February 2010

Estate Planning Series

ASSET PROTECTION STRATEGIES

In today's ever changing economic environment, everyone who owns a business or a professional practice or has investment real property is subject to the risks of a lawsuit that may threaten his/her personal assets. Even people who do not own a business in normal day-to-day activities can be subject to liabilities through lawsuits or being guarantors or co-maker of a loan for a friend or relative. It is therefore important as part of your estate plan to implement asset protection strategies to help minimize or reduce those liability risks. This article discusses the risks you face and strategies to consider to minimize or reduce those risks.

I. Background

The Risk of a Lawsuit

The reality of our legal system is that people are named as defendants in lawsuits not because of their degree of fault but because of their ability to pay. When an attorney is approached by a potential client who is claiming injury or economic loss, the attorney will consider whether a theory of liability can be developed against a party who can pay a judgment. This is called the search for the "Deep Pocket Defendant." The Deep Pocket Defendant will have either substantial insurance coverage, significant personal assets or both.

When a lawyer threatens to sue you, he knows that the outcome of the case will be uncertain regardless of the merit of the case. He knows that if you have reachable and collectible assets, the risk of loss will cause you extreme worry and stress. Finally, he knows that if you choose to fight the case, you will need to expend a great deal of time, your privacy will be violated and your resources will be depleted or exhausted by tens or hundreds of thousands of dollars in legal fees and costs.

If you have available and easily reachable assets, a plaintiff's lawyer obtains leverage in settlement of litigation and/or litigation. They know that you are vulnerable for that amount. If you have fewer available and easily reachable assets, you have peace of mind knowing that your assets are either not reachable or are much more difficult to reach. You also regain part of the leverage in a settlement or litigation.

Reduce Your Lawsuit Exposure

Some of the most troublesome sources of liability can be significantly reduced through solid business and risk planning.

II. Business and Personal Planning to Avoid Liability

Set forth below is a summary of what to avoid and what to do in your business and personal planning.

- **Avoid General Partnerships**

  You should never enter into a general partnership for a business. These types of partnerships can produce liabilities for you which are totally unexpected and not your fault. As a co-general partner you are responsible for all partnership debts and any negligent acts of your partners. A business partnership expands the scope of your personal liability when you should be trying to limit your risks.

  If you cannot limit your personal exposure to claims, it is best to use a strategy that utilizes separate entities, such as a limited liability company ("LLC"), or corporation, or a trust, which will protect the assets themselves. That way, even though you may be sued—it will be less worthwhile for the plaintiff to continue the suit.

- **Avoid Giving a Personal Guarantee**

  Much of the protection which can be accomplished with an LLC or a corporation will be lost if you give a personal guarantee of a corporate or LLC obligation. Many of the problems are caused directly by needless guarantees for corporate loans and leases for business ventures which were not successful.

- **Use Multiple Entities**

  When you have more than one type of business or income producing asset, you should use different entities to conduct each facet of the business or income producing asset. The goal is to insulate each separate business from liabilities produced by the other activities, or liabilities against you personally.

- **Personal Residence**

  If one spouse has greater exposure to liabilities and claims than the other spouse, as part of the overall estate plan, consideration should be given to transfer the residence to the spouse with the least exposure.

- **Real Estate Holdings**

  If you own several significant real estate properties, it is generally best to use different entities to hold each one. If there is a lawsuit in connection with one of the properties, the others will not be endangered.

- **Separate Safe Assets from Dangerous Assets**

  As a general principle, the ownership of Dangerous Assets, those with a high risk of producing liability, should always be separated from Safe Assets, such as cash or securities. The strategy is that these Safe Assets should not be jeopardized by a liability associated with your business or other Dangerous Assets, which you own.

- **Insurance**

  Maintain a significant umbrella insurance policy to cover liability claims, relating to your home, automobile, rental properties, etc. Make sure all your properties are properly disclosed to your liability insurance carrier.

- **Developing and Implementing an Asset Protection Plan in Advance of Litigation**

  An asset protection plan must be created in advance of any claim or threatened litigation. New Jersey, as well as every other state, has laws prohibiting the transfer of assets to avoid paying existing or anticipated claims. If you make a transfer when you know or have reason to believe that there may be a lawsuit against you, the other party has the right to set aside the plan. It is therefore imperative that you address your asset protection needs before difficulties arise in order to accomplish the best results.

