the LLC for sickness caused by lead paint or asbestosis. The plaintiff can only pursue the assets of the LLC, and everything that the LLC owner(s) own outside that LLC is safe from the lawsuit.

An outside liability claim is one where the owner of the company is sued for something that happened that is not related to the LLC. The plaintiff with a court judgment seeks to collect the judgment against the company's assets. The LLC prevents the creditor with a claim against the owner from taking over control or ownership of the business. But the creditor is not without its remedies.

A plaintiff with a court judgment against an LLC will be able to get what is known as a Charging Order against the company from a court. This means that if and when there are distributions of property or money from the company intended for the owner, the plaintiff gets the money or property instead of the owner, until the judgment is fully satisfied, plus interest.

If the LLC does not make the creditor go away, then what is the benefit of having the LLC? If state law applicable to the LLC says that the member interest in an LLC cannot be foreclosed on (which means seized by the plaintiff and/or sold), then the LLC owner can simply operate the company and stop taking distributions of cash or property. The plaintiff would have nothing to take under the Charging Order. This puts the LLC owner in a better position to either prevent a lawsuit from being filed, or to negotiate a significantly reduced payment to settle a judgment or settle a claim before it goes to trial. This is because a lawsuit is only as good as what the plaintiff can collect on a judgment.



What about an S Corp? As described above, the stock in an S Corp is subject to creditor claims against the owner, just like stock held in a public company would be exposed. This is a disadvantage of an S Corp compared to an LLC.

Another failure is to run the business like it is your personal alter ego. It is important to follow the provisions in the company's governing instruments about company operations. For an LLC, that would usually be the Operating Agreement. For an S Corp, that would be the Code of Regulations, Articles of Incorporation, a Close Corporation Agreement, or other shareholder agreements. If you fail to respect and observe the legal formalities that you yourself have set up for your company, the courts will not assert those legal formalities to bar creditors with court judgments.

## **CONCLUSION**

It is critical to planning with an LLC that you create your LLC under the law of a state that clearly, without any doubt or room for interpretation, makes a charging order a creditor's sole remedy on a judgment against an LLC member. Ohio is one of several states that has enacted legislation to this effect.

Know what to expect when you create an LLC or S Corp. Learn your state's law first. Conduct your business in an ethical manner and observe all applicable laws. Asset protection planning should be viewed as a safeguard to protect you and your family from economic disaster as a result of human error, and not as a way to avoid accountability.

Asset protection planning is a good idea for any business owner or rental property owner. When done correctly, it can be effective. But there are traps and landmines for the uninitiated and amateurs in this area. Assistance from a qualified lawyer is the best way to protect your business, your livelihood, your family, and your future.

For help setting up a LLC or S Corp or if you would like us to review your setup give us a call at 513.721.1513 to speak with a member of our legal team about the compassionate and knowledgeable legal representation we can offer. Call now to get started.

*This report is intended for educational purposes only, and is not meant to be a thorough and exhaustive discussion of all relevant planning and legal issues. Do not take action in sole reliance on this report. Consult a qualified lawyer in your state of residence.*

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## **ABOUT THE ZIMMER LAW FIRM**

Zimmer Law Firm, LLC is a charter member of the American Academy of Estate Planning Attorneys. It is the only member firm in Southwestern Ohio. The Firm has been providing quality estate planning services since it was founded in 1993. The fastest growing demand for its services has been asset protection from the cost of long term nursing care. Whether you need an Elder Law attorney, an attorney for general estate planning with trusts or wills, or an attorney to help settle an estate, our team of qualified staff are here to help you and your loved ones.

In these turbulent times, access to an experienced lawyer to protect your estate and accomplish your goals is more important than ever. If you or your family would like a complimentary consultation to discuss your estate plan or how to protect your estate from depletion to pay for long term nursing care, call us today at **513-721-1513** or visit our

website at [www.zimmerlawfirm.com](http://www.zimmerlawfirm.com). Check our website for upcoming seminars, or learn more about the firm at [www.avvo.com](http://www.avvo.com) where you will also find testimonials from our clients. See why *Cincinnati Magazine* recognizes us as a Five Star Wealth Manager. If you would like to receive email announcements for upcoming seminars, call to be added to our seminar mailing list.

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## A MESSAGE FROM THE FIRM FOUNDER



The goals of Zimmer Law Firm are to make asset protection and estate planning pleasant, easy, and understandable processes for clients. We believe that planning is much more than just creating legal documents. Rather it is about establishing relationships with clients and their family by providing a continuum of services through the passages of their lives. What we do makes an important difference and we take great professional pride and satisfaction in that.

If you or your loved ones would like a complimentary consultation to review your estate plan or to implement a plan, visit our website at [www.zimmerlawfirm.com](http://www.zimmerlawfirm.com) or call us today at 513-721-1513 (Toll-Free 1-866-799-4050) to schedule an appointment. See for yourself why *Cincinnati Magazine* has recognized the Firm as a Five Star Wealth Manager. For the latest news about estate planning or upcoming law firm events, subscribe to our blog and “like” us on Facebook. Check

our website for upcoming educational events. We continue to expand our capabilities and services to meet the demands of a complex and changing estate planning world. Our experience has shown us what was a solution yesterday may no longer be adequate to fully protect our clients today.

This report reflects the opinion of the Zimmer Law Firm. It is based on our understanding of state and federal laws and is intended only as a simple overview of the planning issues. We recommend you do not base your own planning on the contents of this report alone. Review your estate planning goals with a qualified estate planning attorney.

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## ABOUT THE ACADEMY

The Academy is a national organization dedicated to promoting excellence in estate planning by providing its exclusive membership of attorneys with up-to-date research on estate and tax planning, educational materials, and other important resources to empower them to provide superior estate planning services. The Academy expects members to have at least 36 hours of legal education each year specifically in estate, tax, probate and/or elder law subjects.. The Academy has also been recognized as a consumer legal source by *Money Magazine* and *Consumer Reports Money Adviser*, and its Education Department has been quoted by other consumer press.

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## HOW TO CONTACT US



9825 Kenwood Road, Suite 201  
Cincinnati, Ohio 45242  
(513) 721-1513  
(513) 287-8623 Fax  
Toll-Free 1-866-799-4050  
[www.zimmerlawfirm.com](http://www.zimmerlawfirm.com)  
[info@zimmerlawfirm.com](mailto:info@zimmerlawfirm.com)