

JOHN CUNNINGHAM'S LLC NEWSLETTER FOR TAX AND FINANCIAL PROFESSIONALS

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HOW CAN YOUR CLIENTS PROTECT THEIR INVENTORY FROM CREDITORS?

Dear Colleagues:

At this time of year, most tax professionals are deep into tax, and I suspect the last thing you want from a newsletter like this is yet more tax.

So let me share with you in this newsletter a nontax idea – namely, a business law-based method for protecting inventory. You, in turn, may wish to pass this idea on after tax season to those of your clients who, whether as wholesalers or retailers, make their living by sales of inventory. Some of these clients may be very grateful for your words.

By way of background:

Many of us have clients who own businesses that must maintain substantial inventory. If the products that such a client carries in inventory are capable of causing injury and if such an injury occurs, the client's business is likely to be sued, and among the more valuable assets that the business may lose in the suit is its entire inventory. This loss alone could destroy the client's business and foreclose any hope the client may have of starting another business.

EXAMPLE: XYZ Distribution Company, Inc. is a single-shareholder New Hampshire corporation. It is located in Concord, New Hampshire. Its shareholder is John Doe. XYZ sells auto parts at retail. As a requirement for supplier discounts and to meet customer needs, XYZ must carry a comprehensive parts inventory, whose average daily wholesale value is \$500,000. To avoid bank interest and other disadvantages, XYZ self-finances its inventory; but to do so, it must maintain substantial cash.

Needless to say, many types of auto parts routinely sold by XYZ – e.g., brake linings and even batteries - are of such a nature that if they were to malfunction, XYZ could be the subject of a major product liability suit. There is, of course, a good chance that the outcome of the suit would be a judgment against the manufacturer of the part in question, not XYZ. However, you never know what a jury will do. And an adverse judgment against XYZ could, among other things, result in XYZ's losing its entire inventory in a sheriff's sale.

What can John Doe do to protect XYZ's inventory?

As is so often the case in the world of business asset protection, the short answer is that Doe should conduct his business not, as now, through a single entity, but rather, through two entities.

- One entity will be the current XYZ. However, XYZ will now no longer function as a seller, but rather, as a financing company, and Doe will change XYZ's name to XYZ Financing, Inc.
- Doe's second entity will be a newly formed single-member LLC – to be named “XYZ Distribution, LLC” – whose sole member will be XYZ Finance. Under the default rules of the IRS's Check-the-Box Regulations, XYZ Distribution will be a “disregarded entity;” that is, for tax purposes the IRS will deem XYZ Distribution not to exist, and its income will be taxable only to its parent. However, for financial and legal purposes, XYZ Distribution will exist as fully as any other business entity, including XYZ Financing itself.

Once this new structure is in place, here's what will happen:

- 1) XYZ Financing will sell its current inventory to XYZ Distribution under a promissory note.
- 2) XYZ will finance any additional inventory that XYZ may ever need under a revolving demand note.
- 3) XYZ Financing and XYZ Distribution will sign a security agreement. The key provision of the security agreement will be one that provides that the collateral for the above promissory note and revolving demand note will be all of XYZ Distribution's assets. This collateral will include XYZ Distribution's inventory, its cash on hand, its equipment and everything else that isn't subject to a bank lien or other third-party claim.
- 4) Finally, XYZ Financing will file a “financing statement” – also known as a “UCC-1” – with the New Hampshire Secretary of State. The New Hampshire filing fee will be \$10, and the filing will be effective for five years. Filing costs will be minimal: Doe can do the filing in person at 125 Capitol Street or, if he's made the proper financial arrangements, online. The effect of the filing will be to give XYZ a first position in the above collateral as against all other creditors, including any plaintiff who gets a judgment against XYZ Distribution as a result of a product liability suit. Filing costs will be minimal

The above financing arrangements and UCC filing arrangements will provide John Doe with a very strong wall of protection of his inventory against creditors. In effect, these arrangements will turn New Hampshire debtor-creditor law from a potential enemy of John Doe to a friend.

And, as I've already noted, the structuring and implementation of the arrangements will cost Doe only the most modest expenditure of time and government fees and, depending

on the lawyers and accountants he uses, total professional fees that, depending on the specific facts, should be at most several hundred dollars.

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