

HOW TO PROTECT WHAT YOU OWN
FROM LAWSUITS AND CLAIMS



ASSET PROTECTION

*for Physicians and
High-Risk Business Owners*

ROBERT J. MINTZ, ESQ.

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(800) 223-4291

www.rjmintz.com

rjmlawoffice@yahoo.com

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INTRODUCTION

A great deal has changed since the first edition of this book almost ten years ago. In addition to the dramatic economic impact of the credit crisis and the crash of the real estate market, there have been many changes in the law that have a major impact on asset protection planning. Although we have communicated these changes through our Web site (www.rjmintz.com) and newsletters, the book, in its physical form, necessarily lagged behind. This revised edition is our chance to catch up with our presentation to you of all the latest legal developments as well as our most recent experiences with our clients in the real world of lawyers, judges, and courtrooms.

I first began to focus my law practice on asset protection issues about twenty years ago. A client came to our office with an unusual request. He was the owner of a business which manufactured medical equipment for doctors and hospitals. He had accumulated a substantial net worth and wanted to know how he could make sure that if something went wrong in his business, he would not lose everything he had put together over the years.

Since his business was doing well at the time, I asked him about his particular concerns and he began to list an unnerving variety of potential dangers. He felt that, as a successful business owner, he was a visible and attractive target for lawsuits from employees, competitors, business associates, and government agencies. He was concerned about the effect of a downturn in business and had personally guaranteed leases and lines of credit. He wanted to know how to protect himself.

Up until that time I had never focused specifically on the problem of protecting assets from business risks. Most of my clients were business owners and real estate developers whose financial concerns were limited to doing deals, making money, and saving taxes. I had never

given much thought to the question of evaluating risk and protecting assets in a dangerous business world.

As I discussed it with my law partner and as it has evolved over the years, we can now see that an effective asset protection strategy involves two steps. To begin with, to the greatest extent possible, our goal is to have our clients avoid the legal mistakes that lead to lawsuits in the first place. That's our primary goal and to accomplish that it means digging into exactly those issues that our first asset protection client had raised with us. What are the legal and financial consequences if things go wrong? What happens if there is a downturn in the economy or if a lender calls in a line of credit or if partners split up? How should we organize business and financial matters, so that if something unexpected happens, the client is prepared for the consequences and won't lose everything he has? The first part of any asset protection plan is to accurately assess the legal risks faced by a client in order to isolate and minimize those risks with the most appropriate business plan.

The second part of the planning is making sure that if a client is sued, despite these precautions, his or her personal and business assets are protected to the greatest extent possible. Our objective is always to create a plan that will insulate valuable assets and minimize the risk of loss from potential liability. What we have seen, over the years, is that the point of good legal planning is to allow our clients to operate their businesses or conduct their professional practices without placing everything they own in legal jeopardy. As an added bonus, our experience is that a successful asset protection plan by itself helps eliminate the threat of most lawsuits by extinguishing the claimant's economic incentive to sue. If a potential adversary knows that nothing is available for collection—even with a judgment—it is foolhardy and irrational to willingly incur the uncertainty and expense of litigation. Those are the goals of what an asset protection plan should accomplish.

These particular issues, as we framed them, are certainly not new considerations in the legal field. To the contrary, the elements of asset protection planning have a long and deeply rooted foundation in our laws. Business entities, now familiar to us as corporations, were central to the growth of commerce during the industrial revolution.

INTRODUCTION

Wealthy investors sensibly refused to expose their accumulated wealth to business risks and to undertake large scale finance and industrial projects without a guarantee of protection against personal liability. One by one, state legislatures enacted modern corporate laws with the key feature of *limited liability*, specifically to limit investors' potential losses to the amount of their investment in the business. Early in our economic development it was recognized that permitting business owners and investors to define and limit their financial risk is an essential prerequisite to expanding investment and economic development. More modern vehicles such as Limited Partnerships, Limited Liability Companies, and trusts are also intended to offer protection from personal liability in a wider variety of circumstances.

Asset protection planning is the specific area of the law that addresses many of the most important concerns of business owners and investors. What legal risks and dangers are presented by any particular set of business and personal circumstances? What are the best ways to organize business operations and investment holdings to minimize liability and lawsuit risks? What steps can be taken to make sure that accumulated wealth and future earnings are insulated and shielded against potential loss? These are the questions that we are addressing in this book.

Much of the material in this book is supplemented by our Web site. To preserve the narrative of the book, some topics are abbreviated with the expanded discussion moved to the Web site. At some point, the digital form of the book will permit us to add updates with new cases, articles, and comments directly into the text. In the meantime, for topics which are of particular interest to you, we recommend that you check the Web site for our newest additions.

As a word of caution, this book cannot substitute for detailed and personal legal advice. Our treatment of the law is general and is not intended as a comprehensive discussion of all relevant issues. The law in each state will vary to some extent, and the applicability of the law will depend upon your individual circumstances. If you have a particular question about the information in this book, you can telephone us at (760) 728-4748, and we will try our best to help you. Our Web site is www.rjmintz.com, and our e-mail is rjmlawoffice@yahoo.com.



PART ONE

THE LAWSUIT PROBLEM

CHAPTER ONE

SEARCHING FOR THE DEEP POCKET DEFENDANT

THE LITIGATION EXPLOSION

It has been estimated that 50,000 lawsuits are filed in this country every day of the week. This has come to be known as the “litigation explosion.” Whatever the causes—a breakdown of traditional values, the loss of a sense of community, too many hungry lawyers, wasteful insurance companies—the impact on each of us is significant.

When patients sue doctors, the cost of healthcare rises. To compensate for product liability claims, manufacturers add a premium to the price of their products. Litigation cripples business. It is time consuming, expensive, and emotionally charged. It detracts from our ability to focus on productive matters, as attention is directed away from matters of efficiency and innovation. Parties to a lawsuit spend so much time meeting with lawyers and fighting with the other side that nothing gets accomplished. As businesses are dragged under by the burdens of litigation, our whole society suffers.

If you are engaged in any business activity or if you have a professional practice, chances are that sooner or later you will be sued. And if you are sued, everything that you have worked hard to create will be placed in jeopardy. The costs of defending even a frivolous suit can easily reach \$50,000 to \$100,000. Once you get to court, you will find that the system is heavily weighted toward the sympathetic plaintiff, as judges and juries play Robin Hood with your money. These judges and juries are continually expanding theories of liability, and stratospheric damage and punitive damage awards are now routine. It is no longer uncommon for awards in negligence cases to exceed \$1 million.

Our legal system should hold people responsible for their acts. If someone causes injury, that person should be required to fairly compensate the victim for his or her loss. Not many people would seriously object to this principle. The problem is that this general principle bears no relationship to what is actually occurring in the legal system today.

The Ability to Pay

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 substantial insurance coverage or significant personal assets. The measure of an attorney’s skill is his ability to create a theory of liability which will connect a Deep Pocket Defendant to the facts of a particular case.

Here is an example of what might happen in a particular case. Mr. Wilson is driving in his car. Mr. Fineman runs through a stop sign at an intersection, smashing into Wilson’s car and causing Wilson severe injury.

From his hospital bed, Wilson Googles “local attorneys” and calls the first attorney he sees, Alan Abel. He is what is known as a “contingent fee” lawyer. He works for a percentage of the ultimate recovery and determines whether to invest his time and money in a case based

upon what his expected return will be. Since the time and expense of preparing for litigation can be considerable, an attorney cannot afford to take a case that is not likely to pay off. Remember—*no recovery, no fee*. Usually the attorney advances all costs and expenses, and in exchange, he recovers these costs plus 30 percent to 40 percent of any amounts that he can get from the defendant.

Before Abel decides to take Wilson's case, he will want to do some serious research to determine the merits of the case. Not the legal merits—the financial ones. He will want to know whether Fineman has substantial assets in order to make the case worthwhile.

Abel runs a financial search and determines that Fineman has no insurance and no significant assets such as a home or a retirement nest egg. What happens? Is that the end of the case? As for Fineman, it probably is the end of the case. Abel is not going to waste his time suing someone who can't pay. But Abel is not going to give up so easily. He has a client with substantial injuries and that means a large damage award—big bucks. But first he has to find someone who can pay.

Here is how a successful lawyer would analyze the case to try to draw in a Deep Pocket Defendant:

1. Was Fineman on an errand for his employer at the time of the crash? If so, the employer can be sued.
2. Did Fineman have any alcohol in his system? The restaurant that served him may have liability.
3. Was Fineman on any medication? The pharmacist, drug company, or physician may have potential liability for failure to provide proper warnings, or for writing or filling the prescription improperly.
4. The stop sign Fineman ran through was in a residential neighborhood in front of someone's house. Did the homeowner properly maintain his property and clear his foliage to provide an unobstructed view of the stop sign? If not, there is a case against the homeowner for negligence.

5. Did the municipality take due care in the placement of the stop sign? Should it have used a traffic light instead? There may be a case against the city or county.
6. The driver's side door of Wilson's car collapsed on impact. There is a possible case against the manufacturer for not making a more crash resistant frame.

Do you see how far we are moving away from Fineman—the person responsible for the accident—in an effort to tie in a remote Deep Pocket Defendant? In any rational legal system, Fineman would be regarded as the wrongdoer—he disobeyed the traffic law and he caused the injury. Instead, we have an attorney trying to force the blame onto someone else—who wasn't at the scene and doesn't even know the people involved.

The example that we just gave you is taken from a real case. Guess who ended up as the defendant.

In the actual case, the defendant was Fineman's ninety-two-year-old widowed great-aunt Ellen. As it turned out, she had purchased the car for Fineman as a gift to him. Abel's private investigator searched the assets of Fineman's relatives and found that Aunt Ellen had a house that she owned and some savings in the bank. She was named as the defendant in the case and was found liable on a theory called Negligent Entrustment. The jury found that she should not have bought the car for him. She should have known that he was a careless driver and might cause an accident. *She caused the accident by buying him the car.* The verdict was for \$932,000, and Aunt Ellen lost nearly everything she owned.

The point of all this is that the foundation of every lawsuit is a defendant who can pay. Once such a defendant is located, it is easy enough to construct a theory of why that defendant should be responsible. Judges and juries often act on their emotions—not on the law. And when the contest is between an injured or a sympathetic plaintiff and a wealthy or *comparatively* wealthy defendant, the plaintiff will win virtually every time, regardless of the defendant's actual degree of fault.

As a result, the plaintiff's attorney will search for a party who can pay a hefty judgment. In the old days, it was said that "*He who has the gold makes the rules.*" Now the saying goes: "*He who has the gold pays the plaintiff.*" The fact is that no matter how remote your connection to an injury, if you have even modest assets, an attorney for the injured party will attempt to show that you are somehow legally at fault and you will be named as a defendant in the case.

Not Enough Good Cases to Go Around

It used to be that people thought of deep pockets as a bank, insurance company, or other big company with billions of dollars to pay claims. Unfortunately, that's no longer the case. There are nearly 1 million lawyers now, and each year another 100,000 come out of law school and set up a practice. There are not enough good cases to go around.

A good case involves a serious injury with clear negligence by a company with significant assets or insurance. The problem for the lawyers is that most of the good cases go to a relatively small group of established trial lawyers with a history of multimillion-dollar verdicts.

This makes sense. If you are seriously injured by an Exxon-Mobil gasoline truck crashing into your house, you want the best trial lawyer you can find. You want a lawyer who has won large jury awards. The ability to argue successfully and convince a judge or jury of the merits of a claim is a unique and specialized talent. Few attorneys possess these skills, and those who do often earn millions of dollars each year. Since all contingency fee attorneys charge the same one third or 40 percent of the award, why not hire the best trial lawyer in the country? It doesn't cost you any more.

And if your case is a good one, any attorney would love to work for you. You can get the top trial lawyer in the country to handle your case, and he won't charge you a penny more than your niece's brother-in-law who has never been inside a courtroom. This is democracy in action. The poorest of the poor can hire the richest and smartest trial lawyer in the nation to fight for his rights. All it takes is serious injury or death and a defendant with deep pockets.

THE LEGAL EXTORTION RACKET

What are the rest of the lawyers going to do? What about the other 95 percent of trial lawyers who are not so great and not such good lawyers? How is a lawyer who is not at the top going to feed his family? His chances of getting your case against Exxon-Mobil are about the same as hitting the lottery. Many of my close friends are personal injury attorneys. They think and dream about the one good case that will earn them enough to be on easy street. But the one good case never seems to come. Instead, most lawyers make a living by looking for somebody to sue and filing bad cases with bad facts. As long as a lawyer can find a potential defendant with even modest assets, he will attempt to make his case. If he doesn't have a good case, he has to go with what he has. That's how he makes a living.

The lawyer is willing to gamble that by filing a case he will be able to squeeze a settlement or play "lawsuit roulette" with the jury. Just like the population in general, from whom they are drawn, jurors can be confused and misled by emotional and irrational arguments. Experiments in human behavior show that most of the time individuals are unable to distinguish the truth from a lie. When asked to distinguish truthful from untruthful testimony based upon the demeanor and expression of the witness, in a majority of cases, the subjects in the experiment incorrectly identified the lie as the truth and the truth as the lie. The conclusion of the study has frightening implications. *Jurors are more likely to believe a witness who is lying than one who is telling the truth.*

This phenomenon has been understood and exploited for years by political leaders and others with a message to sell. A lie that is repeated forcefully and with conviction becomes accepted as truth. Think of the Nazi propagandists and the McCarthy type demagogues who convinced millions of people of the "truth" of their cause. More recently, public hysteria over so called "death panels" illustrates the relative ease with which fear and irrationality can be heightened and manipulated by skilled politicians to influence the outcome of the public agenda. *Advertising messages repeated often enough are believed, regardless of the merits of the product and despite overwhelming evidence to the contrary.*

That's the foundation of the advertising industry and is the basis on which political leaders and corporate interests present their programs.

In the same manner, a lawyer attempts to “sell” his case to the jury. Facts are distorted. Lies, half-truths, and perjured testimony are zealously advanced on behalf of the “injured” plaintiff. If things go right and the lawyer gets lucky or knows what he is doing, the jury will reward these efforts with a judgment for several hundred thousand or maybe a few million dollars. *Every day in court a sympathetic plaintiff prevails against a wealthy or comparatively wealthy defendant— even in those cases which appear to be absurd, illogical, and utterly without merit.*

Any lawyer who is still in business after a few years of practice has learned that the unpredictability of human behavior can be used to his advantage. The uncertainty of the outcome creates a potential risk of loss for even the most “innocent” defendant. Lawyers know that for most people the risk of financial loss also creates a highly uncomfortable level of emotional strain. If you have ever been sued—no matter what the cause—you understand that the unpredictability of the result and the possibility of economic loss can generate a severe degree of stress and emotional charge.

The Appeal of Settling

When a lawyer threatens to sue you, he is exploiting all of these facts about human nature. 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, your time and your privacy will be violated and your resources will be depleted or exhausted by tens or hundreds of thousands of dollars in needless legal fees and costs. Doesn't settling the case sound much more appealing and logical?

Settling *is* more appealing, and that is exactly what you should do. As unfair as it sounds, if you fight the case, you may well lose. You will certainly spend much more money and time, and you may never recover from the emotional toll, the damage to your personal relationships, and the impact on your business.

If you have available and reachable assets, which can be uncovered in an investigation, then the lawyers hold the leverage. They know that you are vulnerable, and you are better off settling the case. They want some easy money from you, and then they will move on to the next case. That's how the legal extortion racket works.

The Easy Cases Are Gone

Over the past decade, as the number of lawyers and lawsuits have increased, the insurance companies have adopted a policy of not settling cases. In the past, insurance companies routinely settled virtually every claim for a multiple of the injured party's medical expenses. A slip and fall or auto accident case was worth approximately six times the amount of the medical expenses incurred by the client.

When an individual went to an attorney claiming injury from an accident, the attorney would send the client to a cooperative doctor for extensive medical care and therapy. The doctors (and chiropractors) billed wildly for every imaginable treatment and procedure—almost all of which was unnecessary and was performed solely to inflate the amount of the medical bill. The physician would get paid out of the proceeds of the eventual settlement. The lawyer had a nice fat medical bill—multiplied by six under the standard formula—which he could then present to the insurance company. The insurance company paid the inflated claim then raised the rates on all its policyholders to cover these costs.

At least several generations of personal injury attorneys have made handsome livings by playing this game. But unfortunately for them, in most states, this game is over. Starting in the early 1990s, many insurance companies adopted a policy of no settlement. When the attorneys offered up the medical expenses, the claims adjusters were required by their companies to reject the claim. The policy was to litigate every claim all the way to trial.

It was understood that this strategy would be more expensive in the short run as the companies incurred huge legal bills fighting even the smallest claim. The upside was that the personal injury lawyers, deprived of their bread and butter fast settlements, would be driven out of business as their cash flow disappeared. Most attorneys can't wait

two, three, or five years to get paid. And they certainly don't want to shell out all of the costs of bringing a case to trial, including depositions, expert witnesses, and discovery. Even worse is that after putting up all the money and going to trial, the case could be lost. Years of hard work and lots of money down the drain. That result means financial disaster and one more overeducated short order cook.

The insurance companies were like a pack of big goofy elephants. They had no idea that they had the power to step on and crush their lawyer adversaries. Once they decided to use their great strength—virtually unlimited capital—they were successful beyond their expectations. Lawyers stopped taking the “slip and falls,” the bogus auto accidents, or any other insurance case without a big potential payoff. The insurance companies were the big winners. The lawyers, their incomes and lifestyles seriously impaired, looked around for new groups to target—an easier and softer prey not so willing and able to fight back.

The New Deep Pockets

The new targets or the new Deep Pockets are those who have saved up some money for retirement, those who operate a successful business, and those who own a home or have some rental property with any equity. This number is a lot less now than it used to be. Real estate and stock markets have crashed. Many have lost their jobs and their businesses. Those who have survived are vulnerable because their savings are now even more valuable to them. The estimates are that there are more than 100 million adults in the population, and 30 million have mutual funds, savings, and a few even have some equity in their home. That's 30 million people with something valuable to lose.

The Finemans of the world don't get sued, and they don't have to spend their time, energy, and money defending a case. They don't get sued because they don't have any money or anything worth taking. Aunt Ellen, who bought him the car as a gift, got sued because she had some money. *She* was the one who lost her home and all of her savings because *she* was the Deep Pocket. A lawyer's job is to tie a party who has some money into a case so that he will get paid. A successful lawyer is one who can create a clever new theory of liability so that someone

with money or insurance will be found legally responsible. Even if our common sense tells us that this Deep Pocket had nothing whatsoever to do with the injury, a judge or jury or court of appeals will decide a case based upon their own view of what is fair and rational.

A doctor prescribed antihistamines for a patient with an allergy. The patient ignored the warning label about driving while taking the medication and caused a serious auto accident. The patient had little insurance and few assets, so the doctor was sued. The plaintiff's lawyer successfully argued that the doctor *should have known* that the patient might drive his car while on the medication. The jury found the doctor liable for \$6.2 million in compensatory damages. The doctor's malpractice insurance didn't pay a nickel of the claim since the policy only covered claims by a *patient*—not those injured by a patient.

Was the doctor really at fault here? He lost everything he owned, and he didn't do anything wrong. The mistake he made was not realizing that as a physician, and as someone who had a home and some savings, he was an inviting and vulnerable target for a lawsuit.

ORAL CONTRACTS: AN ABYSS FOR DEEP POCKETS

A contract is formed any time two people make an agreement to do, or not to do something. Certain types of contracts, involving commercial transactions, must be in writing in order to be valid. But most contracts do not have to be written.

A promise that you make is considered to be a contract if the other party relies on your promise. Recently, we have seen girlfriends and boyfriends claim that they were promised certain things by their former mates. These alleged promises called for lifetime care and support or a specific dollar amount to be paid at the end of the relationship. Since, by its nature, an oral agreement has no visible trail, these cases come down to one person's word against the other.

One interesting case involved the ownership of a California lottery ticket. George and Sarah lived together but weren't married. He was eighty-five years old, and she took care of him. They kept some spare change and a few dollars in a coffee can in the kitchen. Sarah would take out a dollar every few days to buy a lottery ticket. Over the years,

there were a few winning tickets worth \$20 or \$100, and she would put those winnings back into the coffee can to finance future tickets.

One day they hit the grand prize of \$12 million—twenty annual payments of \$600,000, less taxes. Soon after the celebration was over, human nature being what it is, George claimed that the money in the coffee can was really his money and he was the sole owner of the ticket. Sarah, shocked and hurt, claimed they had always treated the coffee can money as joint property and that she was justifiably entitled to half of the winnings. Both sides hired lawyers, and George refused to settle the case.

The case went to trial in San Diego, and the jury found for George. They believed his story that the money to buy the ticket belonged to him and that there was no legal agreement between them to share the winnings. George got to keep it all.

We certainly do not know who was telling the truth, and that's exactly the point. Nobody ever knows for sure who is telling the truth in these situations. That's why anyone with whom you are involved, in any kind of business or personal relationship, can claim that you broke a promise and that they are entitled to some amount of compensation.

An employee can claim that you promised him a job for life. Let's say that you own a medical practice and you decide that the work of Dr. Jones, a physician who works for you, is no longer satisfactory. If you fire Jones, there is an excellent chance that he will sue you. In the lawsuit, he will claim that he is entitled to a percentage of ownership in your practice based upon an oral agreement which you made. That is all he needs to do. He doesn't need any other evidence. He simply claims that you made certain promises about sharing the practice with him. Now you have to defend yourself and risk losing a portion of your business. It is now your word against his, and the jury can decide who they believe. These types of claims are made every day in our courts, and many employers end up making huge settlements with the fired employee in order to avoid the expense of litigation and the risk of loss.

A Japanese chip manufacturer in the Silicon Valley closed down its plant and laid off all the workers. The company was sued by all 868 workers for more than \$1 billion on the grounds that they were

promised lifetime employment. The case was ultimately settled for more than \$20 million after millions of dollars in legal fees and thousands of hours of wasted time and energy.

Claims of a contract based upon an oral agreement are numerous and difficult to defend against. I have three cases in my office right now where the plaintiff is claiming a legal interest in the client's business based on alleged promises to share ownership. These claims are powerful and effective because they are easy to fabricate, expensive to defend, and may involve millions of dollars.

NEGLIGENCE

Looking for Someone to Blame

In addition to liability for contracts, individuals and businesses face potential lawsuits for negligence. You will be considered to be negligent if a party is injured or his property is damaged because of your failure to exercise reasonable care. This is known as direct negligence. You may also be sued when you are legally responsible for the wrongful acts of others, such as a child or an employee. This type of liability is known as imputed negligence.

Direct Negligence

Direct negligence is exemplified by hitting someone while driving your car in an unsafe manner. The death of a patient due to a physician's diagnosis which falls short of the advice of the hypothetical "common physician" is another example of direct negligence. An attorney's advice to his client which is based upon a faulty understanding of the law or which falls short of the legal standard of proper investigation and diligence is also a matter of direct negligence. In other words, if, in the conduct of your business, you act in a way that is less than the minimum standard of performance the law requires for your job, then you are guilty of negligence and you will be liable for all foreseeable consequences of your careless acts.

Negligence can occur because of your *failure to act* as well as your improper acts. Failing to move to the side of the road when you hear an ambulance coming up behind you is negligent. A physician's failure

to prescribe a recognized treatment is negligent, as is the attorney's failure to advise a client of the law relevant to a particular situation.

Imputed Negligence

In certain situations, you may be held liable for an injury even if you are not directly at fault. Imputed negligence means that the law will hold you responsible for the negligence of someone else. A negligent act by an employee, conducted in the scope of his employment, will be imputed to the employer. If you ask your secretary to pick up some sandwiches for lunch, she is acting within the scope of her employment when she drives to the deli. If she is at fault in an automobile accident, her negligence is imputed to you. You are responsible for the damages caused by her acts.

Expanded Theories

In recent years, courts, state legislators, and clever trial attorneys have dramatically expanded traditional theories of negligence. As stated, negligence means a failure to exercise the proper degree of care. The question is *what is the proper degree of care?* How careful must we be? (See article "More and Better Patient Information" in chapter 10.)

In an iconic case, the rock group Black Sabbath was sued by the parents of a teenage boy who committed suicide. The parents claimed that the boy had been encouraged to commit the act by listening to certain lyrics on a record album. Although it was ultimately determined that the group was not liable for the boy's death, the case did make it all the way through trial. The members of the group sat through countless hours of depositions and testimony and surely spent several hundred thousand dollars in legal fees. All of this time and money were wasted because an attorney for the boy's parents attempted to connect a remote Deep Pocket Defendant to the case in order to obtain compensation for this unfortunate, but blameless event.

Take this example. Meticulous Max noticed that the brakes on his car were not working properly. Feeling the car was unsafe to drive, on Monday, Max made an appointment for his mechanic to pick up the vehicle in a tow truck on Wednesday. Late Monday night the

car was stolen. As the thief was driving away in the car, the brakes failed and he crashed into another vehicle. The person driving the other car, Bob Brown, was injured in the accident. Bob sued Max alleging that Max was negligent in failing to properly maintain his automobile. The plaintiff argued that because of the high incidence of stolen cars, Max “should have” reasonably foreseen that his car might be stolen, and, if stolen, the faulty brakes would likely cause injury to someone. On this theory, Bob was successful and was awarded \$325,000 by the jury. Clearly, Max thought he was exercising due care by not driving his car and by arranging for an appointment to have the brakes fixed. However, the jury expanded the concept of “due care,” ruling that Max acted improperly by agreeing to wait two days to have his car repaired.

This leaves us with a legally required standard of behavior that cannot be ascertained in advance. (And with which most people in Max’s town would disagree.) We know we have to be careful, but we do not know what that means. It is impossible to anticipate what standard a jury will impose with the advantage of hindsight. That is the problem.

REMOVING THE INCENTIVE TO SUE YOU

The first goal of a sound financial plan is to protect your personal and business assets from potential lawsuits and claims. We will discuss this in great detail in later chapters. For now, keep in mind that assets such as your home, your bank accounts, and your brokerage accounts can be moved into a properly designed plan. Someone wanting to see what you have will not find assets reachable and available.

Since the lawyer for a potential plaintiff will usually only sue you if he knows there are assets and he knows he will get paid, it is extremely unlikely that any lawyer would be willing to file a case against you. You can successfully discourage lawsuits by holding your property in a protected manner, without revealing to the world what you own and how much you have. That’s the first important objective that you can accomplish. The importance of these asset protection strategies will be emphasized as we present this material.

**Liability Even When the Patient
Ignores the Doctor's Orders**

The show *60 Minutes* reported the almost unbelievable tale of a psychiatrist and his former patient. The patient, a law student, had been acting unusually. He was referred to the student health service where the staff psychiatrist evaluated him. Over the course of several meetings, the psychiatrist diagnosed the patient as suffering from paranoid schizophrenia and prescribed anti-psychotic medication. The patient showed signs of improvement. The psychiatrist subsequently retired and instructed the patient to continue treatment with his successor on the psychiatry staff at the clinic. Eight months after last seeing the psychiatrist, and having never seen the successor, the patient stopped taking his anti-psychotic medication. His condition worsened. One day, during a delusional and psychotic episode, the patient shot and killed two people. As we would now expect, the patient sued the psychiatrist, claiming that the psychiatrist should have followed up and made the patient see the successor physician. At trial, the patient was awarded \$500,000 against the psychiatrist whom he had not seen for eight months prior to the shooting and whose orders to follow up with medical care he ignored.

CHAPTER TWO

HOW ANYONE CAN FIND OUT WHAT YOU OWN

How does a potential plaintiff find out whether you have enough money to make you an attractive lawsuit target? Thanks to the Internet, a lawyer can find out everything he needs to know.

It's now well understood that Internet search technology allows virtually unlimited access to your most sensitive personal and financial information. Specifically, detailed information describing your real estate and business interests, the name of your bank and brokerage firm, your account balances, and your transaction history can be accessed and assembled without your knowledge or permission. Now, anyone can find out what you have and how much you are worth.

These capabilities have been developed and advanced mostly during the digital revolution of the past decade. Before the Internet, separate bits and pieces of information about your life were scattered in dusty file drawers and county records around the country. Your birth certificate, driving records, insurance file, marriage licenses, and loan applications were maintained or stored in written files, record books, or sometimes

the computer at the office where the records were kept. *Information could not be accessed from outside the office where the records were stored.*

An investigator attempting to assemble information about your life had to travel from one county courthouse to another, stand in line, search through library archives and public records, and hope to come up with some useful information. The process of gathering personal information was a laborious and expensive job.

But all of that has changed. The scraps of paper and the written records have been converted into an electronic form which can be stored and searched by a computer. And these computers and databases have been connected through the Internet so that the information in any one computer can be accessed and searched from any other computer. If somebody wants to find out information about you, a single query will hunt through billions of documents stored on thousands of interconnected databases to produce a frighteningly thorough profile of your life. An investigator can now sit in the comfort of his or her office with a computer, a modem, and a cup of coffee in one hand, and in minutes, access everything he or she wants to know about you.

SEARCHING FOR YOUR REAL ESTATE

Anyone wishing to put together a complete picture of your assets will first locate and value any property that you own. Until recently, a comprehensive and accurate search such as this was difficult or impossible. Even six or seven years ago, there were no statewide or national database listings of real estate owners. Deeds to property were filed in the recorder's office in the county where the property was located. The deed was manually indexed by the clerks. If someone wanted to find out what property you owned, he would have to go to the local recorder's office and look in the Grantee Index under your name. (Grantee is a legal term for the purchaser in a real estate transaction.) That index would show any property, located in that county, which had been deeded to you. Property in a different county would not be found in that index.

An investigator attempting to find all real estate which you owned had the daunting task of searching the index for every county. To make

sure that all of your real estate was discovered, an investigator had to search every county in the country. He, or someone working for him, had to personally go to the recorder's office to look up the information. If he had good sources, he might be able to call on the phone and get a clerk to check the records. In either case, it was a time-consuming, expensive, and inefficient process.

Some time ago, we had a client who was trying to collect a \$1 million judgment from a former business partner we'll call Jake. Wisely, Jake was staying out of sight to avoid our subpoena. We wanted to bring him into court for a debtor's examination to make him tell us what he owned. We knew he had substantial assets, but we couldn't find him or any of his property. A search of all of the county real estate records in Los Angeles—where he lived—and each surrounding county showed nothing. Since there was a lot of money involved, we paid thousands of dollars to search every county in California, Nevada, Washington, and Oregon. Still nothing.

One day, after five or six years of basically futile efforts, we received a call from a former secretary who used to work in our office. She had left the firm to open an art gallery in Vail, Colorado. "Are you still looking for that Jake guy?" she asked. "I just saw him on the ski slopes." That was a great tip. We checked the county records and found a house in his name that he had purchased for \$3.6 million in cash. We immediately entered our judgment in Colorado and filed a lien on the property. Jake settled quickly, and our client ended up with about \$2.7 million, covering the judgment, interest, and court costs. Jake had figured we would never find the property, and without our lucky break, he would have been right.

It doesn't take luck anymore to find somebody's real estate. Almost every county has computerized its records, and the information has been linked to a national database. Instead of visiting every county recorder or trying to guess where property is located, with a single query, a computer search retrieves all of the real estate records in your name—compiled from every state and county in the country. The report identifies the cost of the property, the loan balance, and the type of property. There are at least hundreds of Web sites offering

these search services. The information is produced in minutes, and the cost is nominal.

DISCOVERING YOUR FINANCIAL ACCOUNTS

After locating your real estate, the investigator will search for your cash. Discovering the existence and details concerning bank accounts and brokerage accounts appears more complex than tracing real estate records. Unlike real estate, a financial account is *supposed* to be a private matter. A banker is someone you should be able to trust with your money. By tradition, the relationship between a bank and a customer implies a level of discretion and confidentiality that can be breached only under extreme circumstances. Although no one expects that his or her account is secret, in the Swiss style, the common understanding is that in the absence of some type of inquiry from the government or compulsion from a court, the bank will not make your account information available to third parties.

Unfortunately, anyone with expectations of any degree of privacy with respect to a financial account will be dangerously disappointed. Bank and brokerage accounts records are now easily accessible to those who have learned the basic “tricks of the trade.” For a modest fee, companies specializing in these services can be hired to perform comprehensive asset searches. A detailed report will list the location, account number, current balance, deposits, and withdrawals for every account that you own. A listing of every check you have written on the account—with the payee and amount—is included in the report. For stock brokerage accounts, a complete transaction history can be obtained with every purchase, sale, and current holding. Monthly credit card transactions and safe deposit boxes can be located if desired.

Information Brokers

The number of companies specializing in providing this information has proliferated as Internet technology makes these searches faster and more efficient. In the business, these firms are known as “information brokers.” (See the end of this chapter for a note on the legality of these techniques.) They prepare a detailed financial report about an

individual subject at the request of a particular client. Or they may collect a broad list of names that meet specific financial characteristics. For example, a list can be developed with the name of every bank customer, over sixty-five years old, with more than \$50,000 in a certificate of deposit. The information is sold by the company to a marketing firm targeting these individuals for a competing financial product.

There are now hundreds of these information brokers advertising their services on the Internet. An example of the services offered and the fees is provided in figure 2-1.

You can see from this information that the services are comprehensive and the fees are modest. For less than \$1,000, a fairly complete search will be performed—including real estate holdings, bank and brokerage accounts, and safe deposit boxes. A number of the firms advertising on the Web declare, “No find. No fee.” If they fail to locate accounts in the search, for whatever reason, they do not charge for the service.

At these prices it is also clear that there is not a significant amount of time or labor involved in developing the reports. It is not necessary to bribe bank officials or employees or to send operatives on covert missions to steal protected bank files. An experienced investigator can gather the requested information with a computer and a telephone within a few minutes or hours.

Several years ago, in connection with our own legal practice, we decided to invest some money and create several tests to see what the investigators could find. We were refining our own strategies for protecting financial privacy and wanted to see exactly what we were up against. We wanted to know the most advanced techniques the investigators used and how deeply into a given structure they could penetrate.

