The Prevent Defense

The first of two articles on the need for asset protection plans for your professional clients.

By Roccy DeFrancesco

IF YOU ARE ONE OF THE GROWING number of planners who are trying to be full-service consultants (versus someone who just sells stocks or life insurance), then learning about asset protection is an absolute must. Why? Because your high net worth clients cannot have their estate or financial plans in order unless they are also asset protected.

For many professionals—especially physicians, attorneys, and CPAs—a big concern is the threat they face from runaway malpractice and errors and omissions claims or jury verdicts that could be potentially devastating to their personal wealth. By developing an expertise in asset protection planning, a financial adviser can stand out in the local marketplace from other advisers. This new arrow in your quiver can help you show increased value to your current clients, as well as attract new ones.

I can't cover everything you need to know in a single article—in fact, this is the first of a two-part series on the topic. But I will introduce the main concepts and options for asset protection.

First, understand most professionals see the question of, "Should I get asset protected?" as more of a rhetorical question than a normal query looking for a response. But they do need asset protection, whether they know it or not, because they can be sued personally for acts that are performed in the course of business, like treating patients, drafting contracts, or preparing tax returns.

In reality, chances are slim that something bad will happen to them, and even slimmer that they will be successfully sued for massive damages. For many people with wealth, however, even the slightest chance for personal ruin means that they need to protect their assets.

Doctors in particular have the most exposure, given the often-risky nature of their work and the litigation climate. Depending on what publication you read, you will see statistics like one out of every four physicians will be sued this year, or six out of 10 doctors have been sued at least once during their careers. Statistics can be misleading, but they show physicians do get sued a lot.

According to a survey by *Jury Verdict Research* in 1994, the median award for compensatory damages in medical malpractice lawsuits was $362,500. By 2000, it was $1 million, and that number keeps going higher. If a physician screws up in a malpractice case, that once-in-a-lifetime mistake can result in a multi-million dollar verdict. If the doctor has only $1 million in coverage, the excess exposure directly hits personal assets.

The obvious claims against physicians for medical malpractice aren't all they have to worry about. Professionals and other wealthy clients who have significant assets also are exposed to regular negligence claims that can be brought against the general public. (See "When Accidents Hit Home" on page 74.)

You can start educating your clients by having them list all their assets on a piece of paper. They are often surprised at how much needs to be protected. The following are good candidates:

- Family home or condominium;
- Vacation or second homes;
- Rental property;
- IRAs;
- Stocks and mutual funds;
- Life insurance;
- Bank accounts and CDs;
- Cars, boats, planes;
- Wave runners or motorcycles;
- Business entities (especially S- or C-corporation stock);
- Valuable collectible items;
- Other personal real property of finacial value;
- Future inheritance for family; and
- Accounts receivable in a physician's medical practice.

In general, asset protection is about putting up as many barriers as possible in front of creditors to make it more difficult for them to get to these personal assets. Asset protection is *not* about hiding or concealing those assets or about committing fraud to conceal assets from creditors. Good asset protection discourages lawsuits to the point where a client can bluntly state to a personal injury attorney that millions of dollars in assets are legally protected and, if the client is sued, out of reach.

How can good asset protection prevent lawsuits? The technical answer is that it can't, of course. Any lawyer with a client can sue someone for almost any reason. Most lawyers research the defendant before taking a case, however. If they find out the defendant has little insurance coverage or tightly protected assets, they probably will think twice before agreeing to take the case. To put it simply, plaintiffs' attorneys will not waste time suing for million-dollar damages if there's little to recover.

When they are correctly set up, asset protection plans use existing laws and are completely legal in the eyes of the U.S. government (and foreign governments if offshore planning is needed). Reasonable minds may differ on determining what is the best asset protection plan for a client. But reasonable minds shouldn't differ when it comes to determining whether the asset protection plan options are, in fact, legal. Be careful if you hear an asset protection planner or attorney talking about going offshore to "hide" assets.

