Protecting Your Retirement

by Bryant H. Byrnes

Contractors who have spent years trying to make money often fail to think about how they will protect their assets once it's time to sell or close down the business. But this decision has important legal ramifications, and your goal should be to do it in the cleanest possible manner.

While there are several ways to leave a business, the most common is to simply close the doors or transfer it to someone else, usually by sale. Many of the issues involved in closing a business are routine, like paying taxes and notifying customers. You'll need to close out accounts with vendors and formally terminate your licenses and leases. Don't assume that licenses will lapse on their own: Some states will come after you for past-due registration fees.

Reducing Long-Term Liability

Just as it takes planning to protect your assets while you're in business, the same is true once the business is closed or sold. Here in California, there's a particularly high hurdle to clear — a 10-year statute of limitations for latent construction defects. A contractor's clients and their successors have up to 10 years to sue GCs for latent defects, which are most frequently related to water intrusion. The periods of legal exposure are shorter for other kinds of complaints, but typically a contractor can be sued for breach of contract or breach of warranty for up to four years after completion of the project.

As an attorney, I am concerned less about the exact defect than about the fact that my clients are at risk for 10 years, even after they retire or sell the business. There are similar liability laws in other states. The precise rules vary by state, and different types of liability are subject to different statutes of limitations, but typically a builder is exposed to liability for between three and six years after a project's completion.

In some cases, the clock does not start ticking until the defect is discovered. Contractors are frequently subject to a different set of rules than other businesses, so to be certain, check with a local attorney who specializes in construction law.

Sole owner vs. corporation. How to best protect yourself when you close or sell depends on the kind of business entity you have — sole proprietorship, partnership, corporation, or limited liability company (LLC). Most of my clients have sole proprietorships or corporations, so I'll stick to those in this article.

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Closing Down a Sole Proprietorship

The sole proprietor typically faces the most difficult — and expensive — choices. One possibility is to "self-insure," which is another way of saying to cross your fingers and hope for the best. If problems arise with past

construction projects, you'll have to either make the repairs, pay someone else to make them, or pay the clients if they prevail against you in a lawsuit. In some circumstances, you could be forced to pay the attorney fees for both sides. Considering all the things that can go wrong on a construction project, I would never recommend that a sole proprietor self-insure. If things go truly wrong, all your personal assets will be at risk.

Tail insurance. One way to protect yourself is by purchasing a "tail policy" from your insurance company if one is available. Tail coverage protects you against claims stemming from projects completed in the past. It's expensive, but if you've done a steady volume of work, the rates should fall as the clock winds down on the projects covered. A tail policy needs to run for as long as the statute of limitations, and will usually cover only liability related to construction defects; it will not cover breach of warranty or breach of contract.

Semiretirement an option. Another possibility would be to maintain your current liability policy. This could be a good strategy for a couple of reasons. First, in some states, defect litigation has made tail policies hard to get. Also, as an insurance broker recently told me, most contractors never really retire: Keeping your policy in place while doing occasional jobs as a "semiretired" builder can be an attractive option.

Selling a Sole Proprietorship

Skipping the practical problem of finding a buyer, if you do sell you can create an agreement that apportions risk for claims. It's common practice for a buyer to accept the business "as is," including liability for past actions. This isn't as strange as it sounds: In many cases, the buyer is a longtime employee who is in a position to know the quality of past work.

Indemnification. The sales contract will typically contain an indemnity clause, a negotiated agreement about who will pay for problems that arise on past projects. Because it's negotiated, the party with the most leverage tends to get the best protection. If the seller is calling the shots, the sale will probably be "as is" and he will be indemnified by the buyer. If the buyer is calling the shots, it will be the other way around.

Insurance also plays a role. There is less risk if the company being sold has always been covered by a liability policy. If the existing policy remains in place during the ownership change, that too will mitigate risk. It would be up to the insurance broker to decide whether to cover the company once it changes hands.

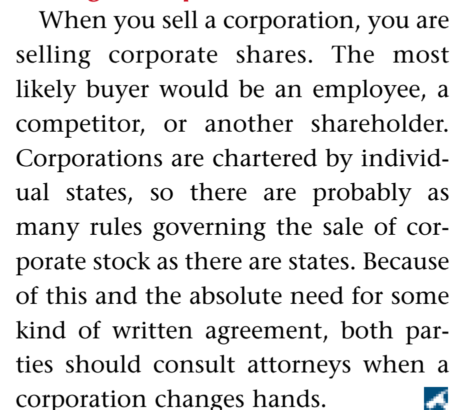
Closing Down a Corporation

Contractors who incorporate usually do so to protect their personal noncorporate assets during the time they are in business. If the shareholders dissolve the corporation when they shut down the business, they place themselves in the same boat as the sole proprietor. The corporation will no longer shield them from liability. Thus, unless the new owners purchase a tail policy, they will have to self-insure.

It's perhaps better for the shareholders to keep the corporation going until all the statutes of limitations or potential claims against them have expired. The shareholders would continue to file their yearly paperwork with the state and pay the required yearly fee. The corporation would have no income, so only the minimum tax would be due. Here in California, the annual tax is $800 — a lot less than a tail policy, and a small price to pay to protect your assets. Additionally, the shareholders could opt for the "belt and suspenders" approach and add a tail policy, too.

Selling a Corporation

When you sell a corporation, you are selling corporate shares. The most likely buyer would be an employee, a competitor, or another shareholder. Corporations are chartered by individual states, so there are probably as many rules governing the sale of corporate stock as there are states. Because of this and the absolute need for some kind of written agreement, both parties should consult attorneys when a corporation changes hands.



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