We selected a close friend of ours, Steve, to be the subject of the investigation. He agreed, but we are not using his real name. Steve is a good subject because he has financial accounts, properties, and business interests which range from straightforward to fairly complex. We were interested in seeing which assets could be found. Here is the description of what he owns.

ASSET PROTECTION

1. Five single family rental houses in California, Texas, and Arizona.
2. Joint checking account with his wife at a California bank.
3. Business checking account—with his signature only—in California.
4. Brokerage accounts with stocks and mutual funds at two different firms.
5. Account in the name of a Nevada corporation at a bank in Las Vegas. Steve is the owner of the company and one of three signatories on the account.

To perform this search, we chose a firm at random from several hundred advertising “Financial Investigations” on the Web. We told the investigator, a woman named Julia, that one of our clients was considering filing a lawsuit against Steve and we wanted to know beforehand exactly what he owned. Julia said she did these type of searches for many lawyers and helpfully suggested that we do a national search of real estate, bank accounts, stocks, and mutual funds for a fee of \$600. We supplied the name of the subject—(Steve) and his Social Security number. If we had not known the Social Security number, the firm would have provided it for an extra \$35. We also asked for the location of any safe deposit boxes.

Three days later we received a faxed report from Julia which contained the following information:

1. Steve’s full legal name and the names of his wife and two children.
2. His current and previous addresses and place of employment.
3. Each of the five real estate properties was listed with street address, legal description, purchase price, loan balance, and estimated value.

Figure 2-1: Asset Searches

Bank Account Locate—\$120 (\$30 no hit fee). This search provides you with the bank at which your subject has an account. Information that you must provide for this search is name, address, Social Security number, or tax ID number. Search results will (in most cases) be returned to you in two to four business days.

Nationwide Bank Account Search—\$500. This search provides bank names and addresses, account types, and balances as of the day of the search. Information that you must provide for this search is name, Social Security number, or federal ID number. Search results will (in most cases) be returned to you in four to six business days.

Real Property Search—\$60. This search provides real estate owned by an individual or business. This is a nationwide search. Information that you must provide for this search is name of individual or business. Search results will (in most cases) be returned to you in twenty-four to forty-eight hours.

Safe Deposit Boxes—\$300 (\$30 no hit fee). This search provides deposit box number and branch address for all boxes located. Information that you must supply for this search is name, address, Social Security number, or tax ID number. Search results will (in most cases) be returned to you in four to six business days.

Stocks, Mutual Funds, Major Brokerages—\$360. This searches all brokerage and mutual fund houses and provides account number, address of institution, and value of account. Information that you must provide for this search is name, address, Social Security number, or tax ID number. Search results will (in most cases) be returned to you in four to six business days.

Complete Asset Search—\$900. All assets are searched. Information that you must provide for this search is name, address, Social Security number, or tax ID number. Search results will be returned to you in four to six business days.

Credit Card Transactions—\$250 per month. To search for monthly credit card transactions, you must provide name and account. Search results will (in most cases) be returned to you in two to six business days.

4. The joint account and business checking account were identified by account number, bank branch, and current balance. An additional account was located which Steve had forgotten he had; it contained \$45.67. We were particularly impressed because this account was in Maine—Steve had opened it when vacationing there ten years earlier—and there had been no activity since that time.
5. Both of the brokerage accounts were listed. The report contained all of the stocks and mutual funds with the account balance and deposits for the month. Julia noted that a list of all purchases and sales for the year could be obtained for an additional \$95.
6. Similarly, the Nevada corporation did nothing to shield the ownership of the bank account. Complete details, with the name of each signatory, was provided. We were supplied, without charge, the names and addresses of the corporate officers and directors.
7. As you might expect from the results so far, Steve's safe deposit box was located, with box number, bank, and branch. To the best of our knowledge, the contents of the box were not revealed.

Even though the accounts were held in different forms and at different financial institutions, each had been discovered. In subsequent tests using ourselves and willing friends as guinea pigs, a total of fourteen out of sixteen possible accounts were accurately located.

For a story in *Parade Magazine*, author Peter Maas researched the availability of personal financial information and had an experience similar to ours. He retained an investigation firm to see what facts about himself could be uncovered. He gave the company forty-eight hours to produce telephone records for an unlisted phone number and bank records for each account he owned, in his name or with his wife. Within the indicated time, the company produced all three unlisted telephone numbers, together with a complete list of all of the toll calls made from each

line. The financial accounts were also quickly discovered. “All my bank account information—the account numbers, the banks involved, balances, and deposits for the previous month—was disturbingly accurate,” Maas reported.

A front page article in the *Wall Street Journal* detailed the ease with which private investigators discovered accurate bank balances for customer accounts at financial institutions throughout the country.

The article highlighted the stories of several individuals who were dismayed to learn that their accounts had been located and the balances disclosed—without their knowledge. The case of Dale Ohmart, a New Hampshire minister, was particularly striking. After Ohmart was involved in a minor accident, a local attorney, Frank Federico, acting on behalf of his client, retained an investigator to search for Ohmart’s bank accounts. As quoted in the article, Federico said he hired the investigation firm because “we don’t like to go after people individually unless they have liquid assets.” Within a short time, the investigator provided Federico with account numbers and balances on four of Ohmart’s accounts at Fleet Financial (now Bank of America). Based upon the small balances in the account, Federico chose not to pursue the case. The article concludes, “Mr. Ohmart, age thirty-nine, didn’t know that his account confidentiality had been violated until he was contacted for this article. He asked, ‘How in the world can I feel that the relationship I have with the bank is secure or that my own assets are secure?’”

HOW THEY FIND YOUR ACCOUNTS

There are three basic tools that investigators use to locate bank and brokerage accounts:

1. Sources.
2. Pretext.
3. Individual reference services, also known as “look-ups” or “locators.”

As we know from our own experience, in most cases, one or the other of these tactics will produce the desired information.

Sources

The term “source” refers to an individual with access to the records of the financial institution. Generally, this is a person who works for a particular firm and is willing to supply information about customer accounts. The source can be any employee with access to a computer terminal. All customer account records of the firm can usually be accessed from any terminal. By typing in the customer name, all account records can be located. The source usually receives a monthly salary or a per transaction fee. An investigator working on a case calls his source at Firm A—one of the largest brokerage firms—and says do you have any accounts for John Doe? If yes, he gets a list of the account numbers with whatever other information was requested by the client. If the answer is no, he goes down the list to Firm B and so on. Ninety-five percent of all brokerage accounts are held by the ten largest firms so most of the time the investigator will be successful quickly.

These networks of sources belong to a few well-heeled investigation companies. It requires a large investment and a steady flow of business to develop and maintain a sizable organization. A lot of energy and money is devoted to keeping these networks in place and operating smoothly. Most private investigation firms are small, one-person operations, and they don’t have the capital to create their own networks. Instead, they farm out the work to the big companies for a fee.

For example, you call Sam’s Detective Agency and ask for a brokerage account search on your father-in-law, Arnie, which will cost \$400. Sam doesn’t have enough money or business to build his own source network, so he calls one of the handful of large companies who specialize in these searches. Sam pays \$300 to X Company, and a clerk there simultaneously e-mails the request to X Company’s contacts at more than 1,200 brokerage firms. Any firm that you can think of is covered by this list. Each source performs a quick computer check to see if Arnie is a customer and e-mails a positive or negative response. The turnaround time for all 1,200 firms can be less than an hour.

Sam gets the results that he asked for and delivers to you the finished report showing that Arnie has a stock brokerage account with more than \$1 million. You don't know how Sam did it, and he won't tell you. He would not want you to bypass him and go directly to the information wholesaler. At the same time, Sam doesn't know who X Company's sources are—that's its secret. X Company would not want Sam to go directly to a source for information so it closely guards its valuable names. It is a sound business model that works efficiently for all of the parties involved. Everyone is satisfied—except, of course, Arnie.

Sources are also useful in acquiring telephone records from the phone companies, which provide a wealth of detailed private information in a single complete package. Once the investigator has obtained a list of your toll calls, he uses a *reverse directory* to look up the names and addresses on the other end of each telephone call. Telephone records for a business or even some individuals can involve thousands of listed calls. Rather than calling each number to see who it belongs to, a reverse directory or Internet service can be used to list the identifying information in seconds.

Financial accounts are often located simply by a review of the list of names produced by the reverse directory. If you have called your bank on the telephone or conducted online banking from your computer modem, your telephone records provide an excellent trail leading directly to the bank's door. Account information is then determined by a source at the bank, or by pretext, using your identifying information.

Pretext

If Sam does not want to pay out a big chunk of his fee to X Company, he has to use a different strategy to find the information. The tactic is called *pretext*. (See the end of this chapter for a note on the legality of this technique.) Posing as Arnie, over the Internet or the telephone, he will attempt to gather the necessary account information.

Here's how the pretext scheme works: When you hired Sam to investigate Arnie's assets, Sam requested Arnie's full name and address. With this information, he then located Arnie's Social Security number.

This is the key to all asset searches. It unlocks the door to almost every other piece of information, and it's easily accessible.

It is easier to find a Social Security number than an address or telephone number. Almost everyone has applied for credit and has provided their Social Security number on the application. The information on the applications is used to create databases, which are available for marketing and commercial purposes. For example, every individual credit report maintained by the three national credit agencies—Trans Union, Equifax, and Experion—contains a “credit header,” which is the portion of the report with the name, aliases, birth date, current and prior addresses, telephone number, and Social Security number. Credit headers may be sold to services that compile information databases on millions of people. In a promotional brochure, one service, People Finder, claims that its database contains credit header information on “160 million individuals, 92 million households, 71 million telephone numbers, and 40 million deceased records.”

Sam maintains a subscription to several database suppliers, and he finds Arnie's Social Security number, mother's maiden name, and telephone numbers in a few minutes. Sam then calls the customer service representatives at the firms, pretending that he is Arnie. The first task is simply to locate the accounts and the account number. One clever ruse is the *wire transfer ploy*. He may say, “This is Arnie Smith, and I would like to wire transfer \$100,000 into my account. Can you please give me the proper routing instructions?”

The helpful employee responds, “Certainly, Mr. Smith, let me just find your account here.” If she can't find the account in the computer, she'll say, “I'm sorry, sir, but there must be some mistake. We can't find your account. Do you have the account number handy?” If she does find the account, she may ask for some verifying information such as date or place of birth or mother's maiden name. But Sam is prepared and he already has the right answer. She will then provide Sam with the routing information for the wire transfer, which will include the account number. Once Sam has the account number, that's the end of the ball game. He can now call and get whatever information he needs.

Although the telephone pretext strategy works well for brokerage firms, which are limited in number, these time-consuming techniques cannot be used when the requested search covers a large number of banks. It is not possible for the investigator to personally telephone even a fraction of the banks where the accounts might be located. And it is not cost effective to hire a room full of callers when the total fee is only a few hundred dollars.

Instead, Sam can use the high-tech solution and can send an e-mail or text message to thousands of banks simultaneously—again posing as Arnie. Most banks now provide computerized responses to customer inquiries, and when the proper identifying data is furnished, the requested information can be elicited. Internet searches, in this manner, allow the investigator to cover banks throughout the country and to obtain account information quickly and inexpensively.

Pretext is often an effective technique for discovering account information even at supposedly safe offshore banks. An attorney friend told us the story of a client who had stashed \$2 million in an account at a Caribbean bank, in preparation for a nasty divorce. For a variety of reasons, there was no trail from the U.S. showing the transfer to the foreign bank so nothing in his banking records provided a tip-off for the wife. But her private investigator secured the husband's telephone records—ran a reverse directory check on the numbers—and found calls to a prominent overseas bank. Then, using a pretext strategy similar to the wire transfer ruse, he learned the account balance from the bank itself. Before this evidence could be presented to the judge—creating perjury and potential tax problems—the husband paid up—and far more than \$2 million.

Many of the offshore banks—despite their purported secrecy—are as vulnerable to pretext calls as their American counterparts are. When the existence of the account is discovered through telephone records or other documents, experienced investigators will often be successful in obtaining the details that they are seeking.

Individual Reference Services

The booming demand for personal information has spawned a new multibillion-dollar industry known as *individual reference services*—we'll

call them *look-ups* for our discussion. Look-ups employ thousands of people, researching and inputting data, to supply personal information about individuals to attorneys, marketers, credit suppliers, financial institutions, and investigators. These companies compete to assemble ever larger and more comprehensive databases of personal information.

Rapid innovation creates awesomely powerful search techniques, combining and sorting information from multiple separate databases to produce a comprehensive personal information report. Instead of different searches for each important piece of data, a single search now presents a compilation of information from different sources. One look-up service claims that it takes any individual name and runs it through a thousand separate computer databases with more than *100 billion* stored records. According to the company, the average report length is one hundred pages.

One hundred pages is a lot of information about you and probably covers just about everything you wouldn't want someone else to know. Besides the commonly available records of Social Security number, date of birth, and mother's maiden name, additional information also may include: place of birth, names and ages of family members and neighbors, schools attended, telephone numbers (listed and unlisted), employment information (past and present), physical characteristics, licenses held, voter registration information, driver's license number, automobile registration, personal identification numbers, association membership, census information associated with the addresses, and asset ownership. A newspaper archives search for any articles with your name may be included in the report.

The information compiled by the look-up services is derived from three principle sources:

1. Information which you have supplied.
2. Information from the public record.
3. Information from proprietary sources.

Voluntary Information

Much of the data about you which is available has been voluntarily furnished by you in connection with a service or a product that you purchased. What you probably didn't know was that the information would be made available for purposes other than those which you intended. For example, a mortgage loan application is a sensitive document. It contains almost every detail of your private financial life, including tax returns and bank account statements. If the information from a mortgage application or other credit application is made available by employees at the lender or by the institution itself for marketing purposes, the material would be integrated into your personal file on the databases forever.

Unlike the credit reporting bureaus that are required by the Fair Credit Reporting Act to furnish you with a copy of your credit report under certain conditions and to correct errors on the report, the look-up services have no such obligations. The subject of a look-up search has no right to see or correct the information presented about him. You may be turned down for employment or insurance or some other service based on inaccurate information received from the look-up service without your knowledge. Unless you are able to subscribe to the particular service or obtain a report, you may never know the extent or the accuracy of the information presented about you.

Although not as comprehensive as the mortgage application, the totality of your subscriptions, warranty cards, purchases, survey responses, and other credit applications provides enough information about you to satisfy even the most diligent investigations. You have voluntarily provided your telephone numbers (listed and unlisted), your checking account number, credit cards, employment, and identifying information on a regular basis throughout your adult life. This information has been stored, assembled, merged, and regularly updated to provide a detailed picture of your personal and financial life.

Information from Public Records

The public records maintained by all levels of government are another rich source of information about you. Ownership of real estate,

marriages and divorces, court records of civil and criminal cases, birth certificates, driving records and licenses, vehicle title and registration, voter registration, bankruptcy, incorporation, worker's compensation claims, firearm permits, professional and occupational licenses, and Uniform Commercial Code (UCC) and Security Exchange Commission (SEC) filings are a portion of the available information about you.

Each of these records provides an extraordinary level of insight into many areas of your life. For example, driver's license records contain accident reports, convictions, police reports, complaints, satisfied judgments, and hearing records in addition to the personal identifying information of age, sex, address, and physical appearance. Many states, such as New York, make these records available directly to the information services for a fee. Illinois sells its records for \$10 million per year, and Rhode Island brings in \$9.7 million just from the sale of its drivers' records. The records are provided directly in usable electronic form or are converted by vendors who then resell the information to the database services.

The information that is ultimately compiled by the look-up service is based upon the hundreds of private and public records which are searched and assembled. A report can be customized, depending upon the depth of detail necessary for the investigation. A simple report with credit header identifying information is often sufficient. An advanced report, including a multiple database search with telephone and utility records and financial information on bank accounts, stock ownership, and insurance policies, may be required in preparation for hardball negotiations or litigation.

Information from Proprietary Sources

Sometimes the information supplied by the databases is supplemented with additional information developed from proprietary sources such as contacts at the financial institutions or telephone companies. By the time the information from the databases has been merged and assembled, the report contains a complete picture of your personal and financial life with all of the details available for inspection and

use—without your knowledge and outside of your control. Look-ups are a powerful source of information for investigators—often providing a comprehensive package of information to combine with the details available through the use of sources and pretext strategies.

The services offered by the look-ups are capable of such powerful and wide reaching searches that law enforcement agencies at each level rely heavily on these companies for assistance in their efforts. The look-ups are used to locate people suspected of criminal activity and to track down witnesses, friends, and associates of criminal suspects.

Computerized databases are among the most important weapons in the prosecution of financial crimes. According to the Federal Trade Commission Report to Congress, the Financial Crimes Enforcement Network (FinCEN), an arm of the U.S. Department of the Treasury, relies heavily on computerized databases to prevent and detect money laundering. FinCEN combines financial information reported by banks with a multiple database search from the look-ups and offers these intelligence reports to other federal and state agencies. The Secret Service and the National White Collar Crime Center of the Justice Department subscribe to more than a dozen look-up services and conduct searches for themselves and related agencies investigating economic crimes.

THE DANGERS OF PRIVACY INTRUSIONS

The availability of information about your financial matters creates potential dangers from a variety of sources. The actual degree of threat to you may be high or low depending upon your business and personal circumstances. But we will give you some examples from our own experiences to help you measure the risks that you face.

The Lawsuit Threat

We can see that the threshold issue of every lawsuit—*can this defendant pay up*—is now resolved quickly and inexpensively. Real estate and bank accounts scattered around the country are easily located in an asset search. Before, a lawyer had to do a lot of digging and ask plenty of questions to make sure the potential defendant had enough money to make the case worthwhile. If there was any uncertainty about collecting

the judgment, the lawsuit usually did not go forward. A lawyer would tell his prospective client, “Bring me some evidence that he has money, then I’ll file the case.” The process of gathering accurate information often took months or years, and the lawyer or the client might lose interest and move on to other things. A lack of reliable information slowed the speed of the litigation freight train.

But now the attorney can make a call to the investigator or can contact the look-up service directly to produce a comprehensive asset report on real estate holdings, financial accounts, and business ownership. Questions about whether a potential defendant can pay are now resolved quickly and efficiently.

A wealthy client, Allen, invested \$10,000 in a software development business owned by a college acquaintance, Mark. Allen received 2 percent of the stock in the company, put away the certificates, and didn’t think about it again for several years until one day he was served with a lawsuit. The suit alleged that the company had breached a contract to develop a particular program for a customer. The failure to deliver the program on time had cost the customer millions of dollars; it was now suing for \$25 million. Allen was named as a defendant, together with the company which was primarily a service business with no substantial assets. It was clear that the real target in the case was Allen and not the company. Allen had \$3 million in stocks and bonds in several brokerage accounts, and this was the prize the plaintiff was after.

The case was disturbing. From a legal standpoint, Allen, as a minority shareholder—not even an officer or director—had no liability for any obligations of the company. Even if the damages were caused as alleged, Allen had no input or responsibility for the operations of the business.

The case had been filed solely because the other side had run an asset search on all of the shareholders—looking for a “shakedown” target—and they hit the jackpot when they found Allen’s accounts. The attorney for the other side later admitted to us that if they hadn’t found Allen’s money, they wouldn’t have filed the case. They had nobody else to go after. But now they had a perfect setup. Although Allen had no

real liability, what happens in court is often different than what we think should happen.

As a named defendant in the case and the only one with money, Allen faced a difficult choice—fight or settle. If he fought, there was a risk that he could lose the lawsuit with damages of several million dollars plus attorney fees. That would probably wipe him out financially. If he won the case, it would still cost \$100,000–\$150,000 in legal fees and expenses and would absorb much of his time and emotions for at least the next few years. The lawyer for the other side knew how to play the game.

After several months of painful negotiations, Allen settled the case for \$450,000. It was difficult for him to pay the money—mostly from an emotional standpoint—because he had done nothing wrong. But he was trapped and outmaneuvered, and he had no choice. By holding his money in an unprotected form, easily discovered and reachable, he was a vulnerable target. The proper strategy, and the one Allen now uses, is to limit access to personal financial information and shield assets from potential claims. That will minimize the threat from these types of cases.

Pre-Divorce Planning

Much of the business of the private investigators comes from spouses engaged in pre-divorce planning. Savvy divorce lawyers tell prospective clients to find out as much as possible as early as possible—before the papers are served. It is much easier, and ultimately more accurate, to gather evidence about financial assets beforehand, when the waters are relatively calm and before the other spouse has begun to think about issues such as hiding and protecting assets.

The plan, which is recommended by the attorney, involves a thorough asset search by a qualified private investigator. A report will be prepared listing real estate, business interests, and bank and brokerage account numbers with balances and transactions. These assets can then be identified and *frozen* at the time the divorce papers are filed. Once the divorce case is filed, money and property often begin to “move.” When this happens, locating assets can become a messy and expensive task.

A *Business Week* article illustrated the difficulties a spouse can encounter tracking assets after the divorce litigation has begun. Two months before filing for divorce, Swiss industrialist Donald Hesse allegedly transferred \$200 million of stock in Hesse Holdings to an offshore trust in Gibraltar. Joanna, his American wife, has purportedly spent \$600,000 in legal fees in numerous unsuccessful attempts to assert a claim on the funds.

In the book called *Tao of Divorce: A Woman's Guide to Winning*, divorce lawyers Steven L. Fuchs and Sharyn T. Sooho advise women to “win” the divorce battle with ancient Chinese tactics of strategic planning, stealth, and deception.

While still living in the marital home, you have a unique opportunity to acquire this information and to continue to maintain close physical proximity to your husband, his financial records, and his confidants. Sage Warriors can gain advantage by accessing strategic information during this window of opportunity we call the pre-filing, “planning stage.”

The authors advise women to perform thorough asset searches, photocopy important documents, monitor telephone calls, and build evidence of adultery, in secret, “while still living in the marital home.”

It's not clear to us exactly when this “planning” is supposed to start. How early in the marriage does the “Sage Warrior” begin to formulate her battle plan? Should she even wait to get married? Why not start on the first date with a little discrete photocopying—maybe a quick dash over to Kinko's on the way to the restroom?

Private investigators are experiencing a booming business in asset searches for strategic planning during all phases of a personal relationship. We have apparently reached the point where preparing for marriage includes a search by each side for the assets of the other to determine the necessity or accuracy of the prenuptial agreement. During marriage, staying informed means acquiring regularly updated asset reports and an analysis of phone records and credit card purchases. But when the marriage is over—is when the *real* action begins.

Ex-Spouses

Even after the divorce has been finalized and the marital property divided, one spouse often has an incentive to keep financial tabs on the other. Alimony payments, and even property settlement agreements, can be modified years after the divorce, based upon a change in the financial circumstances of one of the parties or upon newly discovered information. (See article “Unique Issues for Physicians in Marital Dissolutions” in chapter 12.)

A friend, Alex, was divorced and his wife, Liz, was awarded alimony of \$400 per month for ten years. They had only modest assets at the time. Starting immediately after the divorce, Liz had a private investigation firm perform annual financial “checkups” on Alex. Despite the divorce, she had confidence in his ability to make money—and she wanted to know about it when he did. Three years later, the investigator reported that Alex had indeed become successful. He had built his computer software business into a promising enterprise—worth more than \$3 million.

Liz’s faith in Alex had paid off. She consulted with her attorney, and they filed a petition to modify the divorce decree. She argued that, based upon Alex’s new wealth, the amount of the alimony award should be increased. Also, she claimed that Alex’s idea for his business had been developed during their marriage—the company stock was marital property and she was entitled to half.

Although it wasn’t clear which argument he relied upon, the judge increased the alimony from \$400 to \$9,000 per month. He also awarded her \$1.2 million in cash for a retroactive increase in prior alimony payments, her marital interest in the company stock, and attorneys’ fees and court cost.

A client of ours, Dennis, was awarded custody of his two-year-old son Michael, following a divorce from his alcoholic and abusive wife, Marie. After the divorce Marie never contacted Dennis or visited with Michael. Luckily, Dennis was a good father, and Michael developed into a smart and happy young boy. Dennis was a high school science

teacher and over the years managed to save about \$100,000 for Michael's college education.

One day, ten years after the divorce, Dennis received an unpleasant surprise—a telephone call from Marie. She said that she was getting her life together and wanted to contest custody of Michael. She also said that she had run an asset check on Dennis through a local investigation firm and had discovered the college savings account. Getting directly to the point of the call, she offered to give up her custody claim in exchange for a payment of the \$100,000.

Unfortunately, the cat was out of the bag at that point, and there was nothing we could do (other than advise Dennis to call the police). So he paid her the money because he couldn't risk jeopardizing his life with his son.

It is a cliché by now to say that “information is power.” But we can see that those who are skillful in acquiring the right information can successfully achieve objectives otherwise impossible to accomplish. Bargaining is about knowing the strengths and weaknesses of your opponent. A lawyer, business competitor, spouse, or ex-spouse with information about what you own can exploit this knowledge to attack your most vulnerable points. In the next chapter, we will look at the lawsuit process to show you what really happens if you get sued.

Note on Information Gathering Via Pretext

Most of these tactics are clearly illegal now, but the number of prosecutions is small and the demand for this information is so great that the practice remains popular and effective. The following information was posted on July 12, 2008, by Fred Abrams (www.assetsearchblog.com) and lists the relevant statutes prohibiting the use of pretext.

Privacy and other federal laws generally prohibit pretexting, (the use of false pretenses), when contacting a U.S. bank, phone company, or government agency for confidential information. One example of pretexting would be using a false identity while phoning a bank to elicit a bank customer's personal account information. If an information broker, private investigator, etc. pretexts during an asset search, some of the following federal statutes might possibly apply:

15 U.S.C. § 45 (Unfair methods of competition unlawful; prevention by Commission): By relying on both 15 U.S.C. §45 and 15 U.S.C. § 53 (False advertisements; injunctions and restraining orders), the Federal Trade Commission can sue pretexters for fraudulent, deceptive, and unfair business practices.

15 U.S.C. § 6801 et. seq. (Gramm-Leach-Bliley Act): makes it illegal to access private information by making pretext phone calls to a financial institution or its customers. As my post “The Gramm-Leach-Bliley Act and An Asset Search” further explains, 15 U.S.C. § 6821 also prohibits the use of false documents to obtain private customer information.

H.R. 4709, 109th Congress (2006) (Telephone Records and Privacy Protection Act of 2006): This statute generally prohibits telephone record pretexting and the sale of illegally acquired telephone records.

18 U.S.C. § 1028 (Fraud and related activity in connection with identification documents, authentication features, and information): Both this statute and 18 U.S.C. §1028A (Aggravated identity theft) prohibit a broad range of frauds in connection with identification documents.

18 U.S.C. § 1341 (Frauds and swindles): Covers frauds which use U.S. mail. It and 18 U.S.C. § 1343 (Fraud by wire, radio, or television) are the ubiquitous federal fraud statutes.

26 U.S.C. § 7213 (Unauthorized disclosure of information): Prohibits the unauthorized inspection or disclosure of U.S. tax returns or return information. Subsection (a) (4), entitled “Solicitation,” expressly covers the illegal sale and /or illegal receipt of tax return information.

42 U.S.C. § 1307 (Penalty for fraud): Among other things, covers misconduct like eliciting Social Security numbers through pretext calls to the U.S. Social Security Administration.

47 U.S.C. § 222 (The Telecommunications Act of 1996): Section (c) (2) of this act generally prohibits telephone record disclosure absent “... affirmative written request by the customer, to any person designated by the customer.”

CHAPTER THREE

WHAT HAPPENS IN A LAWSUIT

In this chapter we will discuss what happens in a typical lawsuit. We will go through the various stages of a lawsuit using a hypothetical case involving a fictitious Mr. John Williams.

Williams is an author who recently completed a detailed investigative study of a particular religious sect. After the book was published, the leader of the sect filed a lawsuit against Williams for defamation. The sect has a reputation for attempting to intimidate and coerce anyone who might reveal damaging information about the group, and the major weapon in this intimidation process is the use of lawsuits. (That is why we are not mentioning the group's name.)

A lawsuit has five separate stages:

1. Economic analysis of the case.
2. The pleadings.
3. Discovery.
4. Trial.
5. Collection.

ECONOMIC ANALYSIS: ARE YOU WORTH SUING?

Before any lawsuit is commenced, the claimant (or plaintiff) and his attorney will review the economics of the case. The plaintiff will weigh the costs of prosecuting the case against the likelihood of victory and the amount of the probable recovery.

In our example, the financial investigation of John Williams revealed that he owned a home with about \$100,000 of equity, a savings account at a bank with \$100,000, and a brokerage account with \$535,000 of securities. The decision was made to file the lawsuit. Here's how the plaintiff arrived at that decision.

PLAINTIFF'S COST TO SUE YOU

Hourly Attorney

The costs involved in suing someone depend primarily on whether the attorney is working on an hourly rate or a contingency fee. Most, but not all, cases concerning business disputes are handled on an hourly basis. Typically, these hourly fees range from \$300 to \$1,000 per hour and more. Pursuing a garden variety case to trial can cost \$100,000 to \$200,000. In a case of some complexity, the legal fees can easily reach \$1 million.

An hourly fee attorney has an economic stake in encouraging the litigation. Since the attorney gets paid his hourly rate, regardless of the outcome, there is a huge incentive for the attorney to "sell" the case to his client. The lawyer will encourage the client to sue in order to generate substantial fees for himself. (The next time you are encouraged by an hourly fee attorney to file a lawsuit, try asking him if he will take the case on a contingency.)

The attorney's inherent incentive to litigate discourages early reasonable settlements between the parties. We have seen again and again in our practice that it is nearly impossible to get an hourly attorney to devote his attention to an early and reasonable settlement. Instead, the lawyers generally adopt severe and inflexible negotiating positions while attempting to persuade the client that the *other* side is unreasonable. Cases are usually not settled early in the process unless

the client is particularly sophisticated and understands his attorney's financial interest in pursuing the litigation.

If the case is not settled early, it is almost always settled late—when the client's resources or patience (or both) are nearly exhausted. Usually this occurs just prior to trial—*after* the client has already spent substantial sums and he finds out what the additional fees will be if a trial is necessary. At this point, the attorneys for both sides become reasonable in their demands. Whatever it takes, a settlement is reached at this point. That is why only about 1 percent of all the lawsuits that are filed ever get to trial.

Several years ago we represented a well-known professional athlete in a case against his former financial advisor. The financial advisor “sold” our client on a real estate investment by seriously misrepresenting the important facts about the deal. Our client had lost \$100,000 and wanted his money back.

The other side (let's call him Mr. Jones) was represented by a large prestigious West Coast law firm. The firm was being paid on an hourly basis, \$200 per hour (then a sizable amount), and we were working on contingency. We made a demand for \$100,000, and the attorney for Mr. Jones offered zero. Despite the fact that we had all of the evidence on our side and we stood an excellent chance of winning, the other attorney would not budge.

Prior to filing the lawsuit and over a period of several months, we kept talking but no progress was made. We were puzzled. Mr. Jones had a large and supposedly reputable company which handled investments for many entertainers and athletes. If we filed our suit, the negative publicity would certainly injure Mr. Jones's business and reputation. Once we filed our suit, surely all the other investors would also sue. It did not make any business sense for Mr. Jones to attempt to defend his unwinnable position.

At last, we concluded that Mr. Jones simply did not grasp his legal position. We were sure that his attorneys were telling him that he had a great case and he should not settle. We figured that he had probably spent close to \$35,000 in legal fees at this point. His attorneys were

milking him, and we were forbidden by the legal rules of ethics from speaking directly to Mr. Jones to let him know what was going on.

We finally decided that the only way to reach Mr. Jones was to have an independent third party try to talk some sense into him. We suggested to Mr. Jones's lawyer that we mediate the case with a well-respected former judge. Each side would tell its story, and the mediator would evaluate our claims. To our surprise, Mr. Jones's lawyer agreed.

Several weeks later, we had our mediation. Attorneys for both sides were present along with our clients. We each informally presented our case and, when we were both finished, the judge turned to Mr. Jones and said: "I have been a judge for many years, and based on my experience, I will tell you that, if you go to trial, you will lose. I don't know what your attorneys have been telling you, but I suggest you settle this case right now."

Apparently this little speech did the trick. Within a week, we had our client's \$100,000 back plus interest of \$30,000. That was more than we had asked for originally. Mr. Jones also paid about \$65,000 in legal fees in addition to the settlement amount, so it ended up costing him \$195,000 instead of the \$100,000 we had been willing to take on day one.

This story is not uncommon. It is the rule. Every plaintiff's personal injury attorney who deals with insurance companies knows that once the case is in the hands of an outside insurance defense legal firm, no settlement will be possible until right before trial. Attorneys on an hourly fee basis will prolong the case for as long as possible. (There is a more complete discussion of litigation costs and defense strategies in chapter 10, "Loser Pays" and "How to Protect Yourself in a Lawsuit.")

Expenses of Litigation

It is not just the attorney's fees that have to be calculated in determining whether to sue. The expenses of litigation must also be considered.

Everything connected with litigation seems to cost much more than it should. Fees to stenographers for a six-hour deposition are usually \$2,000–\$3,000. Nobody can figure out why it costs that much.

When all of the costs of discovery, travel, expert witnesses, filing fees, research, private investigators, and jury fees are added up, the amount will be mind boggling. A normal range for expenses will be \$25,000 to \$100,000 in the simplest case.

Contingency Fees

Contingency fee attorneys do not charge by the hour. Instead, their fee is a specified percentage of any recovery. This amount is usually one-third if the case is settled before trial and 40 percent if a trial is necessary. Since it is only large companies and very wealthy individuals who can afford to pay trial attorneys on an hourly basis, most lawsuits are handled on a contingency fee basis.

Usually the attorney agrees to advance all of the expenses and is repaid out of the recovery, if there is one. Although in most states the client is technically responsible for repaying expenses advanced by the attorney, it is rare that the attorney actually seeks to collect these amounts from his client. If there is no recovery, advances for costs are written off.