What you will hear about more frequently are cases of fraudulent transfers. *Asset Protection News* once gave the following definition: "In lay terms, a fraudulent transfer is a transfer of an asset (or incurring an obligation) with the actual intent to hinder, delay, or defeat a creditor's claim (actual fraud), or, regardless of intent, making a transfer while insolvent or one which renders the transferor insolvent (constructive fraud)."

Actual intent can be proven in two ways. The first is by the transferor's own statements, such as, "I knew Mr. X was going to sue me, so I gave the brokerage account to my wife;" more commonly, the second is by a review of the other factors surrounding the transfer.

Over the years, the court cases in this area have identified a list of several factors, sometimes referred to as "badges of fraud," which may be taken into consideration in determining a transferor's intent. These factors include, among others, being sued or threatened with suit before the transfer; removing and concealing assets; concealing the transfer; transferring substantially all of the debtor's assets; and whether the transferor was insolvent at the time of the transfer or became insolvent shortly after the transfer was made.

A classic example would be if a doctor amputated the wrong leg of a patient and the next day transferred all assets offshore to an asset protection trust. In other words, the doctor knew about an impending lawsuit and then transferred assets to protect them. This is a case of actual fraud, which would be fairly easy to prove. This example gives the client rule number one when thinking about asset protection planning: Do not wait.

It is more likely that a fraud will be more subtle or difficult to prove. These instances include tactics like selling an asset for less than its fair market value or selling when a claim for damages against the seller is known. I don't have the room here to explain constructive fraud more completely; if you would like more information, please e-mail me.

There are two main defenses to use in cases of fraudulent transfers claims. One is when the transferor of property can prove the transfer was made for a legitimate business purpose. The other is when he or she can prove the transfer was made before the liability occurred.

There are also some existing laws that can help protect client assets, but they vary by state and by type of asset. The homestead exemption is a statutory right to protect "homestead property" (typically the personal residence). The amount of the homestead exemption in each state ranges widely. States such as Rhode Island, Delaware, New Jersey, Pennsylvania, and the District of

When Accidents Hit Home

Any client who owns a home, has teenage children, owns a boat or an automobile, or has a vacation rental property is liable to have a claim some day for traditional negligence. Here are some examples.

Homeowner. As a homeowner, you typically will throw a few parties each year for your friends. If you serve alcohol at those parties and one of your guests leaves the party after drinking too much and gets into a car accident and kills the passengers (or turns them into quadriplegics), guess who is going to get sued for negligence? The homeowner. Most people think that an umbrella liability policy of $1 million will protect them. But if you can be linked to a death or serious injury via negligence, your umbrella is not going to stretch very far. After your insurance pays $1 million of the $3 million verdict, the attorney for the plaintiff is going to go after your personal assets.

Teenage children. If you have teenage children, chances are you will go out of town on occasion. While you're gone, your children whom you left home (the 16-19 year-olds) may have a party or have friends over. Since statistics say that more than half of teenagers drink on a regular basis (many times binge drinking), chances are good that there will be alcohol at the party at your house. If your children are the ones who procured the alcohol (and maybe even if they did not), and the attendees at the party get drunk and then drive around and get hurt or hurt others, guess who is going to be sued? The parents. Again, the $1 million umbrella with your homeowner's policy is not going to go very far to protect you.

Boat or automobile. Both have liability and the potential to cause significant injuries to others. I have clients that go so far as to put the car their children drive into an LLC to protect the rest of the family's estate.

Vacation rental. If your clients own a condo or house as a vacation home and rent it out, they have liabilities to worry about that are more problematic than just owning a home. An owner of a rental property has a duty to keep that property in good enough physical shape to prevent injuries to tenants and their guests. As a landlord, clients need to worry about lighting of the stairwell, shoveling snow, handrails, and a whole host of other issues that can cause liability claims for negligence if someone is injured.—*RD*

Columbia have no homestead exemptions. Other states like Oklahoma, Iowa, Texas, Florida, and Kansas have unlimited homestead exemptions.

Advisers who don't understand how asset protection really works typically talk about the homestead exemption as a nice asset protection tool. But unless you live in a state like Florida or Texas, the homestead exemption is not one that a client should rely on to protect his or her personal residence.

