



Five Asset Protection Planning Strategies for Professionals and Their Clients

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Two clients, a husband and wife, sit nervously in my office as we meet to discuss the lawsuit naming them and their company as defendants. The clients are the owners of a successful contracting business and they have two children just entering college. They have been referred to me for an asset protection review by the attorney handling the litigation and they are obviously very worried.

Their pending lawsuit is demanding over \$1.8 million in damages as a result of an alleged breach of contract and neither the legal defense nor the damages would be covered by insurance. With a net worth of approximately \$1.5 million, a jury verdict for the \$1,800,000 would bankrupt both them and the business they have worked years to build.

Even worse, a preliminary review of their asset structure reveals that ALL of their assets could be subject to pay the judgment, should the worst happen and they end up losing the lawsuit.

The husband and wife are desperate to know what, if any, asset protection strategies could be employed to help them avoid losing all of their assets. Their biggest fear is that because they have never addressed the need to protect their assets it is too late to put a protection plan in place.

Fortunately, there *are* strategies available to the couple to protect some of their assets. It is *not* too late, but obviously adopting Asset Protection Planning strategies *prior* to the lawsuit might have saved them lots of needless worry and aggravation. While this situation is only an example, it is representative of the types of cases we are involved with.

The following discussion addresses five strategies that may be used to protect a client's assets from lawsuits, creditors and the IRS. Some of these strategies are specific in scope and nature while others offer a general framework for developing an effective Asset Protection Plan. Together they sample approaches that avoid some of the most common errors in asset protection planning.

1. Make Asset Protection Planning an Integral Part of the Retirement, Estate and Business Planning Process

Ideally your estate planning and business advisors should have a general background in debtor/creditor law, particularly as it relates to exemption planning (governing what assets creditors cannot seize) and the overall business and personal activities that result in creditor exposure. Specifically there are four planning areas where asset protection should be - and usually is not - taken into consideration.

- **Asset Protection Planning in the Estate Planning Process.**

Many clients are surprised when we inform them that their estate plan provides little, if any, protection from the claims of creditors. As an example, any significant gifts made during your lifetime, or in your will, should raise the question of whether the recipient will be able to correctly handle the funds received. Significant consideration should be given to the recipient's potential creditors, including divorce and child support claims. Is the

beneficiary well suited to handle investment and spending decisions, and will the beneficiary be subject to pressure from a spouse or other individual to place the assets into joint names, to make gifts that they might not otherwise want to make, or to make high risk investments or loans?

Most people will simply pay out certain percentages to beneficiaries at specified ages. Quite often, when they are made aware of the asset protection benefits of trusts, they change the distribution provision. After the change in the distribution pattern, the funds are held in trust for the life of the beneficiary and the beneficiary may become co-trustee at a certain age, co-trustee with their choice of any licensed trust company or some other similar arrangement.

How many people can look their advisors in the eye and say there is no potential divorce, creditor, or mismanagement situation that could ever apply to their beneficiaries?

- **Asset Protection Planning in the Business Environment.**

Other clients believe that their business structure, set up by a prior advisor, protected their personal assets and other business assets from the claims of creditors. You must understand that there are ways to own assets to protect them from creditors, and that the law *does* allow an individual to arrange his assets so as to insulate them from creditors. Also, you must limit the exposure of a particular activity solely to the assets involved with that particular activity. The most common example involves using a corporation engaged in a high risk activity and keeping only minimal assets within that corporation.

- **Asset Protection Planning for Medicaid Planning.**

Many people still believe that assets in a trust used for estate planning purposes will not be counted in the eligibility for Medicaid and that they will qualify for Medicaid. For the elderly client, such a misunderstanding can become disastrous for both them and their family. Funds, that supposedly were shielded from Medicaid attachment, are instead, completely depleted for health care costs.

- **Asset Protection Planning for Retirement Savings.**

Most people are not aware that assets in an Individual Retirement Account (“IRA”) or Simplified Employee Pension (“SEP”) can be taken to satisfy the claims of creditors. They are not aware that steps can be taken to protect these assets and keep them away from the claims of creditors.

2. Think “Outside the Box” and Don’t Rule Out Potentially Effective Strategies Due To Legal Considerations

We are all taught that fraud is a terrible and actionable thing, and many times a criminal act as well. We have also been told that transferring assets for the purpose of avoiding creditors can be a “fraudulent transfer.”

What we are not told is that a “fraudulent transfer” does not constitute a fraud in the normal criminal or civil sense, notwithstanding the name. The transfer of assets to avoid a creditor’s claim is not considered to be a civil violation or a crime. Under most fraudulent transfer statutes, the sole remedy of a creditor is the ability to reach where the assets were transferred and have access to them to the extent permitted under state law.

The fraudulent transfer statutes generally do not have any attorney's fee provision, and thus the making of a fraudulent transfer is not necessarily a high risk endeavor. Even if you lose, all you have done is make the creditor fight harder to take your assets.

Further, the burden of proof is generally on the creditor to prove that a fraudulent transfer was made. Creditors can have a hard time satisfying this burden where, at the time of a transfer, the debtor's situation was such that in all probability a particular claim, or risk of claim would be resolved by insurance policies, other parties who are more responsible than the defendant, or by the debtor retaining sufficient assets to satisfy the reasonably expected obligations of the claim. In many cases there are business and tax reasons for making transfers.