As opposed to hourly fee attorneys, who make money regardless of the outcome, the contingency fee attorney essentially bears all of the economic risk of the litigation. As we have seen, this risk and the potential reward can be quite substantial.

In this sense, the contingency fee attorney is an entrepreneur. The attorney, rather than the client, must carefully evaluate the merits of a particular claim. The potential recovery is balanced against the amount of work which will be required. A fast settlement of marginal claims is essential to the plaintiff's lawyer. He simply cannot stay in business advancing costs and spending time on small cases.

On cases with potentially large damage awards, the plaintiff's attorney is willing to carry the case to trial. Usually, he would prefer a fast settlement, but if he does not receive a satisfactory settlement offer, he will go to trial. Many of these attorneys are really gamblers at heart, and they are willing to invest a lot of time and money for a sizable payoff. And to get this payoff, *the most important element of the case is finding a defendant who can pay.*

The Search for the Big Bucks

Contingency fee attorneys love to have insurance companies, financial institutions, or large businesses as the defendant. If he wins, the attorney knows that he will collect, unless the amount of the judgment or the number of the claims causes the defendant to file for bankruptcy. That is what happened to Dow Corning Corp. (silicone breast implants), A. H. Robbins (IUD), Manville Corp. (asbestos), and hundreds if not thousands of other companies seeking to avoid legal liability lawsuits. They each filed for bankruptcy to halt the flood of litigation over their products. But ordinarily, these types of companies make good defendants.

If a potential defendant is an individual or a small company, the plaintiff's attorney is going to do substantial investigation before he commits his time and his resources to the case. There is nothing that attorneys like less than working on a case without getting paid.

You must assume then, that the attorney interested in suing you will perform a thorough financial investigation of your background, assets, and income. This work will usually be done by one of the many private investigation firms that operate in each city. The investigator usually subscribes to one or more of the database services offered by the individual reference services. A personal information report is compiled based upon the database search and the proprietary sources used by the investigator. The report may contain basic asset information including real estate ownership and financial accounts.

If you are one of many potential defendants in a case, the lawyer may not want to spend a lot of money on your investigation until he knows whether or not you are a worthwhile target. The first round of searches may be intended to narrow the list of potential defendants. Those who don't have a satisfactory amount of assets don't make the cut. They don't qualify for the all important second round—which usually involves getting sued.

If assets are located in the initial search, then a more detailed investigation is commenced with a view toward the litigation. As we saw in chapter 2, the search is accomplished quickly and for a modest fee. Financial assets are scrutinized to verify ownership, equity, and value.

The investigator checks into outstanding liens and judgments to make sure that nobody else has a prior claim. Information from civil and criminal court cases, employment information, and income data may be gathered and presented to the attorney at this point to be analyzed in order to assess your merits as a defendant in the case.

The lawyer's favorite dilemma is when there is a large group of potential defendants—all with significant assets. Then the response is to name everybody. This often happens in medical malpractice cases. The hospital—together with every physician at the hospital who has any money—will be named in the lawsuit. Actual responsibility can be sorted out later—during discovery or at trial.

The financial investigation will produce one of three results:

- **Substantial, relatively reachable assets are located.** The decision will be made to file the lawsuit.
- **Insufficient assets are located to provide a worthwhile recovery.** The lawsuit will not be filed.
- **No asset information is discovered one way or another.** This is a rare occurrence, but it happens. Since the attorney cannot develop a level of confidence that sufficient assets exist to pay a judgment, in all likelihood, the case will not be commenced.

If the attorney is acting on an hourly basis rather than a contingency, the issue of collectability is a problem for the client but not the lawyer, since the lawyer expects to get paid regardless of the outcome. In most cases, any mentally sound, well-advised plaintiff will have his attorney perform a financial investigation of the defendant, prior to incurring substantial expenses in the case. If insufficient assets are discovered, only the most self-destructive client would elect to proceed with the case.

DEFENDANT'S COSTS

If you are in the unfortunate position of being a defendant in a lawsuit, your lawyer will charge you on an hourly basis. No lawyers *defend* cases on a contingency arrangement. Like the lawyer representing

the plaintiff on a time spent basis, you will be obligated to pay him whether you win or lose. What's more, your lawyer will undoubtedly require that you deposit a retainer to cover his anticipated expenses and costs as well. If you are a wealthy or seemingly wealthy person, your lawyer may tend to view you as a "meal ticket." And, come to think of it, *that is exactly what you are.*

THE PLEADINGS STAGE

The Nightmare Begins

The initial pleading in a case is the "complaint" which is prepared on behalf of the plaintiff and sets forth the allegations of the defendant's wrongdoing. The complaint is filed in the appropriate local court, and this filing commences the lawsuit.

In the usual case, the complaint is produced by the plaintiff's attorney from one of a number of standard forms relating to the particular subject matter of the lawsuit. It is not necessary that the complaint set forth anything other than the vaguest allegations of wrongdoing. The material facts are left to be uncovered during the discovery process.

In our case, John Williams first learned that he was being sued when the complaint and a summons were served on him by a process server. In reading it, Williams saw that he was being sued for defamation by the religious sect. It alleged that Williams willfully and maliciously printed false statements about the group and asked for actual damages of \$1 million and punitive damages of \$5 million.

Of course, Williams was distraught. He had known that the leaders of the sect would be angry about the publication of his book, but because he had been truthful and accurate in his reporting, he had not believed that there would be any grounds for a lawsuit. Now he knew that, groundless or not, he would have to incur substantial expenses in defending the lawsuit and that a considerable amount of his resources and time would be consumed in the process.

A friend of Williams referred him to a local lawyer who agreed to represent him in the defense. The attorney informed Williams that he would have to file a response (or "answer") to the complaint within thirty days, and after that, the discovery phase of the lawsuit would

begin. He advised Williams that the costs of the defense could not accurately be estimated but a good guess was somewhere between \$100,000 and \$200,000. Williams paid his attorney a \$50,000 retainer fee. Within the proper time period, the Answer was filed denying each and every allegation.

Pre-Judgment Attachments

A powerful weapon in the hands of the plaintiff's attorney is the Pre-Judgment Writ of Attachment. This remedy is used to freeze the assets of the defendant and place them under court protection prior to a judgment. This procedure is used to prevent the defendant from transferring, hiding, or wasting his assets before the plaintiff has a chance to collect. Cash held in a savings or checking account cannot be reached by the defendant once a Pre-Judgment Writ of Attachment has been issued. Similarly, real estate cannot be sold or refinanced.

A Pre-Judgment Writ can only be issued in certain types of cases. In California, it is available only in contract cases arising from a commercial transaction. It is not available against a defendant in a negligence suit. The plaintiff's claim must be for a specific dollar amount, and he must demonstrate a substantial likelihood that he will win at trial.

If a Pre-Judgment Writ is granted by the court, enumerated assets which are owned by the defendant are effectively frozen. As a result, the defendant may be unable to obtain working capital to carry on his business. And unless he has a source of funds unknown to the plaintiff, the issuance of the Writ can force the defendant to accept a fast and unfavorable settlement.

In our example, the plaintiff's claim against Williams did not arise out of a contract or a commercial transaction. The Writ was, therefore, not available to the plaintiff.

DISCOVERY

Burying the Opposition

The discovery phase of a lawsuit allows each side to probe the other side for facts as well as legal theories that might be helpful to build one's case and further elucidate the other side's trial strategy. Information

is obtained from the opposing party by means of written questions (or “interrogatories”), face-to-face interrogation (called “oral depositions” or “examinations before trial”), and requests for the production of documents.

This is the stage of a lawsuit where one party may attempt to “bury” the opponent in paperwork. Typically, the side with the greatest financial resources now attempts to burden the other side to the greatest extent possible, in order to exhaust the opponents’ financial resources. This can be accomplished by lengthy and numerous interrogatories, depositions, and subpoenas of documents, all of which are designed to cause the opponent to incur needless legal fees, embarrassment, expenses, and the greatest amount of overall misery.

It is a customary tactic in discovery to attempt to uncover those intimate and personal details about the defendant’s life and habits that he would not wish to have revealed in a public trial. The objective of the opposing attorney is to gather as much “dirt” as possible, with the hope of increasing his bargaining position in the settlement negotiations prior to trial.

Often, medical and psychiatric evaluations are permitted, including blood and urine testing to search for evidence of drug use or illness. Lawyers are permitted extraordinary leeway in the ostensible search for items that may have even the most remote relevance to the underlying case.

Searching Your Computer

A powerful discovery strategy is to subpoena the computer records of the other side. These records often provide the most direct and convenient path to all of the defendant’s personal matters.

Lawyers now routinely demand to search computer and e-mail files in every case—often finding the “smoking gun” document that wins the case. Federal and state government agencies typically begin their investigations with a raid and seizure of written files and all computers. In the recent SEC case against Goldman Sachs, as well as in almost every other major government litigation, e-mail messages are at the core of the evidence. Even in routine business disputes, personal injury

cases, and divorces, e-mail messages and computer records are the gold standard of proof—the “smoking gun” that decisively impacts the outcome of the case.

Many people mistakenly believe that “deleting” a sensitive file will remove it from the computer. In fact, deleting sensitive files doesn’t work. *When you attempt to delete a file or an e-mail message, the contents remain on the computer’s hard drive, stored in its memory. You can’t see the file so you may think it’s gone—but it’s not.* The “delete” function on your computer removes only the name of the file from the file listings in the computer directory—but the contents of the file itself are not altered or destroyed. The information is right there for anyone to look at—if they know some of the basic techniques.

Washington Mutual, formerly a giant financial services firm, learned this lesson the hard way (perhaps presaging its ignominy as the largest bank failure in U.S. history). According to a story in the *Seattle Times*, the company at one point was attempting to recover a dozen computers it previously sold as surplus after learning that “deleted” Social Security numbers, loan applications, and job histories for an unknown number of customers remained stored on the computer hard drives. The employee responsible for discarding the computers thought that the “delete” function would remove the information from the computers. The result of this mishap was an embarrassing public security lapse for the bank and a dangerous privacy breach for the customers.

If your computer is seized during litigation, the stored files and e-mail messages will be examined and searched to uncover incriminating evidence. Experts known as computer forensic technicians specialize in locating and recovering information from files which have been altered, deleted, or even partially destroyed. The information discovered in your computer’s memory may provide a deadly accurate road map through your private financial and business matters.

A prominent computer forensic firm gives this example in their brochure: “It was a messy divorce. The husband claimed he didn’t have any savings or investments other than the ones he had disclosed. . . . After processing his computer at our lab, we found the evidence we needed in cyberspace. The husband had been tracking his stocks via

an online service and downloading the information into his financial program. Need we say more?”

The information stored in computer memory presents a unique challenge in litigation. Written documents, subpoenaed in a case, can be carefully reviewed before being delivered to the other side. The party producing the documents knows what’s there and can prepare accordingly. It is also a fact that, although it is illegal to do so, incriminating documents are often removed or altered by the attorneys or the clients—before they are turned over to the other side. As a consequence, it is rare when damaging written information is voluntarily produced.

In contrast to written documents, you generally don’t know and can’t find all of the items stored in the memory of your computer. You may have letters, e-mail messages, financial records, personal notes, telephone numbers, and calendars—forgotten and invisible to you—but easily recovered by the forensics experts. If you are sued, the plaintiff will immediately attempt to get a court order prohibiting you from altering or removing any computer records. He will then copy the contents of the hard drive and search for incriminating—or at least embarrassing—material. You may have no idea what he will find on your computer, and so you can’t control the information which is produced.

Of course, you will use the same tactics on the plaintiff. Your experts will look through all of his e-mail and note the Web sites he visited and the information that he tried unsuccessfully to “delete.” The outcome of the dispute will often be decided based on which side *inadvertently* produces the most damaging evidence.

Shortly after filing the Answer, Williams was served with more than one hundred pages of interrogatories with questions concerning nearly every detail of his life. He was also required to submit to five days of depositions during which time he was questioned by the attorneys for the religious sect. He was ordered to produce all personal computers from his home and office. All of the written notes which Williams had made in preparation for writing the book, including notes from his conversations with various confidential sources, were subpoenaed and ordered to be turned over by the court. Many of Williams’s family and

friends were also subjected to extensive interrogation on the dubious grounds that they possessed some information which might possibly be relevant to the case.

TRIAL

By the time the case was ready to go to trial, four years after the original complaint was filed, Williams had paid his attorney \$155,000, and his attorney estimated that the cost of the trial might exceed an additional \$100,000. Williams's attorney was approached by the plaintiff's counsel, who offered to settle the case, if Williams would pay the religious sect \$200,000. Since this amount was less than the cost of the trial and less than the amount that he stood to lose if there had been a judgment against him, he accepted the offer and settled the case for the amount proposed. By accepting this proposal, he managed to save his house and still had some of his savings left. The religious sect had proposed the settlement because it really did not wish to go to trial and possibly lose the case with the resulting negative publicity. Instead, the sect believed that it had accomplished its dual objective of punishing Williams and discouraging future journalistic attempts to reveal information about the sect. In reality, it was an abuse of the legal process that was both the means and the end.

Had Williams gone to trial and won, he would not have been entitled to recover his legal fees and costs. In the United States, each party to a lawsuit is required to pay his own costs and expenses. This is known as the "American Rule." In some other countries, such as England and Japan, the prevailing party is entitled to recover its attorney's fees. The exception to the American Rule is that parties to a contract may specify in the agreement that in the event of a dispute, the prevailing party is entitled to recover any costs incurred in a lawsuit, including legal fees. But unless that "attorney's fees" provision is included in a contract, each side bears its own expenses.

Concern about legal fees and costs are usually only one component in the defendant's willingness to settle a case before trial. A second and perhaps more compelling influence is that the outcome of a trial can never be predicted. No one knows which facts will be important and

whose testimony will be believed. A sympathetic or attractive plaintiff or a skillful attorney will often sway the emotions of the jury despite a complete lack of merit to the case.

The ultimate amount of the damage award also cannot be predicted with any level of confidence. One of our clients, a successful business owner, told us that he had previously been sued by a former employee on a completely outrageous and frivolous claim. Prior to trial, he turned down an offer to settle the case for \$25,000, refusing to pay what he felt was pure “extortion” money. You can imagine his surprise when the jury awarded the plaintiff \$750,000—based entirely on manufactured and perjured testimony.

COLLECTING YOUR ASSETS

The Wolf at Your Door

If Williams had lost the trial, the case would have then moved on to the collection stage of the lawsuit. Let’s assume that there had been a judgment against Williams in the amount of \$300,000. He could appeal the judgment to a higher court, but he would be required to post a security bond equal to the amount of the judgment.

This is an important concept to grasp. We have all been taught that in our system of justice, erroneous rulings by trial court judges, often political insiders with little trial experience themselves, will be scrutinized and reversed, if necessary, by more highly qualified appellate court jurists. But, in reality, the right to appeal seldom works well. To appeal, Williams would have to obtain the appeal bond through a licensed bonding company that would require him to post security equal to the \$300,000 bond. That usually means posting property with a far greater value than that so that a sale of the property, if required, would net the bondsman \$300,000.

Then there is the matter of the bondsman’s fee—usually 10 percent of the bond, or \$30,000 cash to Williams. This is all just for the privilege of filing an appeal. To have the appeal heard, Williams will have to pay for trial transcripts and retain an appellate lawyer, who will charge him another \$50,000 to \$100,000 or possibly more. During the time that the case is on appeal, the judgment creditor would not

be permitted to take any steps to collect on the judgment. After the appeals were exhausted, the judgment creditor would then begin the collection process.

What all of this means for Williams, or any other litigant, is that taking one's right to appeal into consideration when evaluating a case is a bad strategic move. Appeals are fine for large corporations that have the financial ability to pay for them, or for criminal defendants, for whom they are often free. For individuals entangled in the lawsuit process, the right to appeal is an illusory consolation.

Locating the Debtor's Assets

The collections process itself often begins with a procedure known as the debtor's examination. As stated, during the discovery phase of the lawsuit, the plaintiff is generally prohibited from obtaining information concerning the defendant's assets. Typically, this information is not considered to be relevant to the underlying case, and no discovery with regard to the defendant's assets is permitted.

After judgment, however, location of the debtor's assets becomes the focus of the investigation. The debtor's exam may be presented by written questions or by oral examination. In either case, the debtor will be asked to list and describe all of his assets and to provide all banking records. He will also be asked whether he has made any transfers of any property by gift prior to or during the lawsuit. All of these questions are asked under oath, and the failure to provide true and complete answers is a felony.

The procedure for enforcing judgments and collection by a judgment creditor is established by the laws of each state. For our example, we will assume that our debtor, John Williams, is a resident of California. Although each state has a different procedure, there is enough similarity in concept to provide you with a general understanding of the collection process.

Personal Property

When a judgment has been entered, the court issues a Writ of Execution, which is essentially an authorization for the collection

action. The judgment creditor gives the Writ of Execution to the marshal (or sheriff) with written instructions describing the property to be seized. The marshal is authorized to take possession of your property by removing it to a place of safe keeping or otherwise taking control over it. Property seized in this manner may then be sold at a public sale.

If your property is in the hands of a third party, the marshal directs that party to turn over the property. Your bank accounts and brokerage accounts can be seized in this manner. If a third party owes you money, that person is notified that he must make payment directly to the marshal's office.

Real Estate

The collection procedure for your real estate begins with the filing of a summary of the judgment ("Abstract of Judgment") with the county recorder in each county where you own property. The Abstract of Judgment creates a lien on the property, similar to a mortgage or deed of trust. The creditor does not have to designate the address of the property or, for that matter, must he even know in advance that you own any real estate in that location. The lien applies to any real estate which you own in that county and also applies to any real estate which you purchase in the future.

Once this Abstract has been filed, your property cannot be sold or refinanced without satisfying the judgment. You cannot avoid this lien by transferring the property to a third party. The lien remains attached to the property until the judgment is satisfied or expires. In California, judgment liens are in effect for ten years and can then be renewed for another ten years.

If the creditor does not want to wait for a voluntary sale or refinancing, he may file a Writ of Execution with the county recorder. After giving proper notice to you, the property is then sold to the highest bidder at a public sale. Cash from the sale is applied to the amount of the judgment, including interest and expenses of collection. Any surplus is returned to you.

Real estate which is sold at this type of public auction rarely brings in an amount greater than 50–60 percent of the actual value of the

property. As a result, if there is a \$100,000 judgment against you, a creditor may seize and liquidate \$200,000 of your property before the debt and the costs are satisfied. The judgment of \$100,000 just cost you \$200,000, not including your legal fees and costs.

WHAT YOU CAN SAVE

With an aim toward avoiding the complete impoverishment of a debtor, the law provides certain partial or complete exemptions from the sale of certain property by a creditor for the collection of his judgment. For purposes of illustration, the following is an incomplete list of exempt property under California law:

■ Government Benefits

Unemployment benefits, disability and health payments, and benefits under the worker's compensation law are exempt from collection.

■ Life Insurance

State laws vary considerably on whether any or all of the cash value of insurance policies is subject to collection by a creditor. California exempts up to \$4,000 in cash value as well as life insurance proceeds, which are reasonably necessary for the support of the debtor's family. In Texas and Pennsylvania, insurance annuities are entirely exempt.

■ Wages

Each state provides for a different degree of exemption of wages from garnishment. Garnishment is the procedure whereby a debtor's employer is directed to withhold some portion of the debtor's salary. The amount withheld is then turned over directly to the creditor. In California, up to 75 percent of the debtor's disposable earnings are exempt from garnishment.

■ Household Furnishings and Automobiles

Ordinary and necessary household furnishings, apparel, appliances, and other personal effects at the debtor's residence are exempt. Items having extraordinary value, such as antiques, musical instruments, or

art work, are subject to execution. The debtor is entitled to proceeds from the sale of these items in an amount necessary to purchase a replacement of ordinary value. Automobiles for personal use are exempt up to \$1,200.

■ Personal Residences

The personal residence of a debtor may be partially protected by the filing of a homestead exemption for a dwelling in which the debtor resides. In California, the amount of the exemption ranges from \$50,000 to \$150,000 depending upon whether family members are living at the residence and whether the debtor is over sixty-five years of age.

Some states have particularly liberal homestead exemptions. Florida and Texas are well known for unlimited homesteads—subject to some minor restrictions, an unlimited dollar amount can be protected in one's principal residence in those states. In Nevada the exemption amount is \$350,000 for a family residence. Illinois, by contrast, has an exemption of only \$15,000, while Pennsylvania provides none.

■ Retirement Plans

In California, IRA and Keogh plans are granted an exemption to the extent of reasonable support needs, but most other states fully protect these plans. Corporate pension and profit sharing plans, formed under ERISA, and other private retirement plans are usually exempt from judgment creditors.

■ Business Property

Property used in the business or profession in which the debtor earns his living is exempt to the extent of \$2,500 of equity. The exemption applies to tools, books, equipment, one commercial vehicle, and other personal property.

You can see from this discussion that unless you live in a state, such as Florida or Texas, which provides a significant homestead exemption, a lawsuit has the potential to obliterate virtually everything that you own. With this sobering thought in mind, let's look at the following chapters, which will give you an idea of the asset protection strategies

WHAT HAPPENS IN A LAWSUIT

that are designed to discourage these lawsuits and protect against future claims.

CHAPTER FOUR

HOW TO AVOID FRAUDULENT TRANSFERS

OVERVIEW

Although the law favors and encourages asset protection in most circumstances, there comes a point in financial transactions and legal proceedings when it is no longer permitted. In some cases this boundary is clearly defined, but often the question of when the remedy of asset protection is still permissible is fuzzy.

Protecting personal assets from risk of loss and liability is firmly established as an accepted part of sound financial and business planning. The use of trusts, corporations, limited liability companies, family limited partnerships, and other strategies encourage business development and investment by enabling individuals and businesses to effectively limit potential losses from their professional activities. Clearly, business activity would diminish and the range of professional services offered would be substantially curtailed if individuals were unable to protect personal assets from lawsuits and liability exposure.

The key consideration in asset protection has to do with *when* and *why* plans are enacted.

Laws in every state prohibit the transfer of property intended to “hinder, delay, or defraud” a creditor in order to avoid paying an imminent legal obligation (a practice known as a “fraudulent transfer”). The law also prohibits transfers that leave you unable to meet your foreseeable obligations.

How does asset protection function within the framework of the fraudulent transfer rules? In some cases the answer is clear: you cannot protect property from an already-incurred debt or judgment. You are obligated to maintain the ability to satisfy existing debts from your available assets or income. It is permissible to create an asset protection plan while you have outstanding obligations, as long as it is not directed at your current debts and you make available sufficient resources, from income or other assets, to repay your outstanding debt on a timely basis. If you fail to repay an existing debt, and it can be proven that the asset protection plan was intended to avoid this payment, fraudulent transfer rules permit your creditors to set aside the plan to reach those assets purposely moved out of harm’s way.

Although the law prevents you from creating an asset protection plan to evade current debts, it does allow for asset protection planning to avoid liability from future, unanticipated creditors. In these cases we can reasonably distinguish between “existing claims” and those that are still “potential, future, unforeseen claims.” Lets say that you are a physician and you set up an asset protection plan. A negligent act involving a patient occurs several months later. Fraudulent transfer is not an issue in this case because the property transfer was unrelated to the claim subsequently developed by this patient. Presumably, at the time you implemented your asset protection plan, you did not know or intend that the patient would be injured. Similarly, loans and contracts entered into after establishing a plan, as long as the creditor is not misled, are also outside the scope of the fraudulent transfer rules.

Some cases, however, are not so cut and dried. Again, using a physician example, lawsuits are often triggered by a negative but unavoidable outcome for a patient, without any wrongdoing or negligence by

anyone. How do fraudulent transfer rules apply to a physician involved in a high-risk case, with clear potential for an unfavorable result? The focus in these cases should be the point at which the patient develops a claim when he or she can establish both negligence and damages. In legal terms, that is when the cause of action arises. If neither of these elements has occurred then the physician is safely in the protected zone. But when one or both happen it is at least arguable that the line has been crossed and asset protection might not be effective if a successful case is later filed by that patient.

FRAUDULENT TRANSFER RULES

For as long as there have been commercial transactions, people have attempted to conceal their ownership of property in order to defeat the claims of their creditors. Concealment may take the form of physically hiding money or jewelry, or it may take the form of “gifts” to friendly parties or relatives. Sometimes, such “gifts” are accompanied by secret agreements to return the property after the trouble has passed.

In an effort to protect creditors from this endless game of hide and seek, English speaking courts have, for approximately 400 years, sought to invalidate transfers made by a person with the intent to defraud his creditors. Any transfer of property which is proved to be a “fraudulent conveyance” may be set aside by a court. Under these circumstances, the transfer will be ignored and the property will be treated as if still owned by the debtor. That means that the property will then be available to be seized by the judgment creditor. This law is currently embodied in the Federal Bankruptcy Code and the Uniform Fraudulent Transfer Act, which are similar in coverage and effectively state the applicable laws in most circumstances. For simplicity’s sake, we will cover the California version which will, of course, vary in some respects from that of other states.

A transfer is subject to being set aside as a “fraudulent transfer” in at least four circumstances:

- The transfer is made with the “actual intent to hinder, delay, or defraud any creditor of the debtor”;

ASSET PROTECTION

- The transfer does not involve the receipt of “reasonably equivalent value” *and* the person making the transfer becomes insolvent (or was insolvent prior to the exchange);
- The transfer does not include the receipt of “reasonably equivalent value” *and* the person making the transfer knows (or should have known) that with his remaining resources he will be unable to pay future debts; and/or
- The transfer is without “reasonably equivalent value” *and* the person making the transfer continues to operate a business with assets that are “unreasonably small” in relation to typical existing or proposed business transactions.

A “transfer” encompasses not only the disposition of assets but taking on additional debt or obligations without receiving an equivalent benefit. For example, giving a friend a mortgage on your home without receiving the cash loan proceeds could qualify as a fraudulent transfer.

Actual Intent to Defraud

First let’s examine the circumstances under which the “actual intent to defraud” exists. Since “intent” is a state of mind, which is not easy for a creditor to prove, courts have inferred from the facts and circumstances of each particular case whether the intent to defraud existed in the mind of a debtor. Those particular facts and circumstances have been branded the “badges of fraud,” meaning their presence is consistent with an actual intent to defraud. The existence of two or more of these factors would allow a judge or jury to conclude that the purpose of the transfer was to unlawfully escape the payment of debts.

Badges of Fraud

Court cases involving the “badges of fraud” are numerous. Here is a partial list:

- The transfer of assets of a family member or a close friend;
- The creation of a debt owed to a family member or a close friend;

HOW TO AVOID FRAUDULENT TRANSFERS

- The concealment or non-disclosure of the fact that a transfer has occurred or a debt was incurred;
- A transfer occurring immediately before the transferor was sued or threatened with a suit;
- The disappearance of the transferor;
- The removal of assets;
- The transferor's receipt of less than the true worth of the asset;
- A transfer occurring shortly before or after a substantial debt was incurred; and
- A transfer of assets to another creditor who then transfers the same assets to a person friendly to the original transferor.

DEFENSES TO FRAUDULENT TRANSFERS

Conversely, a court or jury may take into account facts and circumstances that may imply that the purpose of the transfer was other than avoiding the payment of one's debts. Presumably, transfers associated with or made for legitimate business purposes would fit in this category as would transfers made for estate planning reasons. This creates an interesting paradox: on the one hand, transfers to a spouse or one's children have traditionally been looked upon suspiciously. However, since such transfers are common for accomplishing legitimate estate planning objectives, transfers and gifts which are consistent with valid estate planning motivation may be viewed as lacking the requisite intent to defraud a creditor. Similarly, a transfer to a corporation or other entity composed of one's spouse and children can have a legitimate estate planning or income tax motivation, or it may be accomplished purely as a way to avoid or reduce one's ability to pay debts.

Although cases on the topic do not provide much guidance, certain general principles of law can be drawn:

- The mere existence of the transfer without other suspicious activities is generally insufficient to establish fraudulent intent;

- All of the facts and circumstances of the case and the credibility of the debtor-transferor are crucial in determining whether fraudulent intent exists; and
- Business or familial motivation for the transfer is critical in rebutting an inference that the transfer was accomplished primarily with the intent to avoid the payment of creditors.

Statute of Limitations

An action by a creditor to set-aside a transfer as a fraudulent transfer must be filed within a specified time period. For the creditor who is trying to prove an actual intent to defraud, the lawsuit must be filed on or before four years after the transfer was made or within one year from the date the transfer could have been reasonably discovered, whichever is later. In no event, however, can the lawsuit be started seven years after the date of transfer. In cases in which actual intent to defraud did not exist but “reasonably equivalent value” was not exchanged or a transfer rendered the debtor insolvent, the creditor must bring his suit within four years from the date the property was transferred.

The ideal time to create an asset protection plan is before there are any potential creditors. That way, transfers into a plan should not fall within the fraudulent transfer statutes.

If you make transfers at a time when a lawsuit is imminent or pending or at a time when you have an outstanding obligation, the outcome will be less certain. The success of the plan will be dependent upon your ability to demonstrate remaining solvency and a purpose for the arrangement other than an intent to defraud a creditor.

For instance estate planning and business planning transactions may provide excellent estate planning benefits as well as legitimate risk management features which will be discussed in the succeeding chapters. As part of a coherent plan, the overall structure can avoid the costs and expense of probate, minimize estate taxes, shift income to lower tax bracket family members, and accomplish a myriad of sophisticated business strategies. Since all of these are worthwhile and valuable objectives, depending on the circumstances it may be difficult for a creditor to establish that an intent to defraud was the

motivation for creating the overall plan. This is particularly so if this plan is structured so that it cannot be claimed that you were rendered insolvent at the time the plan was established.

REASONABLY EQUIVALENT VALUE

As we mentioned, unless there is an actual intent to defraud a creditor, a transfer of property for any legitimate purpose will be upheld if you receive “reasonably equivalent value” in exchange. What this term means is not exactly clear from the cases, but generally we can say that the determination is usually based on valuing what you gave up and what you received. The respective values do not have to be exactly equal but close in value seems to do the trick.

For example, let’s say that as part of the planning process you transfer property into a trust for the benefit of other family members. In this situation, since you have made a legal gift, without anything in return, there is clearly no argument that you received anything of value beyond perhaps temporary peace of mind. Since there is no value returned to you, if you are then insolvent or become unable to meet your obligations, this would be a classic case of a fraudulent transfer.

As an alternative, in this type of situation, you should make sure that your plan involves the receipt of reasonably equivalent value in exchange for the transfer of your property. If you create an entity such as a corporation or LLC or FLP, the value of your interest in the company will become the key issue. The ownership interests which are issued to you can negate the fraudulent transfer argument if the valuation is correct. A transfer to a corporation in exchange for stock, or to an LLC for membership interests of equal value should not be considered to be a fraudulent transfer. Understand, however, that now the creditor will be able to seize the stock or membership interests from you so you are not likely to be better off if this is your entire plan.

We will discuss this issue of capital structure and equivalent value in greater detail in chapter 6.



PART TWO

ASSET PROTECTION SOLUTIONS

CHAPTER FIVE

WHEN TO USE A CORPORATION

The first consideration in structuring a sound asset protection plan is deciding which form of entity should be used to operate your business. The possible choices include general and limited partnerships, sole proprietorships, trusts, limited liability companies, and corporations. Each has different legal characteristics, tax attributes, and asset protection features. The right combination is based upon the nature of your business, whether you will have outside investors, the degree of liability protection needed, and which entity creates the greatest tax benefits.

Many physicians use a Professional Corporation (PC)—an entity with special features, determined by the state where the practice is conducted. In this chapter, we will examine the advantages and disadvantages of a corporation and see how it fits in with the overall plan we will develop.

Corporations are a form of business organization permitted by law in every state. A unique feature of a corporation is that it issues shares of stock. A share of stock entitles a shareholder to vote on the election

of a board of directors, which is charged with the overall management of the corporation. The board of directors elects the officers—the president, secretary, and treasurer, who are authorized to conduct the day-to-day business of the corporation. A single individual is permitted to serve as sole director and to hold all of the corporate offices.

One of the unique features of a corporation is that it is intended to have a perpetual existence. The death of an individual director or officer does not terminate the existence of the corporation. Instead, the corporation carries on indefinitely until it is dissolved by a vote of the shareholders.

A corporation is legally formed and begins its existence upon the filing of Articles of Incorporation with the Secretary of State of the state of incorporation. You can choose to incorporate in any state you wish. It is not necessary to incorporate in the state where your business is located. A disproportionately large number of corporations are formed in Delaware. Most large public companies are incorporated there. Delaware has encouraged corporate formations by adopting laws that favor incumbent officers and directors against attack from dissident shareholders, has a long history of decided court cases interpreting its corporate law, and has no state income tax. These are attractive features to consider when choosing a state for incorporating. Nevada is another state without corporate income tax, and its laws are also designed to actively encourage new corporations. Regardless of whether the state you choose has a corporate tax, the state that you do business in will impose its own tax regime on the company. For example, if you incorporate in Nevada and do business in California, the company will be subject to California corporate taxes.

LIMITING PERSONAL LIABILITY

The primary distinguishing feature of a corporation is the so-called *limited liability* of the officers, directors, and shareholders (the “principals”) of the company. In a properly organized, maintained, and capitalized corporation, the principals have no personal liability for debts of the corporation. If a corporation breaches an obligation or causes injury to a third party, only the corporation and not the principals are

legally responsible. If the corporation does not have sufficient assets to satisfy the liability, the creditor is not entitled to seek satisfaction from the personal assets of the principals. This feature of limited liability is distinct from other businesses operated as sole proprietorships, partnerships, or trusts. In those cases, the owner, partner, or trustee, respectively, has *unlimited liability* for debts incurred in the business.