Similarly, state laws are all over the map in how they protect life insurance and annuities. In many states, they are specifically protected from creditors; others offer no protection. Florida and Texas give an unlimited exemption to life insurance policies that have cash value in them, while most other states provide limited protection to either the cash value and/or the death benefit.

Many life insurance agents beat the asset protection drum loudly to scare their clients into buying life insurance. I'd say that about half of all doctors in Florida and Texas have been pitched life insurance (or annuities) as an asset protection tool. While the asset may be protected, clients would be better off financially by putting their money into stocks or mutual funds and protecting them with a family limited partnership (FLP) or offshore trust.

Retirement plans are another area with different protection standards. In 1990, the U.S. Supreme Court made it clear that any creditor (outside of bankruptcy) couldn't touch ERISA-qualified plan assets. In 1992, the Court noted that an ERISA-qualified plan also was not subject to bankruptcy.

Instead of wading through the definition of an ERISA-qualified plan, I'll simply list the ones that are protected: 401(k) plans, profit sharing plans, money purchase plans, defined benefit plans, and 412(i) defined benefit plans. Keogh plans and SEP-IRAs are not ERISA-qualified plans, so they do not get blanket protection from creditors.

Many clients and advisers think that IRAs are asset protected by federal law. This is not true. Each state has determined what, if any, asset protection is afforded to IRAs, and only 26 states protect them fully. Since an IRA might be the biggest asset in a client's estate, it is vitally important to make sure that the asset is well protected.

If your clients live in a state where IRAs are not specifically protected, the options for where to move IRA money depend on their employment status. If a client is employed and the company has an ERISA-governed plan, the client should roll over his or her IRA into the ERISA plan at work. If the client is not employed and has substantial assets in an IRA, one solution is to create a family limited partnership (FLP), where he or she becomes an employee of the FLP and manages it. The FLP can then create a profit sharing plan (an ERISA plan) and roll the IRA assets into that new plan, where they will be protected.

Finally, the form of asset ownership can also be critical in choosing the best protection strategy. The optimal choice is to own property as "tenants by the entirety." *Barron's Dictionary of Legal Terms* defines this type of ownership as follows: "Ownership of property, real or personal, tangible or intangible, by a husband and wife together. Neither the husband nor wife is allowed to alienate any part of the property to be held without (the) consent of the other. The survivor of the marriage is entitled to the whole property. A divorce severs the tenancies by the entirety, and it usually creates a tenancy in common."

The main advantage to tenants by the entirety is that if one spouse is sued, the property (usually only the marital home) is not subject to creditors. But this still does not protect property from joint creditors of the spouses, like the IRS or state government. If a client lives in a state that doesn't provide tenants by the entirety ownership, an FLP or a limited liability corporation might be the best way to protect the marital home.

As a side note, nine states are community property states: Arizona, California, Indiana, Louisiana, Nebraska, New Mexico, Texas, Washington, and Wisconsin. Here, each spouse's interest in the community property is subject to the claims of the other spouse's creditors—meaning all community property assets are at risk.

Other types of co-ownership include joint tenancies and tenants in common. I don't have the space to explain these types of tenancies, but you should know that neither one is a good way to own property for asset protection.

In the second part of this series next month, I will discuss the pros and cons of using corporations as asset protection tools as well as briefly cover offshore planning strategies. **FP**

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Planning Your Own Protection

There's one other compelling reason to learn about asset protection, besides the benefit for clients. You may need it for yourself. Like other professionals, financial advisers can have personal liability related to their professional conduct.

The term "professional" is often used to refer to an occupation that requires extensive academic training. Generally speaking, advisers can be considered "professionals" if they have had extensive formal training or must be licensed or certified by a governmental or private entity before providing services. All advisers with Series 6 or 7 licenses, a life insurance license, a CFP or CLU designation, or an RIA have to worry about lawsuits against them personally for negligence.

I would go so far as to say that a personal injury attorney looking to sue a broker or insurance agent would be committing malpractice if the attorney did not sue the adviser personally. I should know: I used to work as a personal injury attorney for a firm that specialized in professional negligence. Now I'm on the other side of the fence as an asset protection specialist to help high-net-worth clients and their advisers.—*RD*