III. Different Entities and Vehicles, Which May Be Used

A. Limited Liability Companies

The LLC has become a powerful tool for accomplishing many asset protection and estate planning goals. The LLC is generally the most versatile and convenient strategy for owning rental property, insulating Dangerous Assets or Safe Assets, and operating a business. It also is an excellent means to implement a gifting program to children and grandchildren and maintain financial privacy.

The LLC provides the protection from liability of a corporation without the formalities of corporate minutes, bylaws, directors, and shareholders. The owners are permitted to adopt flexible rules regarding the administration and operation of the business. For tax purposes, it is generally treated like a partnership. That means the LLC itself pays no income tax and all of the income and deductions flow through directly to the members on their personal tax returns.

The advantages of an LLC can be summarized as follows (For professional practices, however, see additional restrictions, below):

- **Insider Protection Liability** – A member of an LLC is not responsible for claims or judgments against the LLC.
- **Outside Liability Protection** - Property held in an LLC generally cannot be seized by a creditor of a member. If there is a judgment or claim against the member, the creditor generally cannot reach the property held in the LLC. Generally, a creditor with a judgment against a member of the LLC is limited to a charging order - only permitting the creditor to take whatever actual cash distributions are made by the LLC to the

member without being able to force a distribution or demand any portion of the assets of the LLC.

- **Limited Formalities** -An LLC is not required to maintain formal minutes and resolutions. Unlike a corporation, record keeping requirements can be minimized without a threat that the members will be sued individually through a "piercing the corporate veil" theory of liabilities.
- **Series LLC** – For more sophisticated planning a series LLC can be formed to create different tiers of ownership within a single LLC.

B. Use Trusts for Advanced Plans

Trusts can be designed to complement and enhance your asset protection, estate plan-ning, tax savings, and privacy goals. A trust will provide rules governing a beneficiary's access to the funds, placed in the trust, which is different from the principal function of an LLC, to own a business or particular asset. Trusts may also be used in conjunction with an LLC to complement the LLC by holding an individual's membership interest. The following is a summary several trust options available.

- **Limited Term Trust:** Property can be placed in trust for a designated term of years and for a designated purpose, such as the support or educational needs of a child or other family member. Assets placed in the trust can also be protected from potential claims during the period of the greatest risk.
- **Life Insurance Trust:** Insurance is used to provide adequate funds for family living expenses to meet business liquidity needs and pay estate taxes without a loss of accumulated savings. To achieve these goals, a Life Insurance Trust is established to own life insurance policies, so the proceeds are not subject to estate taxes.
- **Estate Freeze Trust:** Investments that are likely to appreciate in value, or which have recently significantly decreased in value, can be moved into the Estate Freeze Trust. Real estate, stocks, and ownership in a new business venture are often used to fund these trusts. Amounts up to the gift tax exemption amount can be transferred without gift tax. This amount plus anticipated future increases in value can escape estate taxation and be shielded from lawsuits with the proper planning.
- **Personal Residence Trust:** Your largest source of savings may be the equity in your home, a second home or a vacation home. A loss would be disastrous from an emotional as well as a financial standpoint. In the right situation, the Personal Residence Trust is an excellent technique for accomplishing asset protection without losing the unique tax advantages of home ownership.
- **The Domestic Asset Protection Trust (DAPT):** This is a trust that is available in one of the several states, such as Delaware, Alaska, South Dakota, or Nevada, that have favorable anti-creditor trust acts (i.e. trusts that allow you to establish for yourself, which provides protection for your assets).

IV. Professional Practices

If you own a Physician professional practice you own a **Dangerous Asset**. Every patient or customer represents a potential liability—threatening your personal savings.

The bad news for physicians and other professionals, however, is that while many state laws generally allows you to practice as an LLC or professional corporation, it does not allow your practice or you to be shielded from professional liability. The LLC, however, is useful in protecting accumulated assets from lawsuits of a nonprofessional nature and limiting the personal liability of one professional from the professional liability of another professional who is not under his/her direct supervision and control.

The best strategy is to carefully construct and implement an asset protection plan as part of your over all estate plan. We routinely structure integrated estate plans to maximize asset protection plans, and work with you, your accountant and other advisors in implementing the plan.

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