Professional Corporations

The problem for physicians is that personal liability for malpractice cannot be limited by using a corporation. Regardless of whether you conduct your practice through a PC, you will not be shielded from any claims asserted for injury to a patient. If you lose a case, any amount not covered by your insurance will be satisfied from your personal assets. With jury awards of \$3 million and up occurring with some regularity—your entire net worth is on the line with every patient you treat. *We will see that if you cannot legally shield yourself from liability—the proper strategy is to protect what you own from a potential claim.*

Although the PC won't protect you from claims by a patient which you treat, it can be used to defend against the negligence of a partner. If your practice is organized as a general partnership, you are legally responsible for any injury caused by your partner. Even if you don't do anything wrong, you are liable for the actions of your partner. But using a PC limits your responsibility to only those acts committed by you or your employees. You are not liable for injury caused by a "partner" in your medical practice. For those in practice with other doctors, the PC creates a necessary degree of liability protection.

Effect of Personal Guarantees

Anyone doing business with a corporation may require that the principal of the company give a personal guarantee of a corporate obligation. In simple terms, the person signing a guarantee promises to pay the corporation's debts if the corporation is unable to do so. For example, if you wish to lease office or retail space for the business, the landlord may request a personal guarantee of the lease obligation. If the corporation fails to make its payments on time, the landlord can then collect

directly from you. In this manner, a personal guarantee eliminates the benefits of the corporation's limited liability.

Similarly, vendors sometimes will not sell, and banks and other lenders often will not lend to a family corporation without a personal guarantee. To the extent that guarantees are provided, an individual owner will have personal liability for these contracts, and the corporation will not provide protection from these obligations.

Protection from Tort Claims

Except for professional malpractice cases, when the source of the lawsuit is a negligence claim or a claim arising out of the employer-employee relationship, the corporation can be an effective device. We have previously discussed how an employee's negligence may be imputed to his employer. If your secretary injures someone while she is picking up your lunch, you are likely to be responsible for the damages. However, if the secretary is an employee of a corporation, the corporation, but not the officers or directors, will be liable for the injury. This is also the case generally for employee claims of discrimination or wrongful termination. Any such lawsuits will be filed against the corporation as the employer. The principals of the company will not usually be held personally liable for these types of activities.

Protection from Customers

When the corporation *sells* goods or services (other than professional services), liability for these activities will usually be limited to the corporation. A buyer of goods (as opposed to a seller) typically does not require a personal guarantee as to the quality of the product. If the product is faulty or someone is injured by the product, the corporation will be liable but not the principals. If a corporation supplies services, such as contracting or repair work on a house, only the corporation would be liable for faulty services. A corporation provides a useful shield against personal liability in connection with the sale of products or services. When a corporation *buys* goods or services, liability for payment will also be limited to the corporation, unless the principals have signed a personal guarantee of the obligation.

ELIMINATING DOUBLE TAXATION

The way corporations are taxed provides some interesting and challenging planning decisions. A corporation is a taxpaying entity. That is, it must file an annual tax return and pay taxes on its income. If those earnings are distributed to a shareholder, this distribution is treated as a *dividend*, which is then taxable to the shareholder. The effect of this is that corporate earnings are taxed twice—once at the corporate level and once at the shareholder level, when the earnings are distributed in the form of dividends.

The problem of double taxation may be eliminated in one of two ways. First, the corporation can pay out as salary an amount equal to its net earnings. This is called *zeroing out* the corporation. As an example, a medical corporation might have a profit of \$100,000. If this amount is paid to one or more of the officers of the corporation as compensation for services, the corporation will get a tax deduction for this \$100,000 in salary. That will reduce taxable income to zero, and no federal income taxes would be due. The \$100,000 is included in income, and the tax is paid by the recipient. This eliminates the problem of double taxation.

The Internal Revenue Code imposes certain limitations on this technique by allowing a deduction to the corporation, only if the amount of compensation paid to a particular individual is “reasonable.” The salary cannot be excessive based upon the actual services provided by the individual. There have been thousands of cases litigated by the Internal Revenue Service on this issue, and no firm rule has developed. Basically, if the salary is comparable to that received by others in similar businesses, it is unlikely that there will be a challenge from the IRS.

If you attempt to pay salary to your children or your grandmother without any services performed by them, the deduction could be disallowed as unreasonable. If the salary is disallowed as unreasonable, this amount is added back to the corporation’s income and a tax is assessed on this income. Also, the amount which was distributed is treated as income and is taxable to that individual. This produces a double tax on the same income and is clearly a disastrous result.

Using S Corporations

The second method for eliminating double taxation is the use of a device called an *S Corporation*. This is a type of corporation specifically provided for in the Internal Revenue Code. An S Corporation is treated differently for tax purposes than a conventional corporation (which is known as a “C Corporation”). If elected by the shareholders, an S Corporation will not be subject to tax at the corporate level. Instead, all corporate income is included directly in the income of the shareholders. There is no need to zero out the corporation with salaries since corporate income is now subject to tax only once, at the shareholder level. Additionally, if the corporation has a *net loss*, that loss can be used by the shareholders to offset other business income.

In order to qualify, the stock of an S Corporation must be held by one hundred or fewer individuals and all shareholders must consent to the election. One major drawback is that an S corporation is only permitted to have one class of stock, which may limit the use of sophisticated asset protection strategies which vary the rights of different shareholders. Further, shares of S Corporation stock can only be held by individuals and certain types of trusts. Ownership by partnerships, other corporations, and non-residents is not permitted.

PIERCING THE CORPORATE VEIL

The lawsuit protection features of the corporation will be available only if the integrity of the corporation as a separate and distinct entity, apart from the individual, is respected by a court and by the Internal Revenue Service. In matters involving a lawsuit by an injured party, especially if a corporation has no significant assets, the plaintiff will attempt to convince the court that the corporate entity should not be respected and that the principals of the company should be personally liable. In these cases, the plaintiff is attempting to *pierce the corporate veil* in order to obtain a judgment against the principals, who may have personal assets sufficient to satisfy a judgment.

There are many reported cases on this topic, and the outcome is usually determined by whether the corporation carries out its business and looks and acts the way a corporation should. If the principals

treat the corporation and hold out the corporation to third parties as a separate and distinct entity, the court will usually uphold the status of the corporation and will not find personal liability. However, if various corporate formalities are not consistently observed, the corporation will be disregarded and the individuals may be held personally liable.

One of the major problems with the corporate format for small businesses is that as a matter of course the shareholders, officers, and directors will be named in any lawsuit against the corporation. The plaintiff will attempt to pierce the corporation or will argue some theory to make the defendants responsible. In a significant number of these cases, when there is a judgment against the corporation, the court will disregard the legal protection of the corporation and will hold the defendant shareholders, officers, or directors liable.

Much of the practical protection offered by the corporate form is rendered meaningless by these cases. Sometimes the protection is upheld, and sometimes it is not. This lack of certainty makes business planning—and sleeping at night—difficult. Since the shareholder will almost always be named as a defendant in the lawsuit, even if he is ultimately successful, the attorney's fees and the costs of defense can be financially ruinous. The attorney for the plaintiff will use this uncertainty of outcome to his advantage in negotiating a settlement. As we discussed in chapter 1, an uncertain outcome and the possibility of a large financial loss usually forces a defendant to settle a case on unfavorable terms.

There are two solutions to this problem. If you are a principal shareholder or officer/director of a corporation, use a proper asset protection plan to shield your personal assets from the potential liability associated with the corporation. Alternatively, use a Limited Liability Company (LLC)—instead of a corporation to conduct business. We will discuss the LLC in detail, but for now, you should know that an LLC cannot be pierced like a corporation and the members generally cannot be named in a lawsuit for failure to follow any formalities. It provides the protection against liability associated with the corporation but avoids many of the pitfalls. When considering the best asset protection strategy for your situation, determine whether the LLC is an appropriate form to conduct your business activity.

If you are using a corporation, you must pay attention to formalities which the courts have determined to be of particular significance:

Corporate Bylaws. The corporation must adopt a set of bylaws, which provide a written statement of how the internal affairs of the corporation will be handled. The bylaws set the time and place of regular shareholder meetings and meetings of the board of directors. The bylaws may also establish the rules relating to the voting power of the shareholders, the capital structure of the company, the rights of the shareholders as between themselves and any other matters which affect the governance of the corporation.

Corporate Minute Book. The corporate minute book contains a written record of actions by the shareholders and directors of the corporation. At a minimum, there must be annual minutes reflecting the election of directors by the shareholders. Any significant corporate activities, including corporate borrowings, purchases, and the payment of compensation to officers, should be properly reflected in the minutes of the meetings of the directors and shareholders. A lack of complete and up-to-date corporate minutes is the primary reason courts find to dismantle the corporate shield in small business cases. Larger companies generally pay their attorneys to properly maintain the records so it is not an issue in those cases. But in our experience we have seen very few owners of small businesses who have diligently maintained the corporate minutes because it's time consuming and inconvenient and understandably most people involved in business have other, more immediate priorities.

Stock Ledger Book. The corporation must also maintain an accurate stock ledger book. This book shows who has been issued stock certificates and the amounts received by the corporation for the issuance of its stock. The stock ledger book contains an up-to-date record of the names and number of shares owned by each shareholder.

Conducting Business in Corporate Name. When doing business with third parties, the officers and directors must make it clear that they are acting on behalf of the corporation and not in their individual capacity.

WHEN TO USE A CORPORATION

Correspondence should be sent out under the proper corporate letterhead, and contracts should be entered into only with the corporation as a signatory. Unless the documents clearly reflect that a transaction is entered into on behalf of the corporation and all necessary agreements are entered into under the corporation's name, the corporate entity will not survive a challenge in a lawsuit.

Bank Accounts. Corporate bank accounts and accounting records must be separate and distinct from the individual. A corporate bank account cannot be treated as if it were the account of an individual officer or director. Income and expenses must be correctly accounted for on the books of the corporation. One of the biggest mistakes made by clients is that they feel free to move money and property back and forth between themselves and their corporation without properly accounting for such movement in the records of the corporation. This is a fatal mistake, and under these circumstances, the corporate entity will be disregarded by the court.

PROTECTING CORPORATE ASSETS

We must also consider the issue of protecting the assets of the corporation. The corporation, as an entity operating a business, is in the front line of attack for litigation from every conceivable source. If the company loses a lawsuit, all of its assets are available for collection. Because of this, a sensible asset protection strategy must be adopted for the corporation as well as for the individual. As a rule, to the extent practical, you do not want the corporation to hold any significant assets. You do not want a corporation to build up a substantial net worth only to see everything wiped out in the event of a lawsuit.

Multiple Corporations and Special Purpose Vehicles

Whenever feasible, assets, such as real estate and equipment, surplus cash, inventory, accounts receivable, and intellectual property should not be held by the operating corporation.

If the business of the corporation can be divided into separate businesses, both assets and liabilities can be protected or managed through

the use of multiple entities, (which may be corporations, LLCs, limited partnerships, or trusts—all of which together are referred to as Special Purpose Vehicles or SPVs). We have seen over the last ten years many abuses of these strategies in now infamous corporate scandals. Enron used multiple corporations and SPVs to remove liabilities from its corporate balance sheet and to disguise its growing losses from investors and regulators. Lehman Brothers, in the years preceding its bankruptcy, and apparently many of the large banks, still regularly shift liabilities to SPVs prior to the end of a fiscal quarter, which effectively overstates the company's financial strength. Despite these past and certainly ongoing abuses, SPVs allow us to accomplish many legitimate business and legal objectives. In one form or another, most businesses with valuable assets or revenues to protect use multiple corporations or SPVs for structuring flexible financing, issuing securities to investors, and achieving enhanced legal liability protection.

The simplest example of the usefulness of SPVs is a corporation with more than one retail outlet within a single corporation. If business at one of the locations slows down substantially, that outlet may become a financial drain on the others, absorbing all of the available cash in the company. At a minimum, our approach in these situations is to have each store location be separately incorporated. Then, if one were to falter, the liabilities would not drag down the other, still valuable, stores. A judgment creditor of one corporation would not be able to reach the assets of the other companies. An extreme illustration of this is the taxicab company which separately incorporated twenty-six different taxis.

This strategy is also useful for a company that manufactures or wholesales different product lines. Companies in the pharmaceutical business face enormous potential liability for many types of drugs and medical devices. The recent oil leak from an offshore well owned by BP has created one of the greatest environmental disasters in history. The company faces tens of billions of dollars in potential liability claims. It's impossible to say at this point how BP has segregated ownership of other worldwide assets to limit the impact of liability claims, but whatever tactics the company intends to use will be revealed over the

coming months and years. Whenever a particular product may be hazardous, using multiple corporations (or other entities) is an effective technique for insulating each separate product from liability caused by another.

Protecting Trademarks and Trade Names

Trademarks, patents, and copyrights are valuable assets which should not be owned directly by the operating entity. A separate company can own these assets and make them available through a form of a licensing agreement. The objective is to protect these assets in the event of a judgment against the corporation.

One of our clients was in the garment manufacturing business. His company sold primarily to the large department stores. This is always a dangerous business. A large amount of capital is needed to fill orders which are not paid until sixty or ninety days after shipment. A common scenario goes like this: An unusually large order is placed by a retailer, and the manufacturer uses all of its cash and credit to buy the materials and pay the workers to fill and ship the order. Then, ninety days later, before the manufacturer has gotten paid, the truck pulls up with the entire order returned. Since the value of the goods to the manufacturer is only a fraction of the invoice amount, the manufacturer is now out of business since it is out of cash and out of credit. The bankruptcy court and the creditors now attempt to seize and sell every asset of the company including any valuable trademark or trade name.

Our client engaged in the proper planning before these events took place. The trademark and the trade name were owned by a separate company. The new company (NewCo) then licensed the use of these properties to the corporation on a short-term basis. When the cooperating corporation ultimately filed for Chapter Eleven (because of the circumstances we just described), the trademark and trade name were safely protected in NewCo. Since it was these assets which contained all of the goodwill of the business, our client was able to successfully emerge from Chapter Eleven, reorganize, and continue its business under the same trade name and trademarks.

USING CORPORATIONS TO PROTECT PERSONAL ASSETS

Is a corporation a good strategy for shielding personal assets from potential lawsuits? This is a question which has produced needless confusion and misleading advice. There are many heavily promoted schemes—often involving Nevada corporations—which claim to provide a myriad of asset protection benefits.

Our view is that the corporation is generally a poor choice as a vehicle strictly to protect assets. It is clumsy, inefficient, and usually better methods will be available.

The source of the problem is that a judgment creditor can seize any shares of stock which you own. If you transfer assets to a corporation in exchange for stock, the creditor simply takes the stock certificates and becomes the owner of those shares. If he obtains more than 50 percent of the shares, the creditor is then in control of the company—and your assets. Since the shares of stock of a corporation are reachable by judgment creditors, a corporation will not provide a significant degree of asset protection, in the event of a successful lawsuit against you.

Some degree of asset protection can be accomplished if you move the shares into a protected position. For example, corporate shares can sometimes be transferred to an entity that provides necessary legal protection for assets which we will discuss in subsequent chapters, but there are lots of rules and tax traps for the unwary. For instance, as mentioned, shares in an S Corporation can only be held by individuals, particular types of trusts, or an LLC which is a disregarded entity. C Corporations provide greater potential for asset protection since any person or entity can own the shares and also C Corporations are generally permitted to have a varied capital structure with unlimited classes of shares and securities, designed with whatever features are appropriate. That means that we have a wide choice of asset protection structures available for holding corporate shares. Equally important is our ability to maximize the capital structure of a corporation to take advantage of creditor protection features. Not all shares or corporate securities need to have the same voting rights or participation rights in company earnings or assets. It is common for family owned companies to issue multiple classes of stock or hybrid securities, with varying

participation and preference rights to accomplish asset protection and estate planning goals.

USING CORPORATIONS FOR FINANCIAL PRIVACY

Conducting business in a corporation can sometimes create financial privacy advantages. The corporation is a separate entity for legal purposes. It is required to obtain a Federal Tax Identification Number, which is separate from the Social Security Number of the owner. Real estate, bank accounts, and other business interests can be legally owned in the name of a corporation.

The identity of the shareholders of a corporation is not required in any public filing with the state regarding the incorporation or maintenance of the company. In theory, at least, the names of the shareholders are private and evidence of your ownership is not available for public access. But there are many holes in this general principle. Corporate tax returns must disclose the name of the principal shareholders. And companies with publicly traded shares are required to disclose the names of principal shareholders in regular reports to the SEC and various state regulatory agencies.

The identity of the shareholders of privately held companies must be maintained in a written record in the stock ledger book of the company which is as secure as the procedures implemented by the custodian of the corporate records. In addition, information about the stockholders of a private company may be developed by the database services through voluntary disclosure on credit and insurance applications, business and professional licenses, and other regulatory filings. Corporations must annually file, with the state, the names and addresses of corporate officers and directors. If you are listed as an officer or director, a database search will reveal this connection to your corporation. It doesn't matter which state you have chosen to incorporate in—Nevada, California, Delaware—every state has the same requirement and the information is publicly available.

Let's say that, in order to maximize your privacy, you have a friend or business associate serve as the sole officer and director of the corporation. Alternatively, there are companies and individuals

who offer these services, for a fee, to newly formed or existing corporations, in the states where corporate formations are popular. These individuals or companies promise to follow directions and act as your agent with regard to the corporation. For convenience, we will call your “friend” Gumby. Gumby’s name—but not yours—will now be recorded publicly. If he carefully executes all corporate filings and documents, your name will probably not show up in a search of the databases.

The more difficult privacy issue involves the matter of signature authority with regard to corporate assets. Who should be authorized to sign on the corporate bank account? Although the account itself is in the name of the corporation—with its own Federal Tax Identification number the law requires that the bank obtain the name and Social Security number of *every account signatory*. If you are a signatory on the account, you must supply this information. Your name and Social Security number on the account then provide the link to you—exactly what you were trying to avoid in the first place.

You can eliminate this difficulty by having Gumby as the account signatory—but you have now created serious dangers for yourself. You have made Gumby the sole officer, director, and signatory for all corporate assets—presumably valuable to you or you wouldn’t be going to this much trouble. In essence, you have turned over to Gumby much of what you own. As attorneys, we see so many risks and opportunities for fraud with this type of arrangement that we strongly advise against it for our clients.

One of the largest companies supplying these services was recently raided as part of an IRS crackdown. Computers and files were seized, and criminal investigations are proceeding. Imagine the inconvenience of getting Gumby’s signature on a check when he is operating from the federal penitentiary. If your goal is financial privacy, we will show you that there are safer and more efficient alternatives which will accomplish the desired result.

SUMMARY

We have seen that the corporation can provide benefits by limiting the liability of business owners from particular sources of lawsuits. This general rule will not apply to physicians, dentists, attorneys, engineers, CPAs, and other licensed professionals. These individuals remain personally liable for acts of malpractice.

In other cases, a corporation may be effective in isolating individual shareholders from claims of breach of contract and disputes with employees and customers. However, lawsuit protection will be lost if the corporate entity is disregarded by the courts, a very real risk for most smaller companies which fail to adequately maintain corporate records and other required formalities. In attempting to preserve the sanctity of the corporation as a separate and distinct entity, proper minutes and accounting records must be maintained. Correspondence and contracts with third parties also must clearly establish that it is the corporation, and not the individual, which is conducting the business.

Because of the risk of being named as a defendant in a lawsuit against the corporation, the principal owners, officers, and directors should carefully protect their personal assets from this potential liability. Corporate assets can and should be protected through multiple entities and SPVs which can insulate valuable assets and revenue streams from general company obligations and business risks. If permissible, corporate shares must then be held by an asset protection entity to avoid seizure or converted into a hybrid or other form of security which is unattractive or worth little to a judgment creditor.

The corporate format poses a variety of issues regarding financial privacy. Although there are no public records of the shareholders of privately held companies, considerable information is available from insurance and credit applications and government regulatory compliance. Signature authority over corporate assets will also provide an easily discernible trail leading to your door. Gumby's services can be used to act as agent for signing on accounts and corporate documents,

ASSET PROTECTION

but they are notoriously unreliable and present significant dangers from fraud or other malfeasance. In the succeeding chapters, we will see how asset protection techniques can be used to solve many of these problems and to accomplish your important objectives.

CHAPTER SIX

ASSET PROTECTION AND ESTATE PLANNING WITH A FAMILY LIMITED PARTNERSHIP

Over the past decade, the Family Limited Partnership (FLP) has risen from obscurity as a little known tax loophole, into a prominent strategy for asset protection and estate planning. The asset protection and estate planning benefits of the FLP have been written about extensively in every national publication from the *Wall Street Journal* to *Forbes Magazine*. A Google search of Family Limited Partnerships will return thousands of hits with many law firms and accounting firms extolling its virtues.

In this chapter, we will look at the FLP and discuss realistically and critically what this technique can and cannot accomplish. Recent law changes and cases highlight the advantages and opportunities of the FLP, and we will also point out some of the common pitfalls and

traps that should help you to proceed with a clear understanding of planning strategies available with the FLP.

DIFFERENT TYPES OF PARTNERSHIPS

General Partnerships

A partnership is formed when two or more persons agree to carry on a business together. This agreement can be written or oral. A *general partnership* is formed when two or more people intend to work together to carry on a business activity. No local or state filings (other than appropriate tax returns) are required to create this type of partnership. This is different than a corporation, which does not come into existence until Articles of Incorporation have been filed with the Secretary of State.

The distinguishing feature of a partnership is the *unlimited liability* of the partners. Each partner is personally liable for all of the debts of the partnership. That includes any debts incurred by any of the other partners on behalf of the partnership. Any one partner is able to bind the partnership by entering into a contract on behalf of the partnership. If Jackson and Wilson are partners, and Wilson signs a contract on behalf of the partnership, Jackson will be personally liable for the full amount. This is true regardless of whether Jackson authorized the contract or whether he even knew of its existence. This feature of unlimited liability contrasts with the limited liability of the owners of a corporation. As discussed previously, when a contract is entered

An Example of a Limited Partnership

Able and Baker form a limited partnership with Able as the general partner and Baker as the limited partner. Baker contributes \$100,000. Able will run the day-to-day affairs of the business, and Baker will provide all of the initial capital. If Able enters into a contract that causes the partnership to incur a liability of \$500,000, Baker will lose his \$100,000 contribution, but he has no obligation to contribute any additional funds. Able, as the general partner, has personal liability for the entire amount. He has no right to demand that Baker make any further contributions.

into on behalf of a corporation, the owners are not personally liable for its performance.

Because each of the partners has unlimited personal liability, a general partnership is the single most dangerous form for conducting one's business. Not only is a partner liable for contracts entered into by other partners, each partner is also liable for the other partner's negligence. When two or more physicians or other professionals practice together as a partnership, each partner is liable for the negligence or malpractice of any other partner.

In addition, each partner is personally liable for the *entire* amount of any partnership obligation. For example, Dr. Smith may be one of ten partners in a medical partnership, but he is not responsible for only 10 percent of partnership obligations. He is responsible for 100 percent—even though he owns only a 10 percent interest. If Dr. Smith's other partners are unable to pay their respective shares, he must pay the entire amount.

Limited Partnerships

Obviously, the unlimited liability feature of general partnerships is a serious impediment to conducting business using a partnership format. To mitigate the harsh impact of these rules, every state has enacted legislation allowing the formation of a type of partnership known as a *limited partnership*.

A limited partnership consists of one or more *general partners* and one or more *limited partners*. The same person can be both a general partner and a limited partner, as long as there are at least two legal persons who are partners in the partnership. The general partner is responsible for the management of the affairs of the partnership, and he has unlimited personal liability for all debts and obligations.

Limited partners have no personal liability. The limited partner stands to lose only the amount which he has contributed and any amounts which he has obligated himself to contribute under the terms of the partnership agreement. Limited partnerships are often used as investment vehicles for large projects requiring a considerable amount of cash. Individual limited partners contributing money to a venture,

but not having management powers, will not have any personal liability for the debts of the business.

In exchange for this protection against personal liability, a limited partner may not actively participate in management. However, it is permissible for a limited partner to have a vote on certain matters, just as a shareholder has a right to vote on some corporate matters. A typical limited partnership agreement may provide that a majority vote of the limited partners is necessary for the sale of assets or to remove a general partner. The partnership agreement determines whether the limited partners can vote on these matters.

If a limited partner assumes an active role in management, that partner may lose his limited liability protection and may be treated as a general partner. For instance, if a limited partner negotiates a contract with a third party on behalf of the partnership, the limited partner may have liability as a general partner. For this reason, a limited partner's activities must be carefully circumscribed.

Tax Treatment of Partnerships

Since the partnership is a "pass through" entity, there is no potential for income tax on it. Unlike corporations and irrevocable trusts, a partnership is not a taxpaying entity. A partnership files an annual informational tax return setting forth its income and expenses, but it doesn't pay tax on its net income. Instead, each partner's proportionate share of income or loss is passed through from the partnership to the individual. Each partner claims his share of deductions or reports his share of income on his own tax return.

This avoids the potential for double taxation that is always present in a C Corporation. Typically, when a business is expected to show a net loss rather than a gain, the partnership format is used so that the losses can be used by the partners. Limited partnerships have always been used for real estate and tax shelter investments in order to pass the tax deductions through to the individual investors. These losses are then used by the partner to offset other income he might have. Although the Tax Reform Act of 1986 limits the ability to immediately deduct losses from "passive activities" to offset wages or investment income,

the partnership format may still be desirable if the circumstances of the individual partner are such that he is able to take advantage of these losses.

The rules regarding the taxation of partnership activities are lengthy and cumbersome. As a general rule, however, transfers of property into and out of a partnership will not ordinarily produce any tax consequences.

LAWSUIT PROTECTION

The Family Limited Partnership can be an outstanding device for providing lawsuit protection for family wealth. However, it cannot be used by itself as a stand-alone asset protection plan. Meaning, if what you have for your asset protection is simply a Family Limited Partnership, it provides no better protection of assets than a living trust, which is generally no asset protection at all. The FLP can be a valuable component of an asset protection plan when used as part of a properly designed overall strategy. In the sections that follow, we will show you how the FLP is typically used (and misused) and what it really can accomplish for both asset protection and tax savings when a sound and correct legal structure is utilized.

Under the typical arrangement, the FLP is set up so that Husband and/or Wife (or a specially formed Limited Liability Company) is each a general partner. Corporations are not typically used as a general partner if asset protection is a goal. The shares of a corporation can be seized by a creditor, which then effectively transfers to the creditor all management rights over the partnership. This would be a disastrous result in most situations.

The general partners might, for example, own only a minimal 1 or 2 percent interest in the partnership. The remaining interests are in the form of limited partnership interests. These interests will be held, directly or indirectly, by one or more other entities or family members, based on the particular tax, estate planning, and asset protection goals to be achieved.

After setting up the FLP, selected family assets are transferred into it. These may include investment accounts and shares in other business

interests. When the transfers are complete, Husband and Wife no longer own a direct interest in these assets. Instead, they own, directly or indirectly, a controlling interest in the FLP, and it is the FLP that owns the assets. The general partners have management over the affairs of the partnership and can buy or sell any assets they wish, subject to the terms of the partnership agreement. The general partners also may have the right to determine what portion of partnership income and assets are retained by the partnership and what amount is to be distributed to the partners.

Creditor Cannot Reach Assets

Now, let's see what happens if there is a lawsuit against either Husband or Wife. Assume that Husband is a physician and that there is a malpractice judgment against him for \$1 million. The plaintiff in the action is now a judgment creditor, and he will try to collect the \$1 million from Husband.

The judgment creditor would like to seize Husband's bank accounts and investments in order to collect the amount which he is owed. However, he discovers that Husband no longer holds title to any of these assets. In fact, since all of these assets have been transferred to the FLP, the only asset held by Husband is any interest he owns in the FLP. Can the creditor reach into the partnership and seize the investments and bank accounts?

The answer is no. Under the provisions of the Uniform Limited Partnership Act, *a creditor of a partner cannot reach into the partnership and take specific partnership assets*. The creditor has no rights to any property which is held by the partnership. Since title to the assets is in the name of the partnership and it is the Husband partner rather than the partnership which is liable for the debt, partnership assets may not be taken to satisfy the judgment. For example, California Corporations Code Section 15907.03 (f) states this clearly:

No creditor of a partner shall have any right to obtain possession or otherwise exercise legal or equitable remedies with respect to the property of the limited partnership.

CHARGING ORDER REMEDY

If a judgment creditor cannot reach partnership assets, what can he do? Since Husband's only asset is an interest in the FLP, the creditor would apply to the court for a *charging order* against Husband's partnership interest. A charging order means that the general partner is directed to pay over to the judgment creditor any distributions from the partnership, which would otherwise go the debtor partner, until the judgment is paid in full. In other words, money which comes out of the partnership to the debtor partner can be seized by the creditor until the amount of the judgment is satisfied. Cash distributions paid to Husband could, therefore, be taken by the creditor. A charging order does *not* give the creditor the right to become a partner in the partnership and does *not* give him any right to interfere in the management or control of partnership affairs. He only receives the right to any actual distributions paid to Husband.

Under the circumstances in which a creditor has obtained a charging order, the partnership would not make any distributions to the debtor partner. This arrangement would be provided for in the partnership agreement and is permissible under partnership law. If the partnership does not make any distributions, the judgment creditor will not receive any payments. The partnership simply retains all of its funds and continues to invest and reinvest its cash without making any distributions.

The result of this technique is that family assets may be successfully protected from the judgment against Husband. Had the FLP arrangement not been used and had Husband and Wife kept all of their assets in their own names, the judgment creditor would have seized everything. Instead, through the use of this technique, all of these assets were protected.

Although this much is true so far, it is not the whole story. The important issue for asset protection is that the charging order is not always the only remedy available to a creditor.

FORECLOSURE OF PARTNERSHIP INTERESTS

Although it would be attractive to have a single, simple entity solve all of our asset protection issues, the law is more complex than that. In

California, for example, case law and the statutes specifically allow a creditor to foreclose on a limited partnership interest, in addition to the charging order remedy. Corporations Code Section 17302 (b) states:

(b) A charging order constitutes a lien on the judgment debtor's transferable interest. The court may order a foreclosure upon the interest subject to the charging order at any time. The purchaser at the foreclosure sale has the rights of a transferee.

See also (*Hellman v. Anderson*, 233 Cal. App. 3d 840; (Foreclosure of partnership interests); Section 17302 (Foreclosure of LLC interests) In Re: *Ashley Albright*, U.S. Bankruptcy Court for the District of Colorado (decided April 4, 2003) *Olmstead, et. al., vs. The Federal Trade Commission*, Supreme Court of Florida. Case No. SC08-1009 June 24, 2010).

What does this mean? As distinguished from a mere charging order, which allows a creditor to only reach actual distributions to a debtor-partner, a foreclosure of a limited partnership interest has some powerful teeth as a remedy. For example, you may own all of the interests in an FLP holding assets worth \$1 million. Sometime later a judgment is entered against you for \$200,000. A creditor with a judgment can foreclose on the limited partnership interest—worth ostensibly \$1 million—substantially more valuable than the judgment itself. If the creditor's remedy is limited to a charging order, he would be entitled to distributions equal to the amount of the judgment. When and if he is paid this amount (plus interest), the creditor's judgment is satisfied. A creditor who is permitted to foreclose on the partnership interest gets more than that. He is legally entitled to distributions without regard to the amount of the judgment. He could ultimately get paid the full \$1 million of value. In this situation, you will be forced to pay off the judgment at its full amount. You have little to negotiate with and certainly no leverage to attempt to settle the claim at some reduced amount. The creditor holds all the cards because he has security for his claim far more valuable than the actual amount of the judgment. By relying on the Family Limited Partnership and the

charging order protection, the potential loss for you is now far greater than it would otherwise be.

In states other than California, case law and ambiguities in the interpretation of existing laws make a reliance on the charging order protection speculative and, therefore, dangerous. When we talk about Limited Liability Companies in the next chapter, you will see that recent cases have severely limited charging order protection and that seems to be the trend of the cases. Even when the state where the partnership is formed specifically bars foreclosure, rules regarding jurisdiction may dictate that the law of the plaintiff's home state may control the applicable law. In other words, there is no guarantee that a lawsuit against you will end up in a state with favorable laws. Many factors are considered by the courts in determining jurisdiction and the applicable law, and we would not bet the farm (literally) that your choice of law will prevail in any litigation.

Having said all this, the FLP may still be a valuable tool for asset protection. It merely requires that the proper steps be taken to ensure that ownership of the FLP has been correctly established from the beginning so that neither a charging order nor a foreclosure can be applied and the goal of asset protection will be accomplished.

With this in mind and the understanding that the *correct ownership* of the FLP or any other entity involved in your planning structure is the key to any successful asset protection planning, let's look at this issue now.

WHY SHOULD WE USE AN FLP?

The first question to ask is why are we using an FLP? Is it more advantageous than any other type of entity?

The FLP has certain unique attributes that are beneficial for both asset protection and estate planning. It needn't be used to the exclusion of other entities such as corporations, LLCs, and trusts. In fact, it is often combined in a plan with one or more of the others. The proper role of the FLP is often to act as a *holding company*, owning certain assets and interests in other entities. In this way it can be the foundation of a solid plan. The distinguishing features of the FLP are

pass-through taxation and a split in management rights between general and limited partnership interests. The combination of these two characteristics makes the FLP a flexible and efficient vehicle for many types of planning. Sometimes a corporation or LLC can be substituted and may be more appropriate in certain circumstances, but as a general rule the FLP performs well in this arena.

WHO SHOULD OWN THE FLP?

Once the decision is made that the FLP is appropriate in your situation, the next issue to resolve is who should own the interests in the FLP? As we will see in the next chapter, LLC law is similar in many respects so this discussion will apply to LLCs as well.

Assume we have created a Family Limited Partnership. Husband and Wife fund it with property worth \$1 million. Husband and Wife, or an entity which they control, is the general partner, holding a 2 percent interest. Who should own the 98 percent limited partnership interests? Let's briefly consider the merits of some popular strategies, and we will analyze the best of these options in greater detail in chapter 7.