Sometimes clients are advised by over cautious consultants who fear treading into the dangerous waters of criminal liability. While it's always wise to be cautious, only a person who has been informed of these options can make a well-educated and proper decision on how to proceed.

3. Consider a Diverse Array of Protection Strategies

A good many asset protection practitioners are typically pitching one or two mechanisms. Certainly from a satisfaction and closure standpoint, it appears easier to make one or two mechanisms seem to be the right solution for just about every problem. Typically, these practitioners recommend the use of limited partnerships and limited liability companies. But there are a number of potential problems inherent with this type of strategy.

First, you need to understand that having a "charging order" against your limited partnership or limited liability company can effectively prohibit you from receiving any economic benefit from the partnership without sharing with the creditor. A "charging order" is the interest a creditor obtains when he enforces a judgment against a debtor's interest in a limited partnership or limited liability company. In a "charging order" situation, the creditor steps into the shoes of the owner of the limited liability company or limited partnership owner.

In this instance you, as the debtor may have to rely upon a court to allow you to obtain economic benefits such as compensation for services rendered from the partnership. Further, while most creditors can probably be bought out of charging orders for pennies on the dollar, this will not always be the case and you need to know it.

Given the availability of other forms of asset protection planning such as life insurance, annuities, pensions, limited partnerships, limited liability companies, tenancy by the entirety, placing assets in a non-risk spouse's name, domestic and international asset protection trusts, asset leveraging and gifting, most are well advised to use a variety of planning methods and vehicles simultaneously.

For every complicated situation there is a simple answer and it is usually the *wrong* answer. In contrast, complicated situations will often be successfully resolved only by complicated solutions.

4. Maintain a Positive Approach to Negotiation

Clients will sometimes come to our office several months after a claim has been filed against them, with significant assets totally exposed. When asked why the clients have not transferred the assets to an exempt status, they will often indicate that they consulted with another lawyer who told them that asset protection strategies might *not* work.

Their prior counsel, being the perfectionist that so many have been trained to be, may have thought there

was only a 5% or 10% chance that a strategy might not work, as opposed to a 90% to 95% chance that the strategy would work, and that the assets would be saved. If you are the client, which course of action would you embrace?

The fact is, that from a negotiation standpoint, the client has a much better chance of settling the matter if he can look into the eye of the plaintiff or the plaintiff's lawyer and suggest "go ahead and spend all your time and money pursuing me in court, I'm judgment proof anyway."

At that point most plaintiff lawyers are going to recommend to their clients that they accept available insurances or a nuisance value settlement. The plaintiff's lawyer usually will not be so bold as to ask "when did you become insolvent and will I be able to set it aside?" The natural answer to that, however, would be "that's for me to know and you to find out and good luck ever touching my assets."

5. Look for Creative Solutions to Planning Challenges

The use of basic creativity often involves brainstorming with other professionals, investigating alternative strategies that at first may not seem useful -- review of estate planning and business considerations or alternatives -- and sometimes "making things complicated" so that they would not be easily understood by a plaintiff attorney, are time consuming and require dedication to detail.

For example, what can be done with S corporation stock? It needs to be owned by an individual or a qualifying grantor trust to retain the S election, and a foreign grantor trust will not qualify as an S corporation shareholder. S corporation stock can also be owned by a defective grantor trust, but a gratuitous transfer of that stock may be considered to be a fraudulent transfer.

Such stock could be sold at arm's length in exchange for a long term promissory note and a creditor is going to be less than excited about receiving a long term promissory note. A promissory note can be sold at arm's length at a later time, perhaps taking into account a discount. If the client has a shorter than normal life expectancy, the receipt of a private annuity as consideration under this type of arrangement can have a further positive estate tax planning result. Also S corporation stock can be made to be non-voting, and selling a 1% voting interest in S corporation stock to a trusted third party can yield positive estate tax planning results.

Conclusion

It is obvious from the above that there are a great many decisions that have to be made and strategies that could be considered in Asset Protection Planning. Obviously, many planners, given the same factual scenario, would implement significantly different plans. Whose decision should it be as to whether a client will pursue offshore asset protection, get married and place assets as tenants by the entireties, ignore a situation, or file a Chapter 7 bankruptcy before a judgment is even entered against him?

It is never too late to take a pro-active and creative approach to Asset Protection Planning. As I review the circumstances of the husband and wife who sit before me following their lawsuit, I am able to suggest several courses of action that will help to minimize their risk and assuage their fears.

Their referring lawyer indicated that while the husband and wife had indeed breached the contract, the damages they are liable for are probably around \$800,000 to \$1 million, *not* the \$1.8 million demanded in the complaint. Moreover, there is less than a 30% chance that a judgment would be entered against the clients individually as shareholders.

The settlement value has been set at \$750,000 by the clients and their counsel, with legal fees anticipated to cost \$100,000. Although the prospects are certainly far from rosy for my clients, there is no doubt that they also won't be as disastrous as the couple had at first feared.

By applying some of the strategies described above we may be able to preserve a substantial portion of the assets they worked a lifetime to accumulate. In the end, that's what Asset Protection Planning is all about!

Disclosure and Reliance

The material contained in this document is for informational purposes only and is of a general nature. Your situation may be different and, therefore, you cannot rely on the information contained in this document as legal advice!