Ownership by Spouses

The first alternative is that Husband and Wife (or a single individual) hold all or most of the limited partnership interests. The apparent advantage of this arrangement is that it is attractive and convenient. Control is maintained through the general partnership, and equity is preserved through the ownership of the limited partnership interests. The disadvantages of this format are that the interests retained by Husband and Wife are subject to a charging order or may be foreclosed by a successful creditor, eliminating any intended asset protection benefits. *In light of these potential problems, we can conclude that ownership of FLP interests (or LLC interests) in an unprotected form by an individual, Husband and Wife, or a living trust, creates significant danger and risk of foreclosure and loss. In some circumstances, that amount of the loss may even exceed the amount of a potential judgment.*

Ownership by Children

A transfer of ownership of the limited partnership interests to a child or children may provide one good solution. A lawsuit against Husband and Wife would not impact the partnership interests because ownership is no longer in the name of Husband and Wife. Although Husband and Wife may retain management powers, directly or indirectly, over the assets as general partner, there are no limited partnership interests available for the plaintiff. Husband and Wife have effectively protected assets by gifting the limited partnership interests to their children.

The disadvantage is that a direct gift to the children in this form may create gift tax liability, depending upon the amount involved. Further, the children have legal rights as limited partners, which must be respected. The gift to the children is real under this arrangement, so assets in the FLP must be those which Husband and Wife are willing to part with, a matter which requires serious consideration and planning. Those in a position to make an irrevocable transfer to their children may accomplish good asset protection and possibly advantageous estate tax savings with this strategy.

Ownership by a Trust

The most popular alternative for asset protection and for owning FLP interests is to transfer the ownership into a trust, which is designed for this purpose. Recent developments in trust law and advances in strategy now allow unlimited variations in form to accomplish most reasonable asset protection goals. Usually these trusts are known as Family Savings Trusts, and they will be described in detail in chapter 9. For now, keep in mind that the purpose of the Family Savings Trust is to accomplish these specific results:

1. Depending on the terms, partnership interests can be immune from charging order or foreclosure.
2. Family Savings Trusts can be designed to be domestic or foreign, or to convert upon the occurrence of specified events.

3. The plan can be tax neutral, preserving existing tax status, or may create estate tax savings and income tax advantages when appropriate.
4. The family residence and other property can be held by the Family Savings Trust without disturbing the current tax benefits.
5. A high level of privacy can be incorporated into the plan together with these asset protection features.

HOW TO SAVE INCOME AND ESTATE TAXES

Income Tax Benefits

If family assets are held in the form of a limited partnership, it will be possible to obtain certain income tax savings in addition to the asset protection benefits. Tax savings can be realized by spreading income from high tax bracket parents to lower tax bracket children and grandchildren or other family members. Let's look at an example of how this might work:

One of our clients had taxable investment income from various investments of approximately \$200,000, consisting of rental income and interest from bonds, and trust deeds that he owned. He paid combined federal and state taxes of \$80,000 per year on this income. As part of an overall business plan that we established, this investment income was routed through a Family Savings Trust, which owned the interests in the Family Limited Partnership. His adult children and parents that he supported were beneficiaries of the Family Savings Trust. Under the partnership agreement, the children and parents were taxable on \$100,000 of the \$200,000 in income generated by the partnership. The combined lower tax brackets of these beneficiaries reduced the taxes on the \$100,000 from \$40,000 to \$15,000. This produced a savings of \$25,000 in overall family income taxes. Under the partnership agreement, it was not required that the \$100,000 actually be distributed to any of the partners. In fact, the parents as general partners retained all of this amount within the partnership, except for what was needed to pay the taxes on the limited partners' shares of partnership income.

The parents thereby reduced their annual income taxes by shifting a substantial amount of income to these lower bracket family members. This and similar strategies for shifting income from high to low bracket family members will assume increased importance as tax rates increase within the brackets. These plans are currently under consideration in Congress as extending or repealing the Bush era tax cuts are debated.

Estate Tax Benefits

We can also use the Family Limited Partnership as a vehicle for dramatically reducing or eliminating estate taxes. This estate tax reduction can be accomplished because of certain unique attributes of the FLP. Of primary importance is the ability to shift the value of assets out of your estate through a program of gifting limited partnership interests to your children or other family members.

For example, the Smith family owns a business with a current value of \$2 million, a rental property with equity of \$500,000, and retirement savings in stocks and bonds equal to \$1 million. That's a total estate of \$3.5 million. (Although at the time of this writing, we have no current estate tax in 2010, unless changed by Congress, the individual estate tax exemption is scheduled to return at \$1 million in 2011 and beyond. It may be raised from that amount, but for our example we will use this amount.) Under current law, with a properly designed estate plan, taking maximum advantage of the combined current exemption of \$2 million, the estate tax on the balance of \$1.5 million would be approximately \$825,000. Mr. and Mrs. Smith would like to take steps to preserve the family estate for the benefit of their three children, but they do not wish to give up management over their assets during their lifetime.

One solution to the problem involves a properly structured estate plan including an FLP that is established to hold all family assets. Mr. and Mrs. Smith (or an LLC) would be the general partners of the FLP. As such, they would have management over the property in the FLP. Initially, they could make a gift of the limited partnership interests to their children (directly or indirectly through a Family Savings Trust) in an amount equal in value to the combined maximum gift tax credit

(currently \$2 million). Or they could use a portion of their credit now and take advantage of the annual exclusion amount, which is currently \$13,000 per person per donee. That would be \$26,000 that a married couple can gift to each child without using any portion of their lifetime gift tax exemption. In subsequent years, they could gift limited partnership interests equal to the amount that would bring their estate tax down to zero over a number of years.

That's not a bad result, but we can push the advantages of the FLP a great deal further. According to IRS rulings and a significant line of court cases, the value of each gift of a limited partnership interest should be *discounted* in order to account for the lack of marketability and the lack of control associated with those interests. For example, if the parents transfer assets with a value of \$1 million to an FLP, a gift of a 1 percent limited partnership interest should not be valued at \$10,000. Instead, because the interest cannot be readily sold and because the donee has no right to participate in management of the FLP, a reasonable approach to determine value, suggested by many experts, would be to discount the transferred interest to reflect its true value in the market. Discounts in the range of 30 percent are fairly conservative, but some aggressive advisors push this number to the 50 percent range.

Once this discount is taken into consideration, potential tax savings can be accelerated. Using a conservative 30 percent discount, the value of the limited partnership interests in the Smith FLP would be discounted in value from \$3.5 million to \$2,450,000. A substantial amount of this value could be gifted in the first year without exceeding the combined gift tax credit of \$2 million. The remaining \$450,000 in value could be transferred out of their estate at a rate of \$26,000 per year for each child or grandchild they wish to benefit. In a relatively painless fashion, the Smiths have eliminated \$825,000 of estate taxes while maintaining management powers over the assets of the partnership. If a more aggressive discount is chosen, it might take only a few years of gifting to completely eliminate the estate tax.

As an added bonus, this approach will also remove future appreciation from the Smiths' estate. In our example, the Smiths' assets

have a value today of \$3.5 million. I know it seems unlikely now, but if there is any future appreciation in value or there is inflation at a rate of 5 percent per year, for example, in roughly fourteen years these assets would be worth \$7 million with total estate taxes of roughly \$2,750,000. This amount can be avoided entirely or at least in part by timely planning. If you own real estate or a business which you believe will increase in value over the years, the FLP provides an excellent planning opportunity to achieve meaningful estate tax savings. (See e.g., *Kimbell v. United States*, 244 F. Supp. 2d 700. (N.D. Tex. 2003). Also see the article “Avoid Estate Taxes with Family Limited Partnerships” in chapter 11.

KEY CONSIDERATIONS IN CREATING THE FAMILY LIMITED PARTNERSHIP

The Partnership Agreement and the Capital Structure

Concurrently with the filing of the Certificate of Limited Partnership, a written partnership agreement must be prepared. This is a crucial and often overlooked document that governs the affairs of the partnership. It sets out the purpose of the partnership, the duties of the general partners, matters on which the vote of the limited partners is required, the share of partnership capital and profits to which each partner is entitled, and all other matters affecting the relations between the partners.

When creating a Family Limited Partnership for estate planning and asset protection purposes, the partnership agreement must also contain certain key provisions designed to accomplish your objectives. Taken together, these provisions must contain specific legal restrictions on the limited partnership interests to ensure that the interests are worth as little as possible if seized by a creditor and that he can never achieve any influence over partnership affairs under any circumstances. These provisions for restricted partnership interests are unique and essential to a properly structured Family Limited Partnership.

Based on the law of the particular state where it is formed, a Family Limited Partnership is permitted to create whatever variety of traditional equity, debt, or combination hybrid securities that it needs to

maximize the asset protection features. An FLP has great flexibility in designating variations in the amount and the timing of payments to partners, preferences and values on liquidation, voting rights, and every other contract governing the operation and management of the FLP and the distribution of its profits. By carefully structuring the management and profit distribution rights of its debt and ownership interests, a wide variety of important asset protection advantages can be achieved.

The capital structure of the FLP should always be addressed in the partnership agreement and must be specifically tailored to the circumstances and the objectives of the individuals or the company forming the FLP. What rights to income or distributions should be retained? How should voting preferences and liquidation values be tailored to maximize asset protection? In other words, who gets what and when? This is an essential question in making the FLP useful for whatever purpose is desired. A capital structure which employs different classes of partnership interest and hybrid securities will provide the most effective asset protection and estate planning and must be properly structured within the partnership agreement (or within the trust which owns the partnership interests) The possibilities for varying the capital structure of an FLP (as well as an LLC and a corporation) are virtually unlimited and are crucial to accomplishing client objectives. We have provided a more extensive discussion of the topic and the key issues on our Web site at www.rjmintz.com.

Funding the Partnership

The next step in the partnership formation process is the funding of the partnership. That means you must now decide which assets to transfer and the best means for doing so.

DANGEROUS AND SAFE ASSETS

In making the decision about funding the partnership, it is important that you understand the distinction between Safe Assets and Dangerous Assets.

Safe Assets are those which do not, by themselves, produce a high degree of lawsuit risk. For instance, if you own investment securities

such as stocks, bonds, or mutual funds, it is unlikely that these assets will cause you to be sued. Mere ownership of investment assets, without some active involvement in the underlying business, would probably not cause a significant degree of lawsuit exposure.

Dangerous Assets, on the other hand, are those which, by their nature, create a substantial risk of liability. These are generally active business type assets, rental real estate, or motor vehicle ownership, any of which may cause you to be sued.

The reason for the distinction between Safe Assets and Dangerous Assets is that you do not wish to have the FLP incur liability because of its ownership of a Dangerous Asset. If the partnership does incur liability, it will be the target of a lawsuit and all of the assets in that partnership will be subject to the claims of the judgment creditor. This is exactly the situation you are trying to avoid. *Dangerous Assets must either be left outside of the partnership or must be placed in one or more separate entities.* Dangerous Assets must be isolated from each other and from Safe Assets to avoid contaminating the Safe Assets.

Dangerous Assets

An example of a Dangerous Asset is an apartment building. The liability potential of apartment houses is particularly high. Although liability insurance coverage is usually available, the amount of coverage may not be sufficient. A fire in a densely populated building may cause severe injury or death to many tenants. The potential liability for such a tragedy could easily reach into the millions of dollars, exceeding by far the amount of your insurance coverage.

Apartment owners can also be held responsible for the acts of the resident managers. If the resident manager engages in race or sex discrimination in renting to tenants or is guilty of sexual harassment, this liability may be imputed to you as the owner of the property. Acts such as these may not be covered under your standard insurance coverage.

If this asset is transferred to the same Family Limited Partnership that holds all of your other assets, that partnership, as the owner of the property, will face a high degree of lawsuit exposure and all of your assets will again be at risk.

Instead, the best approach for a Dangerous Asset such as an apartment building is to transfer that property to its own *separate* entity. Generally the Limited Liability Company is the proper way to hold Dangerous Assets. Since no individual member of an LLC can be sued for an LLC-related obligation, the liability associated with the Dangerous Asset can be contained and insulated in the LLC. If a number of Dangerous Assets are owned, each should be placed in a separate entity. Once we formed thirty-two different LLCs for a client, each holding one apartment building. If a disaster occurred, only the LLC which owned that property would be sued. The other properties and family assets were safely insulated and shielded from liability under this arrangement.

Some types of commercial real estate may also constitute Dangerous Assets. Office buildings, hotels, restaurants, nightclubs, or any other building where many people work or gather, all have the potential to produce stratospheric liability in the event of some type of disaster.

A physician client owned a medical office building in his professional corporation. His medical practice and the property were both Dangerous Assets and a liability produced by either would jeopardize the other. For example, a problem arising from the building would produce a claim against the equipment, accounts receivable, and cash in the corporation. The office building should have been separated from the medical practice by holding it in a separate LLC. Dangerous Assets must be kept separate from each other asset. We will discuss details about the use and operation of the LLC in the next chapter.

Safe Assets

Safe Assets with a low probability of creating lawsuit liability can be maintained in a single Family Limited Partnership.

Although the family home is a Safe Asset, with liability issues generally covered by insurance, there are a number of tax issues which arise with respect to the transfer of the family home into the Family Limited Partnership. The first problem concerns the availability of the income tax deduction for home mortgage interest. Section 163 of the Internal Revenue Code permits a deduction for “qualified residence interest.”

A “qualified residence” is defined as the “principal residence” of the taxpayer. The only requirements appear to be that (1) the house is the principal residence of the taxpayer; (2) interest is paid by the taxpayer; and (3) the taxpayer has a beneficial interest in any entity that holds legal title to the property. Based on the way the plan is structured, you would not necessarily be treated as the beneficial owner of the FLP and the interest deduction is probably not available. Similarly, the \$250,000 gain avoidance depends on “ownership” of the residence for the prescribed period and if the property is owned by the FLP, this tax benefit will not be available. In chapter 9 we discuss the use of trusts to own a personal residence in the manner to preserve the tax advantages.

Bank and Brokerage Accounts

These types of accounts do not create any potential liability and can be transferred into the Family Limited Partnership. To open these accounts in the name of the partnership, you will present the financial institution with a certified copy of the Certificate of Limited Partnership. The institution will also require the Taxpayer Identification Number issued to the partnership by the Internal Revenue Service.

Interest in Other Entities

The Family Limited Partnership is an excellent vehicle for holding interests in other business entities. The reason that we mention these other business entities is that the Family Limited Partnership must not ever be engaged in any business activities. You do not want the partnership to buy or sell property or goods or to enter into contracts. If the partnership does business, then the partnership can get sued. And if the partnership gets sued and loses, all of the assets that it holds can be lost.

For example, a client of ours entered into a contract to purchase a shopping center. Previously, we had set up a Family Limited Partnership for him. Without our knowledge, the “buyer” under the purchase contract was the Family Limited Partnership. During the pre-closing escrow period, financing became unavailable and the client failed to

complete the deal. The seller sued the partnership for damages for breach of contract and was awarded \$600,000, wiping out a substantial portion of our client's assets. The seller sued the partnership because the partnership was the named party to the contract.

This transaction should not have been handled in this manner. The proper way to conduct this type of business activity is through a separate LLC or partnership arrangement. By using the proper planning techniques, potential liability can be significantly reduced and valuable personal assets can be protected from a dangerous lawsuit. Had this arrangement been used, our client would not have lost \$600,000. Instead, the buyer and seller would probably have renegotiated the terms of the purchase in a way that was mutually satisfactory to each side.

This example illustrates the necessity for conducting business activities through an entity other than the Family Limited Partnership so that family assets are not exposed to the risk of liability. The proper role of the Family Limited Partnership in this context is to hold the interests in the business entities that are themselves subject to risk. The FLP can hold these interests, providing asset protection and estate planning advantages in a single integrated package.

CHAPTER SEVEN

POWERFUL STRATEGIES WITH THE LIMITED LIABILITY COMPANY

The Limited Liability Company (LLC) has become a powerful tool for accomplishing many asset protection goals. The LLC is the most versatile and convenient strategy for owning rental property, insulating Dangerous Assets, operating a business, and achieving an excellent level of financial privacy.

BACKGROUND

The LLC is no longer a new and untested legal entity. It is now recognized in all fifty states with well-established case law and statutes. The adoption of the LLC format began in Wyoming and Florida in the 1970s with approval in most other states shortly after that. The purpose of the LLC legislation is to allow individuals to create a legal entity that avoids many of the tax and business problems inherent in the corporate and partnership structure. The intent of the law is to

allow individuals to conduct their financial and business affairs in an efficient and convenient manner without the restrictions, formalities, and liabilities associated with those other entities.

More particularly, the LLC provides *the protection from liability* of a corporation without the formalities of corporate minutes, bylaws, directors, and shareholders. In contrast to corporate law, which allows shareholders and officers to be individually sued if the corporate formalities are not followed, the LLC law specifically bars a lawsuit against a member for the liabilities of the LLC. That is an important distinction which you should understand. As we discussed, the principle shareholders and officers of a corporation are routinely named as defendants in a lawsuit against the company—forcing them to incur attorney’s fees to defend themselves and rendering the corporate shield meaningless from a practical standpoint.

A primary goal of the LLC legislation was to change this result by clearly stating that the members and managers of the LLC could not be named in a lawsuit against the company. The new law was drawn specifically to provide a vehicle that would protect the owners from liability associated with the business—what the corporation was intended for but no longer accomplished in the modern litigation-prone era.

Besides this enhanced liability protection, the LLC is also convenient to maintain. The owners are permitted to adopt flexible rules regarding the administration and operation of the business. For tax purposes, it is treated like a partnership. That means the LLC itself pays no income tax. All of the income and deductions flow through directly to the members and is reported on their personal tax returns. If the LLC has only a single member, the owner can elect to treat it for income tax purposes as a “disregarded entity.” No federal tax return is required, and the income and expenses are reported as a sole proprietorship on the personal return.

The LLC is formed by filing Articles of Organization with the Secretary of State’s office. Unlike the FLP, which requires the names of the general partners, the disclosure of the names of the principals can be avoided. The name of *either* the member or the manager must be provided in the articles. And several states don’t even require that

information at the present time. We will see that these liberal provisions open the door for a variety of financial privacy strategies. At least some degree of anonymous ownership of business interests and real estate can be achieved with an LLC, which may be an important component of the plan.

The bad news, for physicians and some other professionals, is that state law generally does not allow licensed professionals to operate their practice as an LLC. The liability shield available to business owners has not been extended to doctors—due to opposition primarily from the trial lawyers. Although the LLC may be useful as a tool in protecting business assets from lawsuits, it will not insulate the individual from the liability associated with a professional practice.

THE LLC COMPARED TO OTHER TECHNIQUES

Inside and Outside Liability

To understand the benefits available from the LLC, let's look at a typical example. John and Mary own an apartment building as tenants-in-common. We know that holding the property, as they do now, exposes them to great danger. Ownership of rental property creates more uncontrolled liability and lawsuit risk than any other business or profession we have seen. And because this potential liability usually cannot be covered by insurance, a single unpredictable event, a mistake, or just bad luck can wipe out everything built up over the years.

Injuries to tenants, problems with lenders, lawsuits from future buyers—all subject everything that John and Mary own to potential liabilities from the property. We call this type of liability—arising from the property itself—*inside liability*. John and Mary need to be protected from *inside liability*.

To make matters worse, a lawsuit or claim against John or Mary from a matter not related to the building exposes the equity in the apartment property to seizure in satisfaction of that claim. We call this type of liability *outside liability*. John and Mary's interest in the property must be protected from outside liability. If one of them is involved in an auto accident causing serious injury, they do not want to lose the property because of this outside liability. Clearly, owning

the apartment building in the current manner is not sound business planning. What other options are available to them?

LLC Versus Corporation

John and Mary could transfer the property to a corporation. Each would own 50 percent of the stock in the company. Since the law provides that the shareholders are not responsible for debts of the corporation, a liability arising out of the property would not subject John and Mary's personal assets to danger.

The problem is that this protection against liability is only available if all of the corporate formalities are carefully followed as we discussed in chapter 5. Since most people do not maintain proper corporate records and documentation, corporations often do not provide the intended level of protection. Further, corporations are subject to potential double taxation rules and other tax traps, which can cause severe and unintended consequences.

Finally, the corporation will not protect the property from outside liability—lawsuits against John or Mary unrelated to the property. A creditor can simply seize the stock that they own and reach the apartment building by dissolving the company. For these reasons, it is generally not advisable to hold investment assets in a corporation.

LLC Versus Limited Partnership

If John and Mary form a limited partnership to hold the property, one or both of them may serve as general partner. Since the general partner has unlimited liability for the debts of the partnership, if a liability arises out of the operation of the building, the general partner's assets will be exposed to that claim. The major problem with the limited partnership format is this unlimited liability of the general partner. To avoid this problem, an LLC could serve as general partner of the FLP—this is really a synthetic LLC since no person has legal liability under this arrangement. There may be valid reasons to create a structure like this, but often, simply using the LLC as the only entity will be most efficient and convenient.

THE BENEFITS OF THE LLC

By forming an LLC, John and Mary can accomplish some important objectives.

Protection from Inside Liability

A member of an LLC is not responsible for claims or judgments against the company. When we are dealing with a rental property or an active business, the potential liability associated with the business is a primary concern. But as we have stated, the law specifically provides that the members of the LLC cannot be sued. In our example, John and Mary transfer their apartment building to an LLC. If a tenant is injured in an accident, John and Mary, as members of the company, would be protected from any claim relating to the property.

No Formalities

An LLC is not required to maintain formal minutes and resolutions although it may be a sound and cautious practice to do so. Recordkeeping requirements can be minimized without a threat that the members will be sued individually for a liability of the company. Contrast this treatment with that of a corporation. If the proper formalities are not followed, the corporate protection will be pierced, and the owners will have liability for company obligations. The LLC law is specifically intended to remedy this problem by providing that the entity cannot be pierced because of a failure to maintain any of the corporate type documents.

Protection from Outside Liability

Property held in an LLC cannot be seized by a creditor of a member. If there is a judgment or claim against John or Mary, the creditor cannot reach the property held in the LLC. **However, even though the creditor cannot reach the property directly, he can do so indirectly by seizing the member's ownership interest in a foreclosure.** (California Corporations Code Section 17302 (Foreclosure of LLC interests); In Re: *Ashley Albright*, U.S. Bankruptcy Court for the District of Colorado (April 4, 2003)). The ability of a creditor to foreclose on a membership interest was recently affirmed by the Florida Supreme Court despite

statutory language limiting the creditors remedy to a charging order. (*Olmstead, et al., v. The Federal Trade Commission*, Supreme Court of Florida. Case No. SC08-1009 (June 24, 2010)). As we discussed in chapter 6, the foreclosure remedy is a powerful weapon in the hands of a creditor since it allows a potential recovery by a creditor equal to the full value of LLC property—which may be considerably greater than the judgment itself.

Getting back to our example, what this means is that if the LLC interests are held personally by John and Mary, meaningful protection from outside liability is not achieved since a creditor with a judgment can seize the membership interests. As with the FLP, proper ownership of the LLC interests within a Family Savings Trust or other vehicle is a key component of any asset protection strategy for protecting the membership interests. This fact must be addressed at the planning stage.

LLC Examples

We will give you some real life illustrations to see how these points fit together.

Mrs. Drake was a seventy-five-year-old widow. She sold a duplex she had owned in California for many years for \$200,000 and used the money—her life savings—to move to Arizona and buy a condominium. Her only income was Social Security payments of \$1,200 per month, which she used to pay her living expenses.

Three years after the sale, the real estate market in California collapsed and the value of the duplex dropped by half. That shouldn't have mattered to Mrs. Drake since she had sold the property three years earlier. The new buyer was just unlucky when he lost his equity in the property.

But that's not how it works anymore. The buyer sued Mrs. Drake in California claiming that she had failed to disclose defects in the property. None of these allegations were true. The reality was that the buyer had lost money when the market declined, and he wanted it back. So he asked the court to rescind the sale contract—meaning that he wanted his \$200,000 back plus interest.

The lawsuit placed Mrs. Drake in a terrible position. To defend the case, she would have to hire an attorney—and these types of cases are expensive. She was told that legal fees to defend her would run from \$25,000–\$50,000—money she clearly could not afford. The buyer’s attorney, on the other hand, was handling the case on a contingency—so the buyer really had no cost and nothing to lose by pursuing the lawsuit.

Rather than risk losing her home and the rest of her savings and knowing that the litigation costs alone could wipe her out, Mrs. Drake settled the case for \$70,000. She borrowed the money against the (remaining) equity in her condominium, and she now uses most of her Social Security check to make the monthly mortgage payment. Instead of a comfortable retirement enjoying her life, she lives a Spartan existence, barely surviving each month.

What did she do wrong? She sold her property at the top of the market. She should be rewarded for her good business sense. Instead, because she was an easy and a vulnerable target, the buyer and his lawyer managed to extort most of her life savings.

What should she have done? The outcome of the case would likely have been different if she had used an LLC with protected membership interests (or a Personal Residence Trust) to hold her Arizona condominium. The lawyer for the buyer would have determined that her assets (the condominium) were unreachable, and without funds to pay a judgment, Mrs. Drake would not have been an attractive defendant. Additionally, with the proper advance planning, even if Mrs. Drake had been sued by the buyer—and if she had lost—her home would have been shielded from the judgment. Legal protection for assets is a plan that usually defeats these types of extortion attempts.

The next illustration involves a client, Dr. Bell, who owned a valuable medical office building for many years. He had paid about \$100,000 for it in 1970, and because of depreciation deductions, it had a zero basis for tax purposes. At the time he came to see us, the property had a value of \$2 million. He had two principle objectives: First, he wanted to protect this asset from any claims that might arise from his medical practice or personal activities. Second, he wanted

to protect himself from any liability associated with the property. He didn't want to get sued because of some problem with the property and risk losing the other assets he had accumulated. He had no pending or threatened lawsuits or other immediate concerns. He was simply interested in developing a prudent business plan.

We felt that these objectives could be accomplished, and as a part of his overall plan, we put the office building into an LLC with his Family Savings Trust holding the membership interests.

A few years later, Dr. Bell got involved in some serious business problems because of a partner in a real estate venture. The partner refused to pay his share of the expenses, and Dr. Bell was stuck with judgments and bills totaling more than \$1 million. The creditor with the judgment attempted to collect from him. Because the office building was in the LLC, the judgment lien did not apply to that property. He was free to sell, refinance, or deal with the property as he decided. Dr. Bell's home and savings were protected in the Family Savings Trust that we designed for his planning so the judgment had virtually no effect on Dr. Bell's accumulated assets.

Compare the difference in this case that resulted from the strategy he used. If he had not put the office building in the LLC, the judgment lien would have attached to the property. The creditor would have foreclosed on the property to collect the debt.

For income tax purposes, a foreclosure is treated like a sale for the amount of the debt. In other words, if the creditor had seized the office building, Dr. Bell would have been treated as if he had sold the property for \$1 million. His tax basis was zero so the taxable gain would have been \$1 million. Not only would he have lost the property with all that equity—he would have been stuck with a fat tax bill to the IRS. This is a common problem these days in both the residential and commercial market as properties are foreclosed or short sold and some or all of the debt is relieved.

Instead of these dire consequences, he managed to shield his valuable assets and continue to defer the taxes on the office building. This is a dramatic example of the advantages that can be obtained by using the correct legal structure to protect valuable assets.

INSULATING BUSINESS RISKS

The major criteria in selecting the entity within which to conduct a business is the degree of insulation offered from the liabilities of the business. If you already own a business or are planning to start one, do you want to place everything you own at the risk of the business?

Any business venture is a Dangerous Asset. There are leases to sign, bank loans, customers, employees, competitors, and government agencies—all with the potential to blow you sky high. You don't want the liabilities from this business to threaten your other assets. The proper strategy is to contain the liabilities within the shield of the LLC. If something happens inside the company, make sure that it doesn't contaminate your savings and other assets.

The purpose of asset protection planning is to allow you to engage in a business activity while protecting your other assets from the risks associated with the business. The proper plan enables you to pursue attractive investments and business opportunities without jeopardizing everything you own. Do you want to buy real estate or start a business? Understand your level of risk and then protect what you have. That's the sensible approach.'

OTHER DANGEROUS ASSETS

Elderly Drivers

A client asked us to set up a plan for his elderly mother whom we will call Louise. She was eighty-four years old and owned a home and some savings. She was in good health and drove her car to do errands and visit with friends every day. Louise had been in two minor fender benders in the past three years, and our client was concerned that there could be a more serious accident—one in which Louise or an innocent party would be injured.

In this case, Louise's car was the Dangerous Asset, capable of producing a large lawsuit liability if she got into an accident. Since adequate insurance was impossible to obtain, it was necessary to create an asset protection plan that would protect Louise's home and savings if the worst happened. We put her home into a trust and her investments into an LLC and a Family Savings Trust. Six months later, there was

indeed an accident, and both passengers in the other car had bruises and broken arms.

The lawyers for the plaintiffs ran an extensive asset search on Louise to see if they should proceed with the case. They found that there were no reachable assets, except her car, and they accepted the insurance company's offer of the \$100,000 policy limits. Louise managed to avoid a devastating financial loss, and she held on to her home and savings.

Small Investments Can Create Large Liabilities

A physician client invested \$50,000 in a new restaurant. The arrangement was that he would put up this money and the other partner would run the business. The doctor did not realize that he would be fully responsible for all debts of the company—even if he never knew about or signed an agreement. In a general partnership, each partner is liable for all partnership obligations, even those incurred by another partner. And, not surprisingly, his partner signed a five-year lease for the restaurant and bought several hundred thousand dollars of equipment on credit. When the business shut down six months later, our client, as the only partner with any money, was responsible for the remaining lease payments and the equipment, all of which totaled more than \$500,000.

This case emphasizes that a relatively small investment can create a large liability. The restaurant investor analyzed the business deal based upon what could happen to his initial investment. He thought that in the worst case he would lose his contribution of \$50,000. He certainly didn't want that to happen, but he was prepared to risk a certain sum of money. But the amount of the investment is only a part of the equation. He did not think about the extent of the risk to his personal assets created by the liabilities of the business. The real question should always be: "How much trouble and how much money can this deal cost me?"

By now you know that the restaurant business should have been formed as a Limited Liability Company (LLC) rather than a partnership. As a member of the LLC, the investor would not have had any liability and could not have lost more than his initial contribution. The decision-making process involves understanding the legal risks that are created in the proposed business and creating the proper legal structure to contain those risks.

Teenage Drivers

A client in the banking business set up a plan to protect his savings from potential liability associated with his business. He and his wife went to Mexico for a vacation, leaving his eighteen-year-old son at home. The son had a party, got drunk, and crashed the family car causing serious injury to three other people.

An automobile is a Dangerous Asset because anyone is capable of an accident that results in catastrophic injury. It is possible to cause injury that exceeds the amount of any reasonable insurance coverage. In particular, if there are teenage drivers, anyone who might drive while intoxicated, or an elderly driver whose abilities are somehow impaired, it is essential to isolate the auto from the other assets of the family.

KEEP YOUR PROPERTY FREE FROM ATTACHMENTS AND LIENS

The most powerful weapon of a potential legal adversary is the ability to freeze your assets. When your bank account is frozen, it means nothing can be moved. You cannot pay your bills or run your business or withdraw your money. Your residence, rental property, or business can also be attached. You can't collect rents or income, and your property cannot be sold or refinanced.

The plaintiff can attach your property *during* or *after* the lawsuit. An attachment during the case is known as a prejudgment attachment. After the case is decided, it is called a judgment lien. A prejudgment attachment is only granted in certain types of cases, generally those involving a contract dispute over a particular amount of money.

A judgment lien applies if the plaintiff receives an award in his favor. The judgment lien immediately attaches to all real estate in your name, all bank accounts, brokerage accounts, and other assets. A lien acts like a mortgage or trust deed. You cannot sell or refinance a property without paying off the creditor, and he can foreclose on the real estate and seize any accounts in your name. A creditor with a judgment lien clearly holds all of the cards. You have no leverage and no room to negotiate. At that point, he has got you. You are trapped,

and there is no way out. Certainly that is not the position you want to be in when you deal with an adversary.

One of our clients, Ed, was a wealthy real estate investor and owned five apartment buildings worth about \$3 million. We set up a plan for him using several LLCs to hold the properties. About two years later, we received a call from Ed telling us that he had lost a lawsuit concerning one of the properties, and there was a judgment against him for \$1.5 million. Had he not set up the plan he would have been in big trouble. The plaintiff would have had a lien on all of the client's real estate, worth \$3 million, as security for the judgment. The property would have been frozen and then seized. The plaintiff would not have taken a penny less than the full amount of the judgment. Nothing to talk about or discuss—just pay up. That's a bad position to be in.

But because Ed was a smart guy, he was not in a bad position. Since all of his assets had been transferred into the plan, the judgment lien did not affect the properties. Ed was free to sell, refinance, collect rents, and deal with his property just like he had always done. Since the creditor had no security for his judgment and stood to collect nothing, Ed now had the leverage to negotiate a favorable settlement. He held all of the chips, and in fact, he settled the case for \$75,000—clearly a better result than losing the \$1.5 million. In this case, the proper asset protection plan changed the relative bargaining power of each side. *Ed could have been weak and vulnerable but instead was able to negotiate from a position of superior strength.*

Another client, an architect, had savings of about \$75,000, which he had inherited from his mother. Architects have a high lawsuit risk, and our client needed to protect these funds for the care and special education of his eight-year-old child, who had severe physical and learning disabilities. Sure enough, within two years after setting up the plan, my client was served with a lawsuit. The plaintiff attempted to get a prejudgment attachment of the savings, but the judge ruled that the assets were properly protected and could not be reached by a lien. Without any assurance of payment, the plaintiff's attorney quickly lost interest, and the case was settled for under \$2,000.

These examples illustrate the importance of protecting valuable assets from prejudgment attachments and judgment liens. Without access to your funds, you can't pay your household expenses, and you can't operate a business. Worse, if you can't pay your lawyer to defend the case, you will be forced into an immediate and unfavorable settlement. The proper strategy allows you to maintain access to your funds and your property during and after litigation, and that is sound financial and business planning.

SERIES LLCs

The Series LLC is a relatively new variation of the LLC, now adopted by legislation in eight states (Delaware, Illinois, Iowa, Nevada, Oklahoma, Tennessee, Texas, and Utah) with more sure to follow as the legal and tax issues are clarified by the states and the IRS.

The purpose of the Series LLC is to allow for the creation of a master LLC, which is then divided as needed into one or more separate LLCs with common or varying business purposes, governing rules, and ownership interests. The key is that each of the sub-LLCs is intended to be treated as a distinct and separate entity—each isolated from the liabilities of the other.

- Each unit has its own owners (members) and may be managed separately from the master LLC and other units.
- Each unit must maintain separate books and records.
- As with a regularly formed LLC, the owners (members) of each unit are not financially responsible for the debts and obligations of the other units.
- A unit may conduct part of the business of the master LLC, or may conduct a wholly different business.
- Each unit has its own assets and liabilities. The members of each unit are treated under the laws of the state where the master LLC is formed as owning an interest in only that unit, and have no rights as members of one unit in the assets or income of any other unit.

- Each unit is liable only for its own debts and obligations. For example, this type of vehicle would be popular with real estate investors who own multiple properties. A Series LLC would be formed and would provide for a subdivision into separate sub-LLCs—one for each property. It is easy and inexpensive to create the protection of multiple LLCs without additional cost or extensive paperwork on each. The idea is to achieve the benefits of liability protection of separate LLCs without the costs of formation and state taxes associated with separate entities.

Since the concept is new, we don't have definitive law on how these structures will be regarded by the courts or the IRS. California, which does not have Series LLC legislation, has announced that Series LLCs from other states will be permitted, but each entity in the series will be required to pay the full Franchise Tax (minimum \$800). Once the legal treatment of the Series LLC has been settled, it may be useful and convenient in a variety of circumstances, but outside of the states which have passed specific legislation, the outcome remains open to question.

TAX TREATMENT OF THE LLC

All income of the LLC is passed directly through to the personal returns of the members. When property is transferred to the LLC or distributed from it, there are no separate tax consequences. Except in unusual circumstances, the general rule will apply, and no gain or loss will be recognized on a contribution to or distribution from the company. There is no tax when funds are withdrawn from the company. The only tax paid is on the income earned, which is reported on the owner's personal tax return. This system avoids the complications and potential double taxation that plagues the corporate format. If an LLC has a single member, it can elect to be disregarded for tax purposes and the items of income and loss appear directly on the Schedule C without the filing of a federal tax return. Alternatively an LLC can elect to be taxed as a corporation. This may be useful in certain unique situations but probably not for the average investor or business owner.

THE OFFSHORE LIMITED LIABILITY COMPANY

Forming the LLC in a offshore jurisdiction may provide enhanced asset protection and financial planning advantages in a variety of situations. In particular, it may be appropriate for those in high-risk businesses and medical specialties and those for whom insurance coverage is inadequate or unavailable.

Asset Protection Features

Assets in the Offshore LLC are generally protected from lawsuit and business risk because of the “charging order” limitations and the legal and practical inability to collect against the Offshore LLC in a foreign jurisdiction.

We have discussed the point that a charging order or foreclosure against a domestic LLC can be a powerful remedy for a creditor. However, a collection action against an Offshore LLC membership interest will generally not be successful. The difference in result is due to the fact that neither the Offshore LLC nor its manager can be compelled by a domestic creditor to liquidate assets or distribute funds. The typical jurisdictions where these LLCs are formed have very strict, well-written legislation that protects the LLC and its membership interests from claims other than charging orders. Additionally, a U.S. judgment will not be enforceable by the offshore jurisdiction so the underlying claim would have to be retried under that court system. The myriad of obstacles to collection under these circumstances is likely to deter even a highly motivated and well-financed plaintiff.

No Tax Burdens

The Treasury Regulations treat the Offshore LLC just like a domestic LLC. If the company has a single member, it is permitted to elect to be disregarded for federal tax purposes with all income reported directly on the owner’s personal return.

As we discussed with the FLP, membership interests in an Offshore LLC can be transferred to family members at a discount for significant estate tax savings.

Example of the Offshore LLC

A popular strategy is to form a Family Limited Partnership to hold your savings and brokerage accounts. The limited partnership interests in the FLP will be held by the Offshore LLC. We will protect the ownership of the Offshore LLC by holding membership interests in the Family Savings Trust.

Under this arrangement, savings and brokerage accounts are well insulated in the FLP. But we opened up new tactics and levels of protection with the Offshore LLC.

To combat a perceived threat, or to take advantage of investment opportunities, at any point in the future, assets of the FLP can be moved into an overseas account in the name of the Offshore LLC. If there is a subsequent judgment against you, even a charging order is unlikely since you do not own interests in the FLP or Offshore LLC. Any collection order would be without enforcement capabilities in the U.S.

If litigated in the jurisdiction where the Offshore LLC is formed, it is likely that the plaintiff would have to prove that any transfers were a violation of the applicable fraudulent transfer laws and such a claim would have to be initiated within the Statute of Limitations period (generally one or two years). The obstacles presented by this arrangement, and other features which can be added, provide an excellent legal shield against even the most aggressive and determined plaintiffs.

The Offshore LLC is an effective and flexible asset protection tool. It reinforces the available domestic protection for those with significant liability exposure. Tax filings and returns are minimized, and administration and offshore money management issues only arise at the time, if ever, that the Offshore LLC is funded with bank or brokerage accounts.

SUMMARY

In this chapter, we have discussed major benefits which can be accomplished with the LLC.

First, the LLC can be an important element of a plan that produces an excellent level of asset protection. Lawsuits and claims, which are

based upon a knowledge of your personal financial matters, will be discouraged before they begin. When your assets are held in a protected form, a plaintiff or his lawyer looking for a Deep Pocket Defendant will not find reachable assets when they investigate you. Since lawyers only sue if they believe they will be able to collect a judgment, using an effective plan will discourage most people from filing a lawsuit against you. Although the LLC by itself won't protect you from outside liability, the strategies discussed in these chapters will help you construct a plan that shields membership interests from potential loss.

Second, if someone does file a lawsuit, we want to protect your assets from liens and attachments. Prejudgment attachments are filed during a lawsuit and can freeze your real estate and bank accounts. Without access to funds to pay your personal and business expenses or to defend the case, you are, as they say, dead in the water. You will have no choice except to make a fast and unfavorable settlement—giving the plaintiff all or most of what he wants.

Similarly, a judgment lien will attach to all property that you own. You will be unable to sell, refinance, or collect rents on your property; and all accounts will be seized. An asset protection plan will allow you to shield your property from liens and attachments during the lawsuit and after a judgment. Clearly this puts the negotiating chips on your side of the table and provides you with powerful leverage to create a successful result.

Third, Safe Assets such as your home and savings must be protected from the liability that can be caused by Dangerous Assets. There are hundreds of different ways for you to lose the nest egg that you have put together over many years of work. No matter what you do for a living, it will be hard to save up that money all over again. Sound planning allows you to insulate yourself from the potential liability of a Dangerous Asset. When risk is properly contained in this fashion, you can proceed in the world with confidence that your savings will be secure and available when you need them.

CHAPTER EIGHT

THE LIVING TRUST

The Foundation of Estate Planning

The entity known as a trust will be essential in creating various strategies for accomplishing asset protection, estate planning, and privacy benefits. This chapter will provide a background for understanding how these techniques work and how a trust will be a part of your overall plan.

The legal arrangement, known as a trust, has been around for at least several hundred years. Every trust has certain essential characteristics. A trust has one or more *trustees*, who are responsible for administering and carrying out the terms of the trust. The *beneficiaries* are those who are entitled to trust income or principal either currently or at some time in the future.

A trust is typically in the form of a written trust agreement between the *settlor*, the person creating the trust, and the trustee. The written trust agreement provides that the settlor will transfer certain assets to the trustee and the trustee will hold those assets for the benefit of

the named beneficiaries. (The terms “trustor” or “grantor” are used interchangeably with the term “settlor.”)

Until recently, trusts were used almost exclusively by the wealthiest families to maintain privacy and to pass their wealth to succeeding generations. The privacy benefits were particularly important. Grandpa Robber Baron had no desire to allow the muckraking newspapers and the antagonistic public to know exactly what he owned and how much he was worth. Grandpa was savvy enough to know that revealing the details of his fortune was not good for business and wasn't smart politics. The Vanderbilts, Whitneys, Rockefellers, and Carnegies created trusts, which have now successfully shielded from public scrutiny the family wealth of five or more generations.

But it is no longer only the wealthy who are attracted to the powerful benefits offered by a properly designed trust. Now, those with equity in the family home or some savings put away for retirement or college are using trusts as an essential ingredient in their asset protection and estate plans. In this chapter we will discuss one popular form of estate planning trust, and in chapter 9 we'll investigate a variety of techniques for additional asset protection and privacy.

THE REVOCABLE LIVING TRUST

A revocable living trust is a trust that can be revoked or canceled at any time by the settlor. The term “living trust” means simply that the trust is established during the lifetime of the settlor. (Testamentary trusts, those created upon the settlor's death, do not avoid probate and are not nearly as popular today as they once were.) During the past ten or fifteen years, revocable living trusts have gained enormous popularity as a sound technique for accomplishing a number of legitimate estate planning goals.

Avoiding Probate

A revocable trust (or irrevocable trust) that is properly drafted and funded will avoid probate. This is the most significant and valuable feature of a revocable trust. The benefits of avoiding probate can only

be appreciated by understanding what happens when an estate must go through the probate process.

If a person dies owning property, not protected by a trust, a court will supervise the transfer of that property to those people named in his will. If someone dies without a will, his property passes to his relatives in the manner set forth under the laws of his state. The actual transfer of title to the decedent's property is carried out under the court's supervision by a person designated in the will as the executor of the estate. If a person dies without a will, the court must appoint an administrator to carry out the transfer of the decedent's property. An executor or administrator is known as a personal representative.

The personal representative has the responsibility to perform the following:

1. Locate, inventory, and appraise all of the assets of the decedent.
2. Make final payment to all of the decedent's creditors.
3. Prepare and file any federal and state death tax returns.
4. Distribute the assets of the decedent's estate according to the decedent's will or according to state law.

The personal representative will almost always hire an attorney to perform this work on his behalf. The attorneys collect their fees from the estate for these services. The amount of legal fees, depending upon the state, is either a fixed percentage of the estate or is based upon what a judge determines to be a reasonable fee.

The reason that most people do not want their estate to go through probate is that this process is expensive, time consuming, and inconvenient. Attorney's fees may range from 2 percent to 10 percent of the gross value of the estate. An estate of \$1 million, depending upon the complications involved, may incur attorney's fees of \$25,000. These fees are usually based upon the gross value of the estate rather than the net value. An estate of \$1 million with \$950,000 of liabilities might still pay attorney's fees of \$25,000. But now this amount is 50 percent, not 2½ percent of the net value.

Second, attorneys rarely feel the same sense of urgency about completing the probate that is felt by the decedent's wife and children. While the decedent's family wishes to get on with things as quickly as possible, the attorney for the estate is often busy handling other matters and the time period for completing the probate may take from two to five years. Probate causes significant stress and frustration for the survivors, and avoiding the process is a legitimate planning concern.

Trustees and Beneficiaries

Revocable trusts are effective in avoiding probate only when the trust document has been properly drafted and only when all of the decedent's property has been transferred into the trust prior to his death. The trust document, like a will, provides for the disposition of trust assets upon the death of the settlor. In the typical arrangement, a husband and wife will create a revocable trust with both husband and wife as the initial trustees. They are also the beneficiaries of the trust. The trust provides that during their joint lifetimes the trust may be revoked at any time. Upon the death of either spouse, the trust typically becomes irrevocable, and the surviving spouse becomes the sole trustee. When the surviving spouse dies, the trust property passes according to the wishes expressed in the trust document.

Funding the Trust

For the revocable trust to be effective in eliminating probate, it is essential that all family assets be transferred into the trust prior to a spouse's death. Any property that has not been transferred into the trust will be subject to probate, defeating the purpose of creating it in the first place. An amazing number of people go to the trouble and expense of forming a revocable trust and then fail to complete the work necessary to fund it.

Funding the trust involves transferring legal title from husband and wife into the name of the trust. For example, if Harry and Martha Jones are funding their revocable trust, they will change title to their assets from "Harry Jones and Martha Jones, husband and wife" to

“Harry Jones and Martha Jones as Trustees of the Jones Family Trust, Dated January 1, 1999.”

For real estate, the change in title is accomplished by executing and recording a deed to the property. Bank accounts and brokerage accounts can be transferred by simply changing the name on the accounts to reflect the trust as the new owner. Shares of stock and bonds in registered form are changed by notifying the transfer agent for the issuing company and requesting that the certificates be reissued in the name of the trust. Stock in a family owned corporation can be changed by endorsing the old stock certificate to the trust and having the corporation issue a new certificate to the trust. Other types of property can be transferred by a simple written declaration called an Assignment.

The living trust also can be funded indirectly by transferring interests in other entities. For example, if you hold your property in a Family Limited Partnership or Limited Liability Company, the living trust can hold your shares in those companies.

Estate Taxes

The trust must also contain the appropriate provisions in order to minimize federal taxes payable upon the death of either spouse. It is important to point out that estate taxes can be minimized with either a properly drawn will or a properly drawn revocable trust. The revocable trust does not provide any tax advantages that are not available to a person using a will or some other form of trust in order to accomplish a transfer of his property. But as long as you are using this type of trust to avoid probate and to take advantage of its unique features, you should make sure that the estate tax provisions are properly handled. The unified tax credit allows each spouse to transfer up to the exemption amount to his children (or anyone else) free of any federal estate taxes. In its simplest form, a properly drawn revocable trust takes advantage of this benefit by providing for the creation of two separate trusts on the death of the first spouse. These two trusts are referred to as the A trust and the B trust.

In a large estate, the B trust will be funded with the exemption amount and the balance will go into the A trust. From the A trust, the

surviving spouse will have the right to all income for life plus a power to use any portion of the principal that he or she so desires. The B trust will generally provide that the surviving spouse is entitled to all income during his or her life plus the right to use principal for health, education, maintenance, and support.

Any amount left in the A trust, in excess of the exemption amount, at the death of the surviving spouse will be taxable in his or her estate for estate tax purposes. However, since the surviving spouse is given only limited rights over the B trust, the amount in the B trust will not be taxable in the survivor's estate upon his or her death. The effect of these provisions is that the spouses' combined exemption amount (scheduled to be \$2 Million in 2011 but may be changed by legislation pending in Congress) can be passed from husband and wife to their beneficiaries without being subject to estate taxes.

Income Tax Treatment of Revocable Trusts

During one's lifetime, revocable trusts do not provide any income tax savings. For tax purposes, the trusts are treated as if they do not exist. A revocable trust is known, for tax purposes, as a Grantor Trust. A grantor trust is not a taxpaying entity. No annual tax return is required to be filed. Instead, all income and loss of the trust is reported on the tax returns of the husband and wife.

REVOCABLE TRUSTS AND ASSET PROTECTION

A revocable trust does not provide any protection of assets from judgment creditors. It is ignored for creditor purposes just as it is ignored for income tax purposes. In most states, the law provides that if a settlor has the right to revoke the trust, all of the assets are treated as owned by the settlor. Perhaps because of the promotion associated with these trusts, many people mistakenly believe that a revocable trust somehow shields assets from creditors. This is not correct. If there is a judgment against you, the creditor is entitled to seize any assets that you have in the trust. In order to accomplish asset protection, a trust must meet certain conditions which effectively keep the property out of the reach of a creditor.

Gifts Between Spouses

Gifts between spouses qualify for the Unlimited Marital Deduction, which eliminates federal gift taxes on these kinds of transfers. The ability to shift the ownership of property between husband and wife without creating a tax liability creates some useful opportunities for achieving valuable asset protection.

Community Property

In community property states, each spouse's interest in the community property is subject to the claims of the other spouse's creditors. If there is a judgment against the husband, all community property assets held by husband and wife are available to satisfy the judgment. On the other hand, the separate property of a spouse will generally not be subject to the claims of the creditors of the other spouse.

These rules provide some obvious opportunities to achieve a measure of asset protection. If community property is divided into equal shares of separate property of the husband and separate property of the wife, those separate property interests will not be available to satisfy the claims of the other spouse's creditor. Generally, a living trust would be created for each spouse—for the estate planning benefits and to confirm that the marital property has been divided. Those in community property states can at least limit their potential exposure to a creditor's claim to one-half of the marital property, rather than all of the marital property, by creating this type of division.

The primary drawback of this technique is that a division of community property into separate property trusts may be disadvantageous from an income tax standpoint. All property held as community property receives a stepped-up basis on the death of the first spouse. For example, a husband and wife buy a property during their marriage for \$50,000 that is later worth \$100,000. If they sell the property, they will have a gain of \$50,000 and will pay taxes on that amount. Suppose that instead of selling, the property is held until the time the first spouse dies. All community property now receives a new tax basis equal to its value as of the date of death—\$100,000 in this example. Therefore, if the property is held until the death of the first spouse, all taxable gain is eliminated.

This favorable situation does not occur when a husband and wife hold separate property. In this situation, only the deceased spouse's interest in the property receives the stepped-up basis. In the above example, if the property were held one-half each by the husband and wife, only the interest of the deceased spouse would receive the new basis. This would result in a \$75,000 basis, and a \$25,000 gain, if the surviving spouse sold the property for \$100,000.

If you hold community property that has substantially appreciated in value, it probably would not be advisable to divide the property into separate shares and thereby lose out on the significant tax savings that can otherwise be achieved. Alternative methods of asset protection should be explored.

Separate Property

■ Unequal Division of Property

For those living in states which do not recognize community property, gifts of separate property between a husband and wife can achieve some useful asset protection.

If one spouse is more vulnerable to potential lawsuits than the other spouse, property can simply be transferred by gift from that spouse to a living trust for the other. For example, if the husband is a physician with a high vulnerability to lawsuits and the wife is a schoolteacher with low lawsuit vulnerability, property can be transferred by gift from Husband to Wife's living trust to reduce the amount of assets subject to loss in the event of a lawsuit. In theory, all assets could be moved out of the name of Husband and into the name of Wife's trust. In the event of a subsequent lawsuit and judgment against the husband, no assets would be available to satisfy the creditor.

The advantage of this gift technique is that it is simple and inexpensive to utilize. Gifts between spouses do not create any gift tax liability because of the Unlimited Marital Deductions for gifts between spouses.

One problem with this technique is that, in many cases, a spouse will be reluctant to relinquish all effective control over his property. If all family assets, including real estate and bank accounts are in the sole

name of the wife's living trust, the husband may not feel comfortable with this arrangement. The threat of a potential lawsuit at some future time will rarely be sufficient to overcome the desire to maintain at least equal management and control over one's property.

Along these lines, in the event of a divorce, a court may be unwilling to rearrange any bona-fide transfers previously made between spouses. Although a court in a dissolution proceeding has broad equitable powers to divide marital assets in a fair and just manner, property which was the subject of a bona-fide gift from a husband to his wife may or may not be reallocated by a judge. In our practice, we have found that many clients are not willing to risk the possibility that they will be permanently deprived of assets previously transferred to the other spouse.

Lastly, despite the fact that the wife has a low level of lawsuit vulnerability associated with her work, the fact remains that there are numerous ways she could still be sued. Remember, as the owner of substantial assets, she becomes an inviting target for a lawsuit. Putting all of your eggs in this basket is a dangerous proposition.

■ Equal Division of Property

An equal division of marital property, as opposed to a strict transfer from one spouse to the other, might provide greater lawsuit protection and might also allow each spouse to sleep more easily. Marital property can be divided according to a written agreement, which states that each spouse is to hold one-half of all marital property as their own separate property. This is where a revocable trust may become particularly useful for our purposes. Once the marital property is divided, two separate revocable trusts can be established, one for each spouse. The husband's trust then holds title to his one-half of the property, and the wife's trust holds title to her one-half interest.

When marital property is divided in this manner, a number of our previous concerns are eliminated. First, when property is held pursuant to a written trust agreement, it is unlikely that a court would imply the existence of some other type of trust arrangement that is not consistent with the terms of the written trust. It is unlikely that a

court would allow a creditor of the husband to reach into and claim the property held in the wife's revocable trust on the theory that she is holding that property for the benefit of her husband. As a result, property held by the wife in her trust would be immune to potential claims from the husband's creditors. Although the property in the husband's trust would still be available for these creditors' claims, at least one-half of the total estate has been removed from the reach of the husband's creditors. Admittedly this is only a partial solution to the problem, but it is a useful beginning.

This arrangement also minimizes concerns about losing management and control over one's assets. The husband would still have full management and control over the assets in his revocable trust, and, in the event of a divorce, each spouse is likely to have no more property than they would otherwise be entitled to.

Many of these points are spectacularly illustrated in the current divorce case of Frank and Jamie McCourt. One of the key issues in the litigation is whether the Los Angeles Dodgers are the separate property of Frank McCourt or the community property of husband and wife. Frank McCourt alleges a post-nuptial agreement signed by the couple, before moving from Massachusetts to California, specified that the ownership of the Dodgers was intended to be his separate property and that Jamie was to own their ten residences as her separate property. According to trial testimony, the purpose of this arrangement was to insulate the family houses from the risk of Frank's business liabilities. As things stand now, it looks like the value of the Dodgers has increased and the real estate properties have tanked, and not surprisingly, Mrs. McCourt is contesting the validity of the post-nuptial agreement. What is clearly highlighted is that dividing property between spouses during marriage has its risks as an asset protection plan and may lead to confusion and litigation about who "really" owns the property in the event of a divorce dispute.

Gifts to Family Members

Making gifts of property to family members is a useful tool that may accomplish a variety of asset protection and estate planning objectives. A properly structured program of gift giving, to one's children or grandchildren, can result in a minimization of estate and income

taxes and can also be useful for achieving a significant degree of lawsuit protection.

There are significant tax advantages to a gift giving program. Life-time gifts reduce the size of one's estate and consequently minimize the ultimate amount of estate taxes. Since estate tax rates are high, substantial savings will be realized from this technique.

A gift giving program may also produce some annual income tax savings. Depending on a child's age and income, amounts earned on the property transferred to him will be taxable to the child rather than to the parent. If a child is in a lower income tax bracket than the parent, a gift program will effectively spread the income tax liability of the family among lower bracket taxpayers and will thereby reduce the overall income tax burden.

A gift program also provides significant lawsuit protection. If a gift transfer does not violate the fraudulent conveyance laws, property that has been transferred to a child or a grandchild cannot be reached by a judgment creditor of the husband or wife. Once an effective gift has been made from a parent to a child, this asset cannot be seized by the parents' creditors.

Drawbacks of Outright Gifts

The most obvious difficulty with outright gifts is the total loss of ownership and control of the gifted property. In our years of legal practice, we have rarely encountered instances in which parents are willing to transfer complete control over large sums of money to their children. Despite considerable estate and income tax savings, few people are willing to give up a portion of their wealth, which they have worked hard to accumulate during their lifetime.

Even when their wealth is beyond what they reasonably need to live comfortably, parents are concerned about the wisdom of making outright gifts to their children. Sometimes there is an issue concerning the child's marital status and what will happen to the gifted property in the event the child is divorced. Sometimes there are concerns about the child's level of financial responsibility and whether the funds will be squandered. Many times the parents are concerned about the creditors

ASSET PROTECTION

of a child reaching the property. When the situation involves minor children or grandchildren, who are not legally capable of holding title to property, there are questions about who will act on the child's behalf in holding the property and when the property should be distributed to the child. These are all matters of great consequence and must be carefully considered by parents contemplating this type of gift giving program.

CHAPTER NINE

FAMILY SAVINGS TRUSTS

Asset Protection, Tax Savings, and Privacy

FAMILY SAVINGS TRUST

Most of the problems of an outright gift to a child can be eliminated through the use of Family Savings Trust (FST), which we have mentioned in previous chapters as an asset protection strategy for holding ownership interests in entities such as corporations, Family Limited Partnerships, and Limited Liability Companies.

The term Family Savings Trust is a broad descriptive term for a trust intended to hold and protect assets against lawsuits and business risks. A Family Savings Trust is extremely flexible in form and can incorporate provisions, which combine the features of domestic and even offshore arrangements within the language of the plan documents. All of your assets can be held within the trust—but be governed by special terms appropriate for that asset.

For example, your trust may be designed to hold your home, accounts receivable, and savings and brokerage accounts. Or the trust can own the entities, such as an FLP or LLC or your personal residence with specific language preserving the tax benefits associated with the home (including the mortgage interest deduction, property taxes, and avoidance of gain on a future sale). If estate tax savings are a priority, you can choose to construct the FST to take maximum advantage of whatever traditional or enhanced tax strategies are appropriate based on your goals and the types of assets you own.

An additional feature, which can be added to a Family Savings Trust, if desired, allows the trust to obtain certain “offshore” advantages, at some later point. The FST can be structured to permit a migration of the trust to a more favorable jurisdiction—domestic or foreign—when and if necessary. In the right situation, this provision can be used to force any future plaintiff to proceed with a lawsuit against you in a string of unfriendly foreign jurisdictions to which the trust has continuously migrated. For example, under normal circumstances, the trust exists and is governed by whatever domestic law we choose. But, if circumstances warrant and strategy dictates, you can convert all or a portion of the trust or its assets into an Offshore Trust or Offshore LLC—legally protected and effectively out of reach. A plaintiff attempting to litigate in a foreign country would be faced with nearly impossible hurdles, subject only to local fraudulent transfer rules and the applicable statutes of limitations. We have discussed the use of Offshore LLCs in chapter 7, and more detail about Offshore Trusts is discussed later in this chapter.

An overview of the types of planning which can be incorporated within a Family Savings Trust or which might stand alone or together with other entities to enhance an asset protection and estate planning structure are discussed below. The available strategies are certainly not exhausted here and may be limited only by our imagination and legal creativity. But these examples are intended to provide you with some of the ideas which have been used successfully and which can be added or modified to accomplish your particular goals.

INCOME TAX PLANNING

The first issue to be considered in creating the Family Savings Trust is the income tax treatment of the trust. Who do we want to be taxable on the trust's income? Do we want the income included on the parents' tax returns or perhaps the children's returns or some other family member? Sometimes we might want to have the income taxed to a different entity entirely, maybe a corporation or an LLC.

Grantor vs. Non-Grantor Trusts

The ability to direct the income tax consequences of the trust often depends on whether it is designed as a Grantor Trust or a Non-Grantor Trust. The provisions of Sections 671-679 of the Internal Revenue Code specify the terms of whether the trust is a Grantor Trust or not, depending upon the extent of the powers retained by the trustors. The difference is that when a trust is treated as a Grantor Trust, all of the income is required to be included on the tax return of the person(s) who establishes the trust.

For example, let's say the assets of the Family Savings Trust consist of a 98 percent limited partnership interest in a Family Limited Partnership and the FLP holds investments which generate \$100,000 in income. The Family Savings Trust would have \$98,000 of income, and the question of who reports and pays tax on that amount depends on whether the FST is considered a Grantor Trust or a Non-Grantor Trust. If it is a Grantor Trust, then the FST is ignored for federal tax purposes and all of its income is reported on the parents' tax return. If the FST is a Non-Grantor Trust, then the income is included on the tax return of the FST or, if distributed, on the return of the beneficiaries.

Shifting Income to Lower Brackets

The choice of who we want to be taxed on the income is often based on whether an overall tax savings can be generated. When a trust beneficiary is in a substantially lower tax bracket, because of lower earnings, it sometimes makes sense to shift the income to that beneficiary. We looked at this issue with the Family Limited Partnership in chapter 6.

As Congress considers whether to increase the tax rate on high income earners, the savings which result from income shifting from the highest bracket to a lower bracket can produce substantial savings. If the Bush tax cuts expire in 2011, a shift of \$35,000 of income from the proposed top bracket of 39.6 percent to the lowest bracket (0 percent to 15 percent) would produce an absolute tax savings of about \$10,000. There may be other circumstances where income can be shifted to a particular individual or entity to take advantage of large current or carry-over tax losses.

Tax savings from income shifting may also arise if the trust or a beneficiary is domiciled in a state with lower personal income tax rates than the parents' home state. Many of the "trust friendly" states, such as Nevada, Alaska, Delaware, and South Dakota (plus, Florida, Texas, Washington, and Wyoming) have no state income tax and an obvious advantage is gained if income is shifted from a high tax state to a zero tax state. The ability to shift income may be particularly important to those who anticipate a large capital gain on a future sale of stock in a private or public company. In some circumstances, it is possible to avoid a state capital gains tax by careful planning to domicile a trust in a zero or low tax state.

ASSET PROTECTION FOR A LIMITED TERM OF YEARS

A popular strategy which can be added to the Family Savings Trust and is often used by physicians is a trust which is designed to last for a specified term of years with the trust assets returned to the settlor or the trust beneficiary at the end of that period. For instance, Dr. X is forty-five years old, married with two young children, and earning a comfortable living. He has \$2 million in savings and doesn't currently need the income generated from these investments.

His primary goal is to protect his savings from any type of lawsuit or claim, and he wants to make sure the funds are available for his planned retirement in twenty years.

He established a trust with the \$2 million (or with interests in an FLP that holds the funds), which provided that income and principal be used to pay for support and education of his children until they

complete their education. At that time, the remaining balance of the funds is returned. The benefits of this arrangement are that the amount in the trust is well protected from potential claims during the period that the children require support. Ten or fifteen years later, when they are on their own—and the parents need the funds for their retirement—the money is available. At that point, since Dr. X will no longer be practicing medicine, asset protection concerns will be minimized.

LONG TERM TAX SAVINGS AND ASSET PROTECTION

Features which extend the term of a trust are fittingly known as “Dynasty” provisions and recently have gained substantial infamy as part of the ongoing political debate about tax cuts and the estate tax. The view of those who claim that the wealthy are not paying their fair share of taxes was voiced in an op-ed in the *New York Times*, which argued that Dynasty Trusts created a powerful new “aristocracy” whose wealth is protected and untaxed for generations into the future.

Sounds appealing right? Let’s look a little more closely at the available benefits and whether these trusts may have a role to play within your overall estate plan.

How Long Should a Trust Last?

The first point to note about the Dynasty Trust is that it is designed to last for a long time. Many states have recently adopted legislation (abolishing the Rule against Perpetuities) which eliminate legal restrictions on the period of years that a trust may last. Now, in these twenty-three states, a trust is permitted to exist for whatever term is chosen—even if it reaches far off generations many years in the future. In Nevada, a Dynasty Trust is permitted to last for up to 365 years. Who might want a trust lasting generations into the future?

Estate plans are typically designed to include some type of trust to take care of the needs of minor children upon the death of the parents—usually lasting until the ages of twenty-one or twenty-five or so. It makes sense to limit the term to this relatively short period of time when the trust fund contains an amount that the child might exhaust for basic living needs or for the expenses of college and higher

education. If there is not going to be anything left over after covering the child's basic needs, an extended term trust would not make sense.

It is a different matter when family wealth consists of substantial accumulated savings, a valuable business, or a large insurance policy. In these cases, the issue of how long a trust should last assumes much greater significance and specific questions must be addressed. At what age do we want a child to receive a full distribution of substantial trust funds? Should we make large sums of money available to the child when he is young or do we want to control and limit the distributions based on whatever standards we can define for need, responsibility, and maturity? These are not easy questions to answer, especially for children who are young when the trust is formed.

The answer to the question of how long the trust should last is often based on two key considerations—the estate tax consequences of the plan and the possible need for asset protection.

Dynasty Estate Tax Savings

It is true that substantial estate tax savings can be created by Dynasty provisions in your Family Savings Trust. As we have discussed, the federal estate tax is normally imposed as wealth that is transferred from parents to children. Each time the wealth is passed to a younger generation a new estate tax is levied. At a 50 percent tax rate, one dollar in wealth is reduced to 50 cents when it is passed to your children. The remaining 50 cents is further taxed so that your grandchildren would receive only 25 cents of the original dollar, and so on until there is nothing much left. For those whose total assets are under the estate tax threshold (currently scheduled at \$1 million for 2011), this is not a problem since amounts under the exemption are not subject to federal estate tax. Those who have accumulated assets in excess of the exemption amount or who have large insurance policies and wish to maximize and preserve these funds for future generations can significantly reduce estate taxes with properly structured Dynasty features.

The provisions in the tax law which allow these benefits are long standing and well established. Briefly stated, if assets are left to children or any younger generation and the beneficiary's rights to the property

are limited by certain defined standards, the trust property is not subject to estate tax as it passes to a younger generation of beneficiaries. For example, if you leave \$1 million in a trust for your child, and he or she has the right to the income from the trust and also a right to principal for “health, education, maintenance, and support,” the trust assets will not be included in your child’s estate on death and can then pass to your grandchildren free of estate taxes. The trust can continue, subject to these same provisions, and there will never be an estate tax imposed as it passes from children to grandchildren and further down the line. Depending on the amount of trust assets and whether income is accumulated or distributed, wealth which is not subject to estate tax can be maintained or compounded over time as succeeding generations of family members become beneficiaries. (As with the estate tax itself, the total amount which can be passed through the generations is subject to a generation-skipping tax on amounts in excess of an exemption amount that has yet to be determined by Congress. Stand by for future developments.)

Protecting Your Children from Divorce and Lawsuit Risk

Whether or not you have a need for estate tax savings, these Dynasty provisions can be designed to help protect children from the risks of divorce and creditor’s claims that they may face in their personal life and business careers. Possible claims by a child’s current or future spouse is always a paramount concern in every estate planning discussion. Facing hard facts, a 50 percent divorce rate means that there is a substantial financial risk of losing assets to a spouse at some point. Trusts are often designed to specifically address this issue to make sure that amounts intended to be the separate and protected property of a child are not available to a claim by a divorcing spouse at any point in the future.

The same logic applies to other types of potential creditors that may arise during a child’s lifetime. Some common examples of these risks include student loan debt which, unlike every other type of obligation, is almost impossible to discharge in a personal bankruptcy. Children attending private colleges or professional schools and facing a difficult job market are often trapped for a lifetime with the burden of

impossibly large student loan debt. Also personal guarantees on loans and debts from bad business decisions or just plain bad luck can cause lasting financial hardship and burdens. The point of a trust is often to make sure that a nest egg is preserved for the child which is not subject to lawsuit and liability claims no matter what happens in the future.

FREEZING ESTATE VALUES

Freezing the value of assets which may appreciate in the future is another strategy which can be added to your planning. If it is anticipated that certain property will appreciate in value over the years, it often makes sense to include provisions in the Family Savings Trust to minimize or avoid estate taxes on one or more particular assets.

A client in his mid-forties owned publicly traded stock with a value of about \$2 million. We calculated that if the value of his portfolio increased at about 7 percent per year, at age seventy-five, the stock would be worth \$16 million. The potential estate tax liability was roughly \$8 million. Also, of immediate concern, the entire amount of his savings was exposed to lawsuit risks from his business.

To solve both problems, we put the stock into a Family Limited Partnership with the limited partnership interests transferred to a Family Savings Trust with estate freezing provisions. The \$2 million value was discounted for tax purposes so that the total amount of the gift was equal to the exemption amount. (After the discount was applied to the \$2 million, the gift was valued at \$1.3 million. Also note that at this time, Congress is considering limiting the use of valuation discounts on these types of transactions so make sure you or your advisor knows the current state of the law. We post regular updates on this issue on our Web site at www.rjmintz.com) The stock was fully shielded from any potential claim, and the entire value of the asset was removed from the client's estate. If the value of the stock appreciates even slightly, millions of dollars in taxes will be saved for the family.

The same principle would apply to ownership in a start-up company which you believe will increase in value over a number of years. When you start a business, the initial value is generally low. That presents

an opportunity to transfer ownership and remove future appreciation from your estate without creating a taxable gift or using a portion of your lifetime exemption. A real estate investment, which has little initial equity but has potential to appreciate, is also a good candidate for an estate freeze.

PROTECTING YOUR RESIDENCE

If you still have some equity in your home, features which protect the family home are often a key component of the Family Savings Trust. Generally, our goal here is to protect the equity in the home, above the homestead amount, while preserving the tax benefits and the continued right to use and enjoy the house. That's what most people want to accomplish.

To understand the key issues involved in protecting the family residence, let's review the tax issues which may be involved. Some trusts are treated by the tax law as if they do not exist. This type of trust is known as a "Grantor Trust," and if certain language is used in the trust document, the IRS will treat you as the owner of the property, not the trust. That's good, and it is what we want for our purposes. We want a legal trust that is respected for protection purposes but that is ignored for taxes. That way we are assured that we'll retain all the tax benefits. So, our first requirement is that the trust we use is treated as a "Grantor Trust."

Once we have solved the tax problems we can consider the asset protection issues. To achieve worthwhile protection for the residence, it is important that your legal rights concerning the house are limited in some manner. If you maintain the full spectrum of ownership rights, it is likely that a judge would order you to turn over the property to a plaintiff with a judgment against you. In other words, to the extent that you have unrestricted power to do anything you want with your home, it can be seized in a collection action.

The key to protecting the home is to limit your rights in some manner so that there is nothing legally available, which can be reached. If your ownership of your home changes from full and complete to something less, your interest may have no value to a prospective creditor.

How should we limit your rights in an acceptable manner? We say acceptable because it is certainly easy to fully protect your home if you want to give it away to your children and not live there anymore. That's perfect asset protection, but in most cases, it would not be a satisfactory solution. Maybe we can accomplish what we want using less drastic measures.

A Personal Residence Trust (PRT) is a term we apply to a trust intended to hold property and apply restrictions, which protect it against possible loss. This type of trust is designed to be ignored for tax purposes so that no tax issues are created and the tax benefits are preserved. There are many different formats and strategies which can be used for creating this type of trust, depending upon the particular circumstances of the case.

One popular technique is to provide in the PRT that your children or other family members take ownership of the house after a certain number of years. The trust reserves your right to live there for a period of time—perhaps ten or twenty years. In addition to powerful asset protection advantages, this arrangement, depending on the exact terms, may provide excellent estate tax benefits by freezing the value of the house at its current amount and removing it from your taxable estate. This estate planning strategy is known as a “Qualified Personal Residence Trust” and is specifically sanctioned under Section 2702 (b) of the Internal Revenue Code. The period of years and the important terms can be modified or tailored to meet most circumstances.

Sometimes we reverse this arrangement if the circumstances are appropriate. Rather than reserving a right to live there for a period of years, the PRT can provide that the home belongs to the trust but can be leased back to you for a period of years. Although you would pay rent to the trust, the usual tax benefits would apply because of the Grantor Trust rules. At the end of the term of the lease, full ownership could be returned to you or passed to your children. It can go either way, depending upon your view of any future potential liability you may have.

In a slightly different vein, the PRT could be provided with an option to purchase or a right to exercise some other authority over the property within the trust. As an illustration, rather than a

recommendation, assume your home is worth \$1 million with a loan of \$500,000. A Personal Residence Trust is created, which grants the trust an option to purchase the property for the loan amount, any time within the next fifteen years. The option agreement is recorded and acts the same as a lien on the property. The equity in the home cannot be seized by a successful plaintiff, since the home itself is subject to the option to purchase for the \$500,000 amount. Under this arrangement you can live in the house without restriction and subject only to whatever terms are provided in the option agreement. There are a number of issues that must be addressed in this type of strategy, but this illustration gives you an idea of the direction that planning can be taken.

RETIREMENT SAVINGS

Private Retirement Plans

How to protect retirement savings that are not under a Qualified Retirement Plan is often an important consideration within the Family Savings Trust. We mentioned in chapter 3 that ERISA Qualified Retirement Plans are fully protected under federal bankruptcy law and generally under the exemption provisions of state laws as well. In addition, some states such as California (California Code of Civil Procedure 704.115 (b)) allow for the creation of a Private Retirement Plan, which is entirely exempt from judgments and bankruptcy. That is, retirement savings plans which are not IRS Qualified Plans, may be protected under state law if certain requirements are satisfied. According to the cases that have been decided, these plans must be carefully drafted and maintained, but they are highly flexible in design, need not cover other employees, and can include annual contributions that can substantially exceed those available under the qualified plans or IRAs. No tax deduction is available for these contributions, but that actually works in favor of asset protection since the plans are not subject to the strict funding and compliance rules of ERISA and the Internal Revenue Code. The complete exemption from judgments for amounts in these plans may be highly valuable in a wide variety of circumstances and should be

considered as a stand-alone asset protection plan or in conjunction with a tax deferred account.

This exemption from judgment also applies to distributions from the Private Retirement Plan so the funds are protected while in the plan and later on in retirement, when the proceeds are withdrawn. As long as the funds can be traced to a distribution from the plan, they can be invested in any manner. For example, if you purchase a home or a boat or gold coins or any other asset with the proceeds, those assets are exempt from judgment.

■ Benefits of a Private Retirement Plan

- A. California residents are permitted by law to establish Private Retirement Plans which are exempt from creditor claims and judgments.
- B. All assets in the plan are completely protected from lawsuits and judgments—even in bankruptcy.
- C. The contributions to the plan are not tax deductible so:
 - 1. No maximum limit on contributions.
 - 2. No requirement for covering other employees.
 - 3. No annual IRS filings.
- D. A Private Retirement Plan can be used instead of or in addition to an existing qualified plan.

You can maintain plan funds at whatever financial institution you choose, and you can choose to manage all investments.

A Private Retirement Plan we recently set up for a physician client provides an example of how this works. The client is forty-five years old, married with one child, and earns about \$500,000 per year as a member of a local ob/gyn group. His goal was to save as much as he could for retirement in a protected vehicle. A Qualified Plan wasn't feasible because of limitations on contributions and the cost of covering other employees. He wasn't sure whether his current income would increase or decrease over time so we established a flexible formula

in his plan based on a percentage of his net income over a certain threshold that allowed him to contribute a larger or smaller portion of his surplus cash each year, based on his circumstances at the time. The client hopes to retire at age sixty or earlier, and the plan documents provide that the proceeds can be distributed to him whenever his actual retirement occurs. In these particular circumstances, where the client wanted maximum but flexible contributions in a protected form, without additional employee or administrative costs, the Private Retirement Plan was a good fit with his financial goals. We also considered the fact that for obstetricians, potential malpractice liability continues even after retirement as the statute of limitations is tolled until the patient reaches age eighteen. With continuing liability from an extended term, the ability to withdraw funds at retirement with the proceeds fully protected was an additional benefit of the plan.

Life Insurance

One of the most popular and effective estate planning and asset protection strategies is to use a Life Insurance Trust to hold one or more policies on the life of either parent.

An important purpose of this trust is to exclude the proceeds of a policy from estate tax. Simply put, if you own an insurance policy on your life, the proceeds are subject to estate tax. If your total property exceeds the exemption amount, 50 percent or more of the policy proceeds can be lost to estate taxes. If you have \$1 million of assets beyond the exemption amount and an insurance policy for \$1 million, you would pay approximately \$500,000 in estate taxes just on the policy proceeds. (See the article “How to Avoid Common Pitfalls When Buying Life Insurance” in chapter 12.)

The simple solution is to create a Family Savings Trust with appropriate language governing the ownership of the policy and the administration and disposition of the proceeds. A properly drawn trust keeps the policy out of your estate—free of estate tax—so that the entire amount of the proceeds are available for your family.

When a policy is held by the trust, the cash value and the proceeds are also protected from potential lawsuits and claims. A portion of

family savings can be transferred to the trust each year and that amount can be used to fund a policy. Amounts invested in the policy are permitted by favorable tax laws to accumulate free of income tax. In this manner, large amounts of value can be built up over a period of years.

As an example, a forty-five-year-old client of ours had a good income and was saving about \$50,000 per year. We set up a Life Insurance Trust with a plan to transfer \$20,000 per year into the trust. He achieved these significant benefits:

- All amounts transferred into the trust and plan proceeds were fully protected against potential claims and lawsuits.
- Investment earnings grew and compounded without annual income taxes.
- The cash value of the policy could be withdrawn or borrowed for any needs of the trust.
- Plan proceeds of \$5 million would be available for his family—free of income and estate taxes—upon the client's death.

The Life Insurance Trust is an important foundation of any asset protection and estate plan where the value of the estate is likely to exceed the exemption amount. Proper planning in this manner can prevent a significant loss of 50 percent or more of your accumulated wealth from taxes and can protect assets from future claims.

DELAWARE AND DOMESTIC ASSET PROTECTION TRUSTS

A particular technique known as a Delaware Asset Protection Trust has been the focus of considerable attention. An ironic twist on the current financial hardships was an article in the *New York Times* pointing out that the Delaware Asset Protection Trust, once popular with physicians and business owners, is now favored by hedge fund managers, bankers, and others in the investment world for protecting substantial assets from government regulators and unhappy investors.

The fact that financial pros are protecting their assets may or may not be good news depending on your point of view. Nevertheless it's always interesting to know what the so called "smart money" is up to.

So let's see what these Delaware Asset Protection Trusts really can and can't do and whether they can be a useful strategy in a sophisticated asset protection plan.

Let's understand the goals of these trusts—what they are intended to accomplish. Many people want asset protection for their nest egg, while continuing to use the income and maybe the principal to pay for their personal living expenses. For example, a retired client wants to protect his savings of \$5 million from general lawsuit risks. The problem is that he needs the income to live on each year. These types of trusts are called “self-settled” trusts, and for centuries, English and American laws have held that an individual cannot protect savings from creditors with a trust while reserving a right to use the income and/or principal for his or her own benefit. This rule certainly makes sense (at least to creditors) and reflects the dominant public policy that one should not be able to maintain full enjoyment of one's property without meeting one's legitimate obligations.

For those individuals who don't need the income from their savings to live on because they have an independent source of income from a business or professional practice, there are many asset protection strategies that will be successful. We have discussed some of them in this chapter. Those who live on their employment earnings and not on the income from their savings are usually in a good position to implement these strategies. But for those without an independent source of income, until fairly recently, the only hope for asset protection was an Offshore Trust, organized under the laws of a country that legally sanctioned trusts for these asset protection purposes. We discuss these trusts later in this chapter but for now the point is that as these Offshore Trusts gained in popularity over the past decade, some U.S. states viewed the demand for these trusts as a ripe business opportunity to provide a lucrative financial service for clients in a local setting without the inconvenience of foreign banking. So about ten years ago, Delaware, Alaska, and subsequently seven other states adopted laws that essentially duplicated the rules in the offshore jurisdictions by creating a category of Domestic Asset Protection Trusts (DAPTs). Simply put, under these new laws, self-settled trusts were permitted.

Asset protection could be accomplished even for trusts reserving to the settlor a right to the income or principal, if the appropriate rules are followed. Each of these states has some differences in their laws, but, generally, DAPTs must have at least one independent trustee located in the state of choice, and any distributions to the settlor must be approved by that trustee.

Are these DAPTs effective for asset protection? There has been a surprising lack of case law on this issue, but it's probably true that if you live in Delaware or one of the other states with these laws and keep your assets and the administration of the DAPT within that jurisdiction, then the legal asset protection should be strong. In the case of a bankruptcy, the Bankruptcy Reform Act of 2006 states that "Asset Protection Trusts" can be set aside by the bankruptcy trustee if formed within the previous ten years with an actual intent to hinder, delay, or defraud a creditor. What constitutes such prohibited "intent" is a fairly large and debatable issue, but it seems likely that DAPTs created prior to the ten-year period will be respected under federal bankruptcy law, even if formed with an "evil" intent and even if formed in a state which does not have its own DAPT law. We don't know this for sure but that is a reasonable inference from the language of the statute. Outside of bankruptcy, for those living in non-DAPT states, because of the lack of case law at the present time, we don't yet know whether assets in these trusts can be protected from a legal judgment and a collection action in your home state.

MAXIMIZING PRIVACY

Legal strategies designed to achieve financial privacy goals are a legitimate concern for many individuals. These privacy strategies can be incorporated into a Family Savings Trust or may stand alone as a separate entity, depending on your overall planning goals. What we refer to as a Privacy Trust is intended to achieve a high level of confidentiality for assets such as brokerage accounts, the family home, rental properties, and interests in other entities. Particular features included in the trust—in addition to the privacy advantages—may provide formidable asset protection and estate planning benefits as well.

Creating Legal Privacy

Legal privacy for financial matters is a scarce and valuable commodity. The U.S. Supreme Court has long held that a customer has no legal right to privacy for account records held by a financial institution. See *United States v. Miller*, 425 U.S. 435 (1976). Attempts by Congress to establish basic customer protections (Right to Financial Privacy Act (RFPA) 1978) have been weakened or washed out entirely by a string of anti-terrorist and anti-drug laws including the USA Patriot Act (2001), the Bank Secrecy Act, and the Annunzio-Wylie Anti-Money Laundering Act.

Besides the legal availability of your financial records for searches with or without notice, developments in technology allow a much greater degree of sorting and assembling of records through interconnected databases. As we have discussed in chapter 2, these programs are capable of locating and assembling disparate facts about your life into a comprehensive personal information report with detailed background, credit, employment, and financial information. The ready availability of bank and brokerage account balances and real estate ownership provides a potential adversary with an accurate picture of sensitive personal matters that you would choose not to disclose.

Limiting the Supply of Personal Information

The success of a strategy to keep your financial assets private depends upon the same premise as the rest of your secrets in life. The fewer people that know something about you—the better. And those few people who know should be very good at keeping it to themselves.

Let's see how this principle applies when you open an account at a bank. You would like to keep the existence of the account, your balances, and your transactions confidential. The representative who opens your account assures you that the bank maintains strict privacy standards and would never disclose customer information to anyone. The account opening agreement requests your name, address, date and place of birth, driver's license number, and your Social Security number. This information is entered into the bank's records and an account number is assigned. What level of privacy should you now expect?

The account information in the bank computer is now available throughout all of the bank branches to virtually every employee. Account information is maintained centrally and is accessed through the terminals of every teller, loan officer, and customer service representative by a search under your name, account number, or Social Security number. The recent merger trend in the financial services industry, accelerated under the TARP program, makes ever larger quantities of customer information available to a greater number of people. Bank of America now owns Merrill Lynch. JP Morgan Chase acquired Wachovia, and the four largest banks now have nearly 40 percent of all customer bank deposits in the U.S. With access to personal account information available to so many employees, the financial institutions cannot control the flow of customer information from the bank to the outside. The investigators and information brokers who seek account information for clients on a regular basis pay bank employees to supply individual accounts records. So the first problem you have with your account secrecy is that even if the bank wanted to protect your privacy, it would have a difficult time preventing disclosure by its employees.

Your second problem is that when your bank tells you that it values your privacy, that doesn't mean what you think it does. It really means that the information about your account is *valuable to the bank*. Sophisticated databases allow financial firms to create intimate profiles of customer portfolios, savings, and spending habits. This information is then used by the firm—or an outside marketing company—to create highly selective and targeted presentations to sell you services and products. Information about you and your account activity is a prime source of revenue for the firm, and it is exploited, traded, and sold like any other asset.

Detailed account information and behavioral analyses of bank customers will allow the combined sales forces of the new entities to individually tailor each pitch for annuities, mutual funds, and insurance products. Imagine the potential. A broker from the Merrill Lynch division of Bank of America calls Mrs. Wilson about her \$100,000 certificate of deposit at the bank, which is about to come due. Although the two have had no previous business relationship, he tells her that he

is calling from her bank and, as a service to its valued customers, has been asked to perform a thorough financial analysis of her account. After weighing the available investment options, his recommendation is that she purchase a variable annuity with her \$100,000 savings. Or he might suggest putting her savings into an investment advisory account, or into a mutual fund—anything to shift her out of the low margin CD and into a high profit, big commission investment product.

Bank of America lures the customers with the convenience of thousands of branch offices, ATMs, and online banking. It might even be willing to pay higher interest rates on CDs and deposits—a loss leader—simply to attract additional accounts. Once you are a customer, your individual customer data is gathered, spending and saving patterns and available cash are processed and analyzed, and the information is turned over to the sales force. Then the real money is made by selling investments and products loaded with fat fees and commissions. With the passage of recent financial reform regulation and some limitations on credit card and account fees which the banks can charge, the push by firms for new profit sources of revenue, such as cross-selling of products based on proprietary customer information is likely to increase substantially over the next few years.

Now that you have the broad picture about how the financial firms operate, what conclusions can we reach about the confidentiality of your account? We know that the information is widely available to employees and is traded and distributed by the firm to inside and outside sales forces. If you hope to accomplish privacy by restricting access to particular information, it is easy to see that this ambition will be defeated from the very instant that the account is opened. As your account information is keyed into the computer, it is turned into a digital packet and shipped into the stream of commerce. To state the matter most directly, you can expect that all information in the possession of the financial firm will be available to anyone who wants it, for whatever reason.

What the Privacy Trust Achieves

The approach we have developed is to hold all financial accounts within the Privacy Trust. This legal arrangement prevents the firm

from acquiring any useful personal information. Since financial firms are not good at keeping secrets, we just won't tell them anything. The Privacy Trust acts as an intermediary to remove the connection between you and the account. Neither your name, nor your Social Security number, nor any other personal identifying information appears in any records related to your account. No employees of the firm are aware of your relationship to the account, and the bank can't sell information that it doesn't have. That's the proper model for creating financial privacy.

Information about your real estate assets—your home and other property can also be shielded from public disclosure. Since these records are publicly recorded and can be gathered through a database search—privacy means severing the connection between you and the property. When the records are searched under your name or identifying information, you do not want your home and other properties to appear on the list. If you hold real estate in a corporation, FLP, or LLC, your ownership of these entities must be concealed, at least from the public records, as part of any privacy strategy. Locating your property and determining its value is the easiest and most popular technique for measuring your attractiveness as a potential target for litigation or any other type of claim.

The Privacy Trust can be created in a simple and straightforward manner to accomplish most privacy, asset protection, and estate planning objectives. Progressive levels of sophistication can be added as the complexity of the financial circumstances increase. Advanced planning strategies may include a variety of domestic or offshore options, depending upon the particular results to be accomplished.

In the typical arrangement, the name on the property and the accounts is changed from your name to the name of the trust. For example, if we use the ABC Trust Company, the name of the trust could be ABC Trust #4006. Title to your home or other real estate is removed from your name and simply reads ABC Trust #4006. The trustee acts on your behalf for executing purchase or loan documents. Many lenders are familiar with these types of trusts and are comfortable with a mortgage loan in the name of the trust. You

are required to maintain and manage the property in the trust. The trustee holds legal title for your benefit, but your responsibilities are not diminished.

An account at a bank or brokerage firm can also be opened in the name of ABC Trust #4006. The account opening agreement and the signature card are signed by the trust company. The tax identification number of the trust company is furnished. This arrangement creates a true model for privacy because the trust company is the signatory on the account.

This strategy successfully protects the privacy of your sensitive financial information by strictly limiting the access. The information is secure because it is not made available to the bank, its thousands of employees, and its sales force. In contrast to your bank, the trust company has a legal and contractual obligation to maintain the confidentiality of the trust. It is in the business of providing fiduciary services and cannot breach the trust agreement without serious legal ramifications. It is certainly true that if somebody wants information badly enough they can penetrate any source. But a trust company with the proper safeguards in place will seriously reduce the risk of unauthorized disclosure.

In addition to the privacy benefits, all of the typical estate planning advantages can be achieved. The trust can perform the same role as a living trust to avoid probate, minimize estate taxes, and pass your property according to your wishes.

Who Should Use This Plan

This arrangement is used most often by individuals who are primarily concerned with financial privacy issues. A client of ours had an elderly mother whose assets consisted of \$200,000 in savings at a brokerage firm. We put the funds in a Family Savings Trust with these privacy features specifically for the purpose of eliminating high pressure telemarketing pitches for investment products and phony investment schemes. Our client wanted to protect against the risk that his mother would lose her money to a scam artist using account information to victimize the elderly.

We also have created this type of Privacy Trust for several clients in law enforcement—police officers and federal agents—who want to avoid privacy intrusions from dangerous individuals they have dealt with in their line of work. Similarly, for entertainers and public officials, who are well known by the public, we are often asked to maximize privacy of their homes and financial holdings with the use of this particular technique. The level of asset protection you wish to achieve will be governed by the specific terms and features included in the privacy structure.

OFFSHORE ASSET PROTECTION TRUSTS

Privacy and asset protection may also be enhanced if the trust is established under the laws of a foreign jurisdiction. In many ways an Offshore Asset Protection Trust (OAPT) looks like a standard domestic trust. The settlor is the person who transfers the assets to the trust. The trustee is a trust company, whose business is operated outside of the United States. The arrangement differs from a Privacy Trust because, in this case, the trust company is located in a foreign country—outside the jurisdiction of U.S. courts. The OAPT is intended to take advantage of favorable asset protection and privacy laws which exist in other parts of the world.

In a typical trust, the trustees are given discretion to accumulate or distribute income among a specified class of beneficiaries. The settlor may be one of the named beneficiaries, together with his spouse, children, or grandchildren. When the settlor is also a beneficiary of the trust, this is known as a self-settled trust, and in most jurisdictions, in the U.S. and overseas, this type of trust will not protect assets. The traditional rule has been that a person cannot set up a trust, retaining a right to income or principal and still have those assets protected from creditors. One unique feature of this kind of a trust is the role of the Protector. The Protector is a person, designated by the settlor, whose consent is necessary for certain activity by the trustees. The term of the trust may be limited to a period of years, or it may continue after the settlor's death.

One way to use an OAPT is to transfer cash, securities, or other liquid assets to an account established under the name of the trust at a bank of your choice in a foreign jurisdiction. The Protector then advises the trustees on the manner in which the funds are to be held or invested. Income can be distributed to the beneficiaries or accumulated in the trust.

For those who want the option to transfer funds into an overseas account—but are reluctant to do so immediately, one solution is to use a domestic entity such as an FLP, LLC, corporation, or even a Family Savings Trust to maintain property in the United States. This arrangement can provide a high level of asset protection benefits. U.S. property is legally insulated within the domestic entity, and the OAPT owns and protects the interests in those entities. Liquid assets can be moved into the overseas trust account for additional protection or investment purposes.

Advantages of the OAPT

The OAPT is a trust established under the laws of a country which are more favorable to asset protection and privacy objectives than the laws in the United States. For example, the laws in some countries provide for a statute of limitations on fraudulent transfer which can be as short as one year and the standard of proof required is the difficult “beyond a reasonable doubt” rather than the lesser civil standard of a “preponderance of the evidence.” The courts in these countries will not enforce a judgment rendered in the United States, or an order of a U.S. Bankruptcy Court. To prosecute a claim against the trust, the creditor would have to go to that country and retry the underlying case, which is an expensive and often impractical obstacle.

A further advantage of the OAPT is that a greater degree of flexibility can be achieved in the way in which the trust is established. The settlor of the trust can serve as beneficiary, and the trust will still be valid under local law. This allows the settlor to retain a substantially greater degree of enjoyment over trust assets than would be permitted under U.S. law, except in those states, like Delaware and Alaska, that

have enacted legislation intended to accomplish the same result. Of equal importance, an OAPT allows a great deal of practical flexibility because the option is always available to move the assets into an account established in the foreign jurisdiction—subject to the protective features of local law. To reach those funds, the creditor would have to commence an action in the foreign jurisdiction and would have to overcome significant obstacles under the law of that jurisdiction.

The problem for a creditor with a judgment is that a U.S. court has no capacity to exercise its authority over a foreign trustee. Simply stated, a foreign person or company with no presence or assets in the United States cannot be compelled to act by a U.S. court. If a U.S. court ordered a foreign trustee to return assets, the foreign trustee, under a duty to preserve trust property, would refuse to comply with the order.

If a foreign person or entity has assets in the United States, a court can exercise leverage by threatening or attempting to seize those assets for failure to comply with the order of the court. For example, on occasion the U.S. Government seeks information about foreign bank deposits in matters concerning criminal tax evasion, drug charges, or securities law violations. Because of its local secrecy laws, the foreign bank usually fails to comply with the government's request for information. However, when the foreign bank has assets, such as deposits or branches in the United States, the government may threaten to seize the assets or impose confiscatory penalties if the bank does not comply with the court order. Generally, this threat is successful and the bank will reveal the sought-after information. Recently, the giant international bank UBS was accused of advising U.S. clients to hide money in secret offshore accounts to evade U.S. taxes. UBS and the Swiss Government have agreed to turn over thousands of names of UBS clients in order to avoid criminal charges and heavy penalties. Similar efforts are being pursued by U.S. authorities against a number of international banks with branches or activity within the United States.

Precisely for this reason, most foreign-based trust companies do not conduct business or have assets in the United States. Any foreign trustee which is selected must have no local business activity in order to avoid the financial leverage which might then be applied by a U.S. court.

Since the creditor cannot obtain satisfaction by obtaining a U.S. court order against a foreign trustee, the only method for compelling the trustee to act is to file a lawsuit in the jurisdiction in which the trustee is located. Whether or not the creditor can be successful in this forum will depend upon the particular laws in effect in that country.

Contempt Orders to Enforce a Judgment

With money and other assets tucked away in a country that won't honor a U.S. judgment, is there any way for the plaintiff to collect his judgment from you? The answer depends on when you set up the OAPT and the terms of the trust agreement itself.

If at the time you make a transfer into the trust the fraudulent transfer rules are violated (see chapter 4) and if you have the power to retrieve trust assets, a judge may order you to do so.

Judges back up these orders with the threat of contempt orders for refusing to comply. Stated simply, on several occasions, in which the defendant's actions were particularly egregious, a judge has ordered the defendant to return the overseas funds and to sit in jail until the money is returned. *Federal Trade Commission v. Affordable Media, LLC.*, 179 F.3d 1228 (9th Cir. 1999), *In re Stephen J. Lawrence*, 279 F.3d 1294 (11th Cir. 2002). In cases where it was found that the settlor's powers over the trust were substantial and that the actions of the settlor involved tax evasion, fraud, or other criminal activity, the contempt power of the courts to force a return of the funds has been employed and upheld on appeal. Certainly, if the trust is intended to allow a defendant to defraud others or to engage in tax evasion or other criminal conduct, the courts are likely to set aside the protective features of the trust and may apply contempt powers to avoid a result which would let a "bad guy" prevail over a government agency or a sympathetic plaintiff.

In cases where the settlor had no power to legally compel the foreign trustee to act, a contempt order against the debtor should not be appropriate. *U.S. v. Grant*, 2008 U.S. Dist. LEXIS 51332, 101 A.F. T.R.2d (RIA) 2676 (D.C. So. Fla. 2008). More specifically, consider the following principles as essential for establishing an OAPT:

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1. The transfer to the trust must not violate the relevant fraudulent transfer rules,
2. The settlor's powers over the trust should be specific and narrowly limited under the trust agreement;
3. The trust must be valid and enforceable under the laws of the jurisdiction where it is established as well as any jurisdiction where it is likely to be challenged,
4. The trust should have a strong estate planning and /or financial planning motivation, and
5. The settlor should not be a beneficiary of the trust unless the settlor is a resident of a state where a self-settled trust is permitted under state law (Delaware, etc.)

Depending on the exact circumstances of the case, based on current case law and our experience, these guidelines are likely to ward off litigation and legal challenges by most plaintiffs.

Where to Create the OAPT

Selecting the proper jurisdiction for the OAPT is a matter of critical importance. As a general rule, the jurisdiction should have a well-established trust law favorable to asset protection strategies. Further, it should be inconvenient or nearly impossible for a U. S. creditor to reach the assets of the trust by commencing an action in the foreign country.

Consider the following factors when selecting a jurisdiction for an OAPT:

■ Experienced and Well-Established Trustees

The country where the trust is established must provide a choice of responsible and experienced trust companies from which to select a trustee. The trust companies must be experienced in the area of asset protection and understand the nature of their peculiar responsibilities.

■ **No or Low Tax Jurisdiction**

Income earned by the trust must not be subject to taxation in that jurisdiction.

■ **Favorable Trust Laws**

Many foreign jurisdictions do not recognize the existence of trusts or severely restrict these arrangements. It is important that the law of the country allows the greatest degree of flexibility in establishing the trust to meet privacy and asset protection objectives.

■ **Stable Local Government**

Political and economic stability is essential to the proper functioning of the trust. A country which may have its legal system or its financial institutions disrupted by unexpected forces should not be chosen.

■ **Favorable Asset Protection Laws**

The existence of laws designed to encourage the formation of trusts used for asset protection strategies is an essential factor. If a creditor elects to file a lawsuit in the foreign jurisdiction seeking to set aside the trust, the laws of that country must make it impractical for the creditor to obtain a successful result. A country which has no treaties with the U.S. and does not enforce foreign judgments is critical to the success of the plan.

■ **Absence of Exchange or Currency Controls**

The ability to move funds, if necessary, in and out of the jurisdiction without interference or restriction by local authorities is a requirement in selecting a location.

■ **Confidentiality**

The country which is chosen must allow for a high degree of confidentiality of information concerning the settlor and the beneficiaries of the trust.

No Tax Avoidance With the OAPT

It is difficult to imagine an issue that is so clear yet produces as much confusion as the proper U.S. tax treatment of the Offshore Asset Protection Trust. Despite thousands of Web sites on the Internet promoting offshore trusts as legitimate strategies for avoiding income taxes—this is not the case. The OAPT does not provide any income tax advantage. All of the income of the trust is included on the tax return of the U.S. settlor of the trust. The trust is treated in the same manner as a revocable living trust. This rule applies whether the assets of the trust are located in the U.S. or in an overseas account. It also applies regardless of whether the source of the income is from the U.S. or from another country. All income of the trust is taxable on the return of the settlor in the year it is earned. It doesn't matter when the funds are distributed or returned to the U.S. There is no strategy or technique which will alter this result without causing you to commit perjury or tax fraud.

This treatment is beneficial from an asset protection standpoint because it allows you to transfer property to and from an OAPT without creating any tax consequences. No gain or loss is recognized, and no taxable income is produced by a contribution or distribution.

SUMMARY

In this chapter we discussed how a Family Savings Trust can be structured to provide asset protection for your home, savings, and investments within a simple and convenient format. We also detailed a variety of additional features and strategies for income tax, estate planning, and privacy, which can be adapted within your overall planning. Although the issues which we discussed presented a broad sample of many popular techniques, there are certainly many creative ideas in the field which can be included in your plan if appropriate. For now, these questions summarize our discussions in this chapter and should assist you in organizing your planning objectives. By posing these questions, you will be able to create a framework for your planning which can be filled out and structured efficiently as details are added throughout the planning process.

1. **Income Taxes.** How should trust income be taxed? Are savings possible by shifting income to lower bracket jurisdictions, individuals, or entities? Are there any large capital gains on the horizon which can be minimized with advance planning?
2. **Estate Tax Savings.** Will the estate tax apply to your assets at any point in the future? It is difficult to forecast what the exemption amount will be in the future and what the total amount of your savings and investments will be. If the estate tax is or might be an issue, consider strategies which freeze or reduce current estate values and minimize taxes on the passing of property to younger family members.
3. **Asset Protection.** In addition to tax issues, what should you do to protect assets from whatever risks may arise from your business or investments or in your personal life? Based on your assessment of these risks, will a short-term strategy for a period of years be sufficient or should you consider a longer-term plan which continues throughout your lifetime? Does it make sense to protect a nest egg for your children that is safe from debts and lawsuits as well as potential claims from a future spouse? If we use a domestic plan, which state offers the best law and are there any advantages which can be gained by including an offshore feature? Each of these questions should be analyzed and considered, and planning strategies should be adopted which address each vital concern.
4. **Privacy.** Maximizing financial privacy is a sound and strategic response to a legal system in which those with identifiable and reachable assets are an attractive lawsuit target. Financial information about you and your business is a valuable asset in the hands of a potential legal adversary, and attempting to limit access to that information is often a worthwhile goal.

Addressing these questions will provide a framework and a sense of direction to your planning. Your attorney will be able to advise you of the relative benefits or drawbacks of the available options and

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your specific goals will become finely honed and clearly defined in the process.



PART THREE

SELECTED TOPICS IN ASSET PROTECTION

CHAPTER TEN

LAWSUIT RISKS & LITIGATION STRATEGIES

Advance Planning Can Cut Liability Risks

By Robert J. Mintz

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A prospective client (Richard) asked for my help with a difficult legal and financial problem. I've changed the details slightly but here is the gist of the matter. Richard is a physician, earning a solid living and in 2005 he purchased an office building near Philadelphia that was leased entirely to the State of Pennsylvania. The lease had five years to run, but the broker assured him that the State had been a tenant there for twenty years and wasn't likely to move. He bought the property for \$2.5 million with an 80 percent loan. The problem is

that the State has now given notice that it will be moving out in a few months, and with no rental income from the property, Richard won't be able to carry the \$15,000 monthly negative. What should he do? If he stops making the payments, the lender is likely to foreclose on the property and obtain a substantial deficiency judgment. Richard's personal savings and the equity in his home are subject to a collection action on the judgment and his twenty-five years of savings and hard work are certainly at risk.

"What were you thinking when you bought the property?" I asked Richard. "Did you consider what would happen if the State didn't renew the lease—with you on the hook for a \$2 million loan?"

"Never occurred to me," he said. "I just thought it was a good deal with a chance to make a lot of money down the road."

This scenario is not unusual these days, and I may get ten or so similar calls each week. In every case the caller has purchased a business or a rental property and the income has dropped substantially over the last two years. The choice is whether to keep dipping into dwindling savings to make the payments, hoping to forestall a collection action for some time, or to give the property back now. In either case substantial losses will be incurred, far beyond the initial investment.

Underestimating Risk

In my experience, this common failure to properly measure and plan for business risk often represents a greater and more realistic financial threat than any other source, including possible malpractice claims. I don't think anyone knows what causes these lapses in judgment but it might be a combination of factors. When everyone is caught up in a rising market, the question of what happens if things don't work out is rarely considered. Over-enthusiasm and optimism about a new deal seem to suppress some degree of critical, cautious thinking. It may also be true that the real legal and financial risks of a particular deal are not always completely understood, even by those who consider themselves experts in the field. For example, analyzing a real estate purchase

requires a sophisticated understanding of financing, comparable rents, the quality of the location, and the credit risk of the tenants. A buyer without a thorough knowledge of this information is open to the wider risk of unexpected developments.

I've heard many people justify risk taking with that standard mantra that big risks should produce big rewards. Nothing could be further from the truth. In fact, those who are the most financially successful usually get that way by taking the least amount of risk—not the most. These financially gifted individuals are able to resist market exuberance and develop a high level of knowledge about each facet of a particular deal. It's true that sometimes big risk takers get rich. Luck can be a good short-term substitute for skill, but as a rule the big risk takers end up broke (unless the government bails them out).

Limiting Potential Liability

I'm certainly not suggesting that no one should ever go forward with a business deal simply because there are risks of financial failure. What I do believe is that whenever a new venture is planned, the degree of risk should be objectively analyzed. What is my risk of loss? How much can I lose if things go wrong or unexpected events materialize? Will I lose just my initial down-payment or do I have liability for the full loan? Richard certainly would not have purchased the property if he had known that he could lose all of his accumulated savings.

Once the amount at risk is calculated, the question becomes how well can I limit this potential loss through proper business structuring and asset protection. Sometimes the purchase can be structured through the use of business entities such as corporations or Limited Liability Companies to limit the potential loss to a finite and acceptable amount. In addition, it is usually possible to protect personal assets from the liability associated with a particular deal if the planning is completed at an early stage. Once the total amount at risk of loss is known, the issue of whether the deal is worthwhile from an economic standpoint can be intelligently addressed.

How to Protect Yourself in a Lawsuit

By Robert J. Mintz

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I've been getting more calls than usual from clients who want to discuss litigation strategy for potential lawsuits they are considering filing, usually against a business associate or insurance company. I've written extensively about the risks of getting sued and being a defendant in a lawsuit (www.rjmintz.com/Chapter3.pdf), but equally dangerous is what can happen when you sue someone as the plaintiff in a case. What types of risks will you face and how can you avoid a potential disaster?

Who Pays the Legal Fees?

When considering a lawsuit, your first step should always be a rigorous analysis of the amount of the potential judgment versus the likely legal fees and costs. In a case where your lawyer is charging only a contingent fee, this economic analysis is less a concern for you than it is for your attorney. Since your lawyer is financing the case with his or her money and time and it's not costing you anything, the downside risk appears limited and any recovery is theoretically profitable.

If you are paying your lawyer on an hourly basis, the economics of the case are radically different. Now you really need to know in advance what the legal fees and costs will be, the likelihood and amount of a potential award, and what your chances are of actually collecting that judgment. The problem is that none of these variables can be estimated with any degree of accuracy; there is no way to know how large the legal fees and costs will ultimately be because so much depends on what the defendant and his or her attorney may do. How many motions, hearings, objections, and delays will there be? If the defendant is well funded, a range of tactics will be designed and applied against you in an attempt to make you spend so much money that financially you just can't continue.

The Counterpunch

These issues are well illustrated in the case of a physician group that was owed \$600,000 by an insurer. The legal issues were seemingly clear: the physicians performed the services and the insurance company kept delaying payment. The two sides fought and negotiated for months, but the doctors got nowhere and finally decided to file a lawsuit. Their attorney estimated their legal fees would be about \$50,000. The contract with the insurer provided that the losing party in litigation would have to pay the winner's costs. On its face the analysis was simple: spend \$50,000 or less to collect \$600,000.

Although each partner in the group was financially well off, and the group itself had a substantial reserve, the legal fees and costs quickly ballooned as the insurance company fought back with a barrage of discovery motions, refusals to comply, and endless court hearings and postponements. After six months, the doctors had invested nearly \$300,000 and there was no end in sight. If they won the case they would recover these fees, but who knew how long that would take? They wondered whether they should keep fighting and running up the costs, or whether they should cut their losses and try to settle.

The physicians' lawyer argued that they were into the case too deeply to get out at that point. He felt that he would be able to obtain a favorable settlement and get everything resolved within a short time. Lawyers paid on an hourly basis are typically optimistic—right up until the day of trial.

Instead of a settlement and an end to the litigation, what the doctors got was a big surprise when the defendant insurance company filed a \$5 million counterclaim against the medical group and each of the physicians personally for fraud and breach of contract for amounts previously paid to the group by the insurer. That tactic is known as a "counterpunch," and it's used by every experienced trial attorney whenever possible to hit back hard against the plaintiff by raising the stakes and dramatically increasing his or her risk of loss. When a doctor or lawyer files a lawsuit to collect unpaid fees from a patient or client, the typical counterpunch is a malpractice claim by the defendant. Generally, this tactic is successful unless the opponent has nerves of steel, is

extremely confident of success, and has ample funds to continue the battle. At this point, the group and the physicians were put at risk for far more than just their legal fees. Defending and possibly losing the counterclaim could be financially devastating since they could each be liable for all or a portion of the total judgment (www.rjmintz.com/general-partnerships.html).

Shortly after they were served with the counterclaim, the doctors in the group asked to speak with me to discuss asset protection strategies for their personal assets. Whether asset protection can be effective at this point in the proceedings is certainly questionable (www.rjmintz.com/pdf/Article-MDNetGuideNovember2007-WhenIsItTooLate.pdf). And as of now, the two cases are still going on and the legal fees and costs paid by the doctors on the collection case and the defense of the fraud charges far exceeds any award they can possibly recover.

When Your Attorney Messes Up

In addition to uncontrolled legal fees and the risks of a counterpunch, another serious issue for any plaintiff is the liability that can arise from the actions of your attorney. If your attorney screws up, you could be on the hook for the damages.

Sometimes an attorney will name everyone in sight as a defendant, hoping to prove negligence later, based on what is learned in subsequent discovery. However, if your attorney names someone as a defendant without a sufficient legal basis, that defendant can sue you for malicious prosecution if he wins the case or is dismissed from the lawsuit.

One case I saw involved a lawsuit against a small, privately held corporation. Although his suit was against the corporation, the plaintiff's lawyer named the individual officers and the principal owners as defendants, too. Although owners can be held personally responsible for the acts of the corporation under a theory of "piercing the corporate veil," if all the corporate formalities are not followed at the time the individual defendants were named, the plaintiff's attorney will have no evidence to support that claim (www.rjmintz.com/Chapter4.pdf). In trial, the plaintiff not only lost the case against the corporation and the individual defendants, but the individuals then sued the lawyer

and the plaintiff for malicious prosecution. Now there were more legal fees and finally a jury verdict against the original plaintiff for more than \$300,000.

How to Protect Yourself

Once you initiate a lawsuit there is no way to predict what will happen. That's why it is always a dangerous business decision. Uncontrolled risk plus an incalculable expected return is certainly a potential recipe for financial disaster. So what should you do if someone owes you money? How can you pursue a case for damages you've suffered?

Before proceeding with a case, make sure that your legal fees and costs—your investment in the case—are limited to an amount that makes sense relative to the expected recovery. You will be able to do that if your attorney agrees to handle the case for a contingent fee or a total fixed fee. Either of these arrangements shifts the risk from you to your attorney. Although he or she may not want the risk either, particularly in a fixed fee case, he or she is in a much better position than you are to judge and accommodate the risks. In exchange for a fixed fee, your attorney may want to charge more as compensation for bearing these risks, but that's a reasonable solution. If your attorney won't take the case for a contingent or a fixed fee, or even some combination, find another attorney or else forget about the lawsuit. If no attorney can calculate the costs in advance and is willing to bear the risks then chances are that your case is a bad investment for you, too. Finally, once you have controlled the legal fees, try to limit your risk of loss from a counterclaim or other unexpected reversals. Think of a lawsuit as a business venture where you risk not only your investment in the case but also your personal assets and savings. Before any lawsuit is initiated, review your asset protection options to see if your home and other savings can be protected from potential loss. These strategies certainly won't guarantee a successful outcome to your case, but hopefully you can avoid some of the traps and unexpected pitfalls that inhabit the dangerous landscape of lawyers and litigation.

*Loser Pays:
How to Avoid Frivolous Lawsuits*

By Robert J. Mintz

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The outline of a new healthcare plan is taking shape but the issue of litigation and tort reform hasn't yet surfaced in the legislation. While there's not much debate among healthcare providers that the direct and indirect costs of litigation and the threat of lawsuits are major contributors to spiraling healthcare costs, proposals to remedy the problem haven't reached the table.

How Lawyers Get Paid

Let's see if we can make some sense of the legal problems. In the U.S, almost all medical malpractice cases and personal injury litigation is handled on a contingent fee basis. The lawyer and the plaintiff enter into an agreement which sets the legal fee as a percentage of the amount of the ultimate recovery. The plaintiff and the defendant are each responsible for their own legal fees and costs. However, in practice it's the plaintiff's attorney who shoulders all of the costs with little or no contribution from the client himself.

This type of arrangement is generally prohibited in most other common law jurisdictions in the world. In Great Britain, for example, lawyers can only accept a case on an hourly fee basis, being paid for their actual time. They are permitted to charge "Success Fees" or "Conditional Fees" but these amounts are a bonus, calculated as a percentage of the normal hourly rate rather than as a percentage of the total damages recovered. Whatever the arrangement, the client pays a substantial amount in legal fees and must feel that his case is very solid before he agrees to commit a large sum of money to go forward.

In the U.S. the plaintiff's lawyer, rather than the client, is actually financing the cost of his time and the expenses of the case, such as court filing fees, expert witnesses, depositions etc., in exchange for a

large percentage of the “action.” An attorney who files a malpractice case is really involved in a business deal risking his costs against a potential dollar payoff. Successful attorneys are good at figuring these probabilities because a case without a recovery can produce a devastating financial loss.

Does Negligence Matter?

That doesn’t mean that good attorneys don’t take cases if the liability isn’t clear. Clear liability is not the deciding factor. The real issue is the amount of the potential recovery and that usually depends more on the amount of damages or injury to the plaintiff than with the degree of negligence of the physician. The key issues from the attorney’s standpoint are the amount of the potential damages and whether an award will be collectible from either an insurance company or the personal assets of the physician.

An attorney can “win” a case with uncertain liability because jury awards are unpredictable and defense costs of litigation are high. If the injury to the plaintiff is serious, there is always the risk of a large damage award and it is the ability to create uncertainty and a risk of loss which enables him to force a settlement. Actual liability is only a small factor because potentially enormous damage awards and defense costs create a financial threat which the defense is unable to reasonably withstand.

Why the Plaintiff Holds all the Cards

As a consequence there is a highly disproportionate degree of risk assumed by each side in a contingent fee case. The plaintiff’s lawyer is risking his time and his out-of-pocket costs which are largely within his control and that’s the key point. If it looks like the out-of-pocket costs might go beyond what he can afford or is willing to invest, then he can essentially “dump” the case—settling for little or nothing but avoiding a big financial toll. The plaintiff’s attorney controls his own costs and can manage the case with a view to properly balancing the risk/reward equation.

The defendant in the malpractice lawsuit has no similar ability to limit his potential loss without settling the case. Unlike the plaintiff,

the defense can't simply decide to drop the case as the costs pile up. The defense can't get out unless the plaintiff agrees and if he is well financed and a strong negotiator, the plaintiff holds the cards and will demand a high price for a settlement. The inherent economic advantage of the plaintiff (controlled versus uncontrolled costs) even in cases of marginal liability, produces the volume of frivolous malpractice litigation and much of the burden on the healthcare system.

Balancing the Scales: Loser Pays

What if we had a tort system where the loser pays? That is, the losing side pays all the legal fees and costs of the winner. Again, that's the way Great Britain does it as well as almost every other country (you may not like their healthcare system but they seem to have figured out the legal system pretty well). Would that alone reduce the incentive to sue? Let's consider it. Even with a contingent fee, a Loser Pays system moves the financial risk out of the plaintiff's control, since, if he loses, he would be forced to pay both sides' costs. It's true that he doesn't have the defense's risk of a jury damage award, but the other side's legal fees and costs can be so substantial that the adverse financial impact and the high level of uncertainty creates almost the same effect. With Loser Pays, the two sides are more evenly matched. The defense is less likely to be forced into an unfavorable settlement because it can recover its costs if successful. The plaintiff can't dump the case to avoid risk because the defense won't give up the right to costs. As the financial risk to both sides is equalized and the plaintiff's advantage is diminished, plaintiffs would be less likely to file cases for the settlement value without clear liability. Quite literally, with every filed case the plaintiff's lawyer will be betting his house on a successful outcome and those with poor skills or judgment will be weeded out of the profession in fairly short order.

A Loser Pays system would dramatically reduce the amount of frivolous litigation while those who are truly injured will be able to find an attorney to finance a legitimate case. The costs and the emotional impact of frivolous cases might be substantially reduced if these reasonable reforms were considered as a part of any new healthcare plans.

*More and Better Patient Information =
More Lawsuits for Physicians*

By Robert J. Mintz

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A recent lawsuit against the major pharmacy chains highlights the liability risks of having too much information about a patient. Essentially, the more information you have at your desktop computer, the more you know or really *should* know about your patient. But as the amount of information you are expected to know increases, the greater your legal responsibility and lawsuit risk becomes.

For example, as Electronic Medical Records are widely adopted and the quantity of information about a patient expands dramatically, does provider liability increase even if the quality of care is vastly improved?

What happens if the quality of care really does get better but because of all the new and easily accessible information, the standard of care for legal responsibility increases? With EMRs plaintiffs' lawyers will certainly try to make the case that greater access to patient information, should result in more accurate diagnoses by physicians and treatment outcomes should be more successful. As a result, even as quality increases, the legal standard of care will keep rising too so that rather than fewer mistakes and fewer lawsuits there are more of each since the information you "should have known" is now right there—at your desk.

An example of how theories of liability expand along with available information is illustrated in a new case now before the Nevada Supreme Court (*Sanchez v. Wal-Mart Stores*). The case is reportedly the first legal test of whether a pharmacy can be liable if a customer causes a fatal car crash after taking medication dispensed by the pharmacy. As recently reported in the *Wall Street Journal*, over a period of several years and using multiple pharmacies, Patricia Copening, a thirty-five-year-old medical receptionist, repeatedly obtained and filled prescriptions for a variety of pain-killers. On June 4, 2004, after apparently mixing Soma and hydro codeine into a potent combination known as a "Las Vegas

Cocktail,” Ms. Copening was seen driving erratically, then swerving off the road, crashing into twenty-one-year-old Gregory Sanchez who had pulled over to the side of the road to repair a flat tire. A friend of Mr. Sanchez, helping him out, was also seriously injured in the accident. Ms. Copening was not hurt.

Although pharmacies can be held liable for mistakes they make in preparing prescriptions, generally they are not responsible for the specific effect of the medication on the patient or third parties who may be injured by the patient. The general rule is that the pharmacist is not legally required to make an independent evaluation of the potential consequences of a medication prescription written by a physician. The pharmacist’s obligation is to correctly fill the prescription.

What happens when the provider of the medication, the pharmacy, has reason to know that the medication may cause injury to the patient or another person? Should the standard of legal responsibility be altered in some respects? This is a similar question to that posed by the so called “dram shop” laws which impose liability on bartenders and liquor stores (and party hosts) that serve alcohol to minors or intoxicated patrons. In most states these bars and liquor stores can be liable to third parties injured by such a patron because someone who is a minor or is intoxicated can often be identified or observed by behavior. The potential danger to the intoxicated patron himself and innocent third parties from drunken driving is obvious. But how would the pharmacist know that the medicine for a particular customer might pose a danger to anyone?

This is the dispute at the heart of the Sanchez case. According to the *Wall Street Journal* article, a total of thirty-three states now offer online prescription tracking databases. Although the type of information maintained differs between the states, Nevada, for example, requires pharmacies to report their patients’ controlled substance prescription records and this information is shared among pharmacists, doctors, and law enforcement with the goal of identifying potential drug abuse. When Ms. Copening filled her prescription prior to the fatal accident, the pharmacist failed to check the available computer records which showed that she had filled similar prescriptions for more than 4,500

doses of the drug at various pharmacies within the same year. The State Board had in fact notified this particular pharmacy as well as fourteen others that based on the quantity of prescriptions she obtained, Ms. Copening was suspected of drug abuse violations.

The lawsuit filed by the victim's family alleged that based on the available information in the database, the pharmacy should have known that Ms. Copening was a danger to herself and others and that this negligence led to the death of Mr. Sanchez. Unlike an intoxicated patron whose behavior provides observable evidence of his condition, a drug abuser may exhibit no noticeable behavior in the few minutes it takes to fill a prescription. But if the evidence of dangerous abuse is readily available at a convenient computer along with the patient's records, the availability of this information may be sufficient to raise the legal standard of responsibility. That's what the plaintiffs in the case are arguing and the Nevada Supreme Court is considering at this time.

In many states physicians already have an established duty to third parties who might be injured by a patient. The obvious relevance of this case is the potential expansion of liability for physicians based upon increasing access to patient health records. Ultimately these records will cover a lifetime of medical care, and the legal standard of care for medical decisions is likely to encompass knowledge of this medical history and its potential impact on the current diagnosis and treatment options. For many time-constrained physicians new standards and responsibilities will certainly be a difficult challenge to meet, and planning for EMR adoption will involve not only business and medical concerns but serious legal issues as well.

Certainly one of the powerful arguments for EMRs is that easy and complete access to a patient's Electronic Medical Records will improve efficiency and quality of care while substantially reducing costs. And as the supply of patient information increases, there should be fewer errors and a decline in lawsuits and liability costs. At least that's the argument

*The New Tort Reform:
Should Asset Protection Be Illegal?*

By Robert J. Mintz

Published in "MDNetGuide" May 2007

It appears certain now that advocates of tort reform, seeking to limit lawsuits and cap negligence awards, have lost the battle in Congress and no substantive improvements appear anywhere on the political horizon. The trial lawyers are breathing easier and in this, more favorable political climate, a wish list for reshaping the tort system is being circulated and is gaining traction in legal and political circles. And as might be expected this New Tort Reform, seeks to make lawsuit filing and judgment collection easier and more efficient. Too many lawsuits are discouraged, they argue, because legal asset protection measures makes collecting awards difficult or impossible. The solution they propose is to restrict or eliminate asset protection strategies to allow more successful lawsuits. Let's consider why they want to get rid of asset protection and what will happen if they win.

Not Enough Lawsuits

As presented in a recent law review article by a leading scholar in the field, the tort system is indeed broken and specific remedies are proposed. (See, Stephen G. Gilles, "The Judgment-Proof Society" (2006); www.law.bepress.com/expresso/eps/772.) The goals of deterring and punishing wrongdoers (both intentional and negligent) and providing compensation for injured victims are not being met under our current law. The reason, he argues, is too many potential defendants or "wrongdoers" are effectively "judgment-proof" because their assets are legally shielded and therefore unreachable from a successful claim. As a result, the deterrent impact of tort law is nullified, there is no compensation for the "victim," and lawyers are discouraged from taking these cases.

What leads to the conclusion that most Americans are judgment-proof? According to the author, although most individuals have suf-

ficient assets or income to pay some claims they are effectively insulated by exemption laws and available asset protection strategies. He states,

“... These legal rules enable huge numbers of working-class, middle-class, and affluent people to be (or become) judgment-proof despite the fact that they have decent incomes and significant assets that could be used to satisfy a tort judgment.”

The exemption laws referred to are state homestead laws which protect a portion or even all of the equity in a home, the complete protection afforded most retirement plans, Social Security payments, and the exclusion of 75 percent of wages from garnishment. Since those with assets above the exemption amount often employ additional asset protection strategies, the practical result is that most potential defendants are comfortably excluded from the liability system.

Creating More Deep Pockets

The proposed remedy for this perceived injustice is simply to remove all barriers to judgment collection. Under this plan, no meaningful assets could be protected from a judgment. Exemptions would be reduced or eliminated and asset protection strategies would be illegal or restricted to non-tort judgments.

“For example, federal law could forbid Americans to enter into OAPTs (Offshore Asset Protection Trusts) unless the trust provides that tort claimants shall have effective remedies against the trust proceeds, and unless the foreign jurisdiction actually enforces those provisions.” (Gilles)

Do Lawsuits Deter Negligence?

The argument that asset protected or judgment-proof individuals are more likely to commit wrongful acts is a theory which well serves the author's purpose but lacks evidence and opposes common sense. Automobile accidents account for the vast majority of all tort claims. Would an increased threat of losing assets make drivers more careful? If rational self-interest in avoiding death or serious injury doesn't make

a driver cautious, the threat of a lawsuit isn't likely to have much additional impact.

Similarly, in the context of malpractice cases, getting sued usually has more to do with bad luck, circumstances and deep-pocket economics rather than any wrongful behavior. The threat of lawsuit loss doesn't improve the quality of patient care. By all accounts it drives up expenses, inhibits needed treatment, and reduces available care for those in the most "risky" categories. For intentional and reckless behavior the criminal laws are obviously important in regulating conduct, but lawsuit liability probably has a minimal role in curbing most form of legal negligence.

Who Wants More Lawsuits?

If the tort system has little practical role in deterrence, it is not apparent what social good would be achieved by eliminating asset protection for individuals. It seems that most of the benefits of this plan would really accrue to the trial lawyers whose financial leverage would increase even beyond the broad powers currently available. Every lawyer knows that those with unprotected assets are easy potential targets. The mere threat of a lawsuit, no matter how baseless, can force a potential defendant to settle—simply to avoid steep defense costs and the uncertainty of the outcome. There are plenty of "deep pocket" defendants now—primarily the affluent with property above the exemption amounts and without other asset protection. To expose the weakest members of society—those living on their pensions and Social Security and with some minimal home equity—to jeopardy and hazard as potential lawsuit targets, is no benefit to anyone besides those in the litigation business.

Conclusion

It's difficult to predict whether the movement to expand the "litigation explosion" to create an even larger pool of potential defendants and make all assets reachable will be successful. Trial lawyers are a powerful political force but popular opinion these days clearly favors relief from lawsuits and greater, not less protection, from business risks and frivolous claims. Will political money and influence overcome significant popular opposition? We're likely to see the results of this

conflict played out in Congress over the coming years, and we all have a significant stake in the outcome.

Analyzing Risk and Shielding Personal Wealth

By Robert J. Mintz

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Because much has now been written on the “litigation explosion” and so many professionals and business owners have directly experienced its impact, asset protection planning is becoming as common as wills and estate planning. A recent article in the *Wall Street Journal* cited a survey of individuals with more than \$1 million in assets. In 2003, 35 percent of those surveyed had some form of asset protection plan, compared with just 17 percent in 2000. Of those who did not have an asset protection plan in place, 61 percent were now interested in creating one. (*Wall Street Journal*, October 14, 2003). According to the article, this dramatic increase in interest in protecting assets has been spurred by the threats associated with the “litigation explosion,” including the widespread perception that professionals with any accumulated savings are easy and vulnerable targets for frivolous claims. To many outside observers, the outcome of every case appears random, with unpredictable jury verdicts and astronomical damage awards.

As would be expected, the increase in lawsuit awards and settlements is restricting the availability of liability insurance coverage for the physician, a traditional and popular “deep pocket” defendant; many malpractice insurers have simply withdrawn from the business. In some “high risk” states—those with a history of large malpractice jury awards—and for some “high risk” specialties, such as obstetrics, neurosurgery, emergency room medicine, and orthopedic surgery, insurance may be unavailable, inadequate, or prohibitively expensive. Even doctors with good coverage now are uncertain about future availability. The “malpractice insurance crisis” is colliding with the

“litigation explosion” to form the “Perfect Mess.” Clearly, physicians need to plan ahead to protect themselves, which is where asset protection planning comes into play.

Asset protection planning is the specialty area of the law that addresses many of physicians’ most important concerns, including the best ways to organize one’s business and financial affairs to minimize liability and lawsuit risks, and the steps a physician can take to insure his or her accumulated wealth and future earnings are insulated and shielded against potential loss. What else is involved in the field of asset protection? Who needs it? What are the strategies used? In future editions of this column, we will answer these and other questions as they apply to the unique characteristics of a medical practice. In this inaugural edition, we will begin with an evaluation of the typical risks physicians might face from sources inside and outside of their practice, and then examine the role that asset protection planning may have as an adjunct to their other business and financial planning.

Why Doctors Are at Risk

The U.S. legal system allows business owners, with the exception of physicians and some other professionals, to shield themselves from personal liability for business risks. Through the appropriate use of corporations, limited liability companies, and/or limited partnerships, business can be conducted without exposing the personal assets of the owner to the obligations incurred by the company. By law, the owner’s risk is limited to the amount of capital invested in the business—the very definition of limited liability. The quantity of risk is known and accepted. An investment of \$100,000 in a business implies a maximum loss of \$100,000. Much asset protection planning is devoted to organizing and reorganizing business structures and advising clients how to take full legal advantage of the limited liability protection available through these entities.

The purpose of allowing limited liability is to encourage business formation, job growth, and economic prosperity. Nobody would operate a business or make an investment if they could not quantify the potential loss. Without a fair measure of the dollars at risk, it would

be impossible to make national business decisions. Not convinced? Ask yourself this question: Would you invest in a company if a stated percentage of the profits if you were required to provide an unlimited guarantee of losses, to the full extent of your net worth? Even though most people would agree this proposition doesn't sound like such a good deal, that's how your medical practice operates; you have no choice if you want to practice medicine. Physicians cannot legally limit their personal liability for claims against the practice, and there is unfortunately no business structure permitted in any state that protects a physician from the primary source of potential liability—lawsuits based on a claim of professional malpractice.

Although most businesses fail within a short time, the few owners who are smart or lucky and manage to accumulate surplus capital dramatically improve their chances for success. With a proper business structure, surplus cash can be withdrawn from the business and used to build a nest egg, make safe investments, and build wealth safe from exposure to the hazards of the business. Decision-making involves an attempt to strike a balance between the amount of capital left in the business for growth and expansion and the amount removed from danger. Starting out, many owners reinvest almost all available cash to accelerate expansion. Nearing retirement, many owners are less inclined to accept risk and seek to build up assets outside the business, free from potential jeopardy.

Unlike other business owners, each profitable year of operation does not reduce a physician's level of financial risk. In fact, the reverse is true. Every dollar saved becomes an additional investment in the practice. Young doctors just beginning their careers, with little or no savings, have the lowest level of risk. But with each passing year, savings are added and the amount at risk is increased. As assets continue to grow, prior to retirement, most other business owners have minimized their exposure, but the risk for a physician has increased to the highest level. With every patient and procedure, they are literally betting everything they own on a successful outcome. The more they have, the larger the amount of their bet. In poker lingo, they're "all-in" on every hand.

Almost every attempt to remedy this situation has been blocked by trial lawyers and the groups influenced by their political contributions. In the last two decades, each state has passed legislation allowing the creation of Limited Liability Companies for business owners. In every case, at the behest of the trial lawyers, physicians and other professionals have been specifically excluded from the benefits of the law.

Malpractice Insurance

Even though insurance carriers may devote substantial resources toward defending a claim, an important concern of many physicians is that a lawsuit may produce an award in excess of their level of coverage, or that coverage may not be available at some point in the necessary amount and at a price that is affordable.

In addition, there are other risks that may not be covered by insurance. Many physicians have concerns about the financial impact of litigation in the event of possible billing disputes with insurers or government agencies. In these types of cases, the first move may be an attempt to freeze all of the physician's assets. If such a freeze is granted, the case is effectively over. A defendant in such a case will have no ability to pay personal or business obligations (or attorney's fees). Without access to funds, regardless of the merits of the case, or whether the defendant would ultimately prevail, an asset freeze virtually eliminates the possibility of conducting a defense, quickly forcing a fast and unfavorable settlement—on any terms demanded by the plaintiff (especially the government).

Other common sources of lawsuits are those faced by every business owner. The courts are overflowing with cases based on complaints by disgruntled employees, disputes with partners, liability from real estate, tax problems, and good deals that turned bad.

The most conservative business approach is to combine whatever insurance coverage is available with appropriate asset protection planning. Asset protection closes the holes in coverage and once established, will be there in the future, regardless of the gyrations in the insurance market. For physicians without insurance coverage now, an

asset protection plan is the only realistic alternative for continuing to operate their medical practice.

The ideal benefit of an asset protection plan is that it stops litigation before it begins. A contingent fee attorney is less likely to proceed against a physician with an asset protection plan; in the case of assets not subject to legal collection—with no “deep pocket” to pursue—an attorney will not knowingly waste his or her time and money on the case. But, if a case does proceed, for whatever reason, asset protection provides a legal shield, protecting and insulating assets from the judgment

CHAPTER ELEVEN

DEVELOPING AN ASSET PROTECTION PLAN

Asset Protection Strategies

By Robert J. Mintz

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Fear of lawsuits and the risk of personal financial loss is a predominant force shaping the practice of medicine today. In the previous article in this series on asset protection we discussed the fact that as a physician, you have a particular vulnerability to lawsuit exposure. Most other business owners are permitted to arrange their business activities in a structure which will legally shield themselves from personal liability—even from their own reckless or negligent conduct. The auto mechanic who fixes the brakes on your car can protect himself from liability, but,

for physicians, no legal protection is available. Whatever you own is available and exposed to a potential claim.

It's fair to say that most doctors are not willing to bet everything on the hope that they will not get sued. Given the sheer number of cases filed and the potential for multimillion-dollar jury awards, that particular risk is beyond what any individual can reasonably withstand.

Other than giving up the practice, the choices for controlling liability are limited to adequate insurance coverage and/or effective asset protection planning. With insurance premiums rising sharply and coverage often limited or unavailable, the *Wall Street Journal* reports that asset protection is increasingly used by physicians as a substitute or supplement to insurance (*The Wall Street Journal*, January 2004). In this article we present a brief introduction to some of the popular asset protection strategies and describe potential limitations on how these plans can be used.

Overview of Asset Protection Strategies

Family Limited Partnership

The Family Limited Partnership (FLP) has been a primary asset protection tool for many years. Originally designed as a tax savings strategy to shift income to lower bracket family members, the FLP is now widely used to reduce estate taxes and protect accumulated wealth from potential claims.

An FLP is a limited partnership with special features to accomplish tax savings and/or asset protection goals. You, or you and your spouse may be general partners each owning a small, one or two percent interest. "Safe Assets"—those not likely to produce liability—are generally transferred into the FLP. For example, bank and brokerage accounts as well as other passive investments (not real estate) are a good fit.

The FLP works well for asset protection because the law in every state does not permit a creditor to seize or collect against property held by the partnership. The property transferred to the FLP is generally safe from attack, but the creditor may attempt to reach your ownership interests in the partnership. To protect against collection activities such as "charging orders" and foreclosure, the limited partnership interests in the FLP are

usually protected with a Family Savings Trust as discussed below. The combination of an FLP/ trust arrangement is diagrammed below.

Limited Liability Company

A Limited Liability Company (LLC) is a legal entity which provides the benefits of liability protection usually associated with corporations, but without corporate tax and without the strict formalities of corporate minutes, bylaws, directors and shareholders.

The LLC is good alternative to a corporation as the proper entity to conduct a going business (but not a medical practice). For asset protection, the LLC should hold “Dangerous Assets”—those which can generate liability—such as rental real estate or business interests. Safe Assets are placed in the FLP and Dangerous Assets in the LLC.

Personal Residence Trust

Most states protect some or even all of the equity in your residence with a “Homestead Exemption.” Depending upon where you live, a specified amount is sheltered from a creditor’s claim. In Florida, Texas, and Kansas, the amount is unlimited. Almost any amount can be protected in the equity of the home. Other states range from \$300,000 to \$20,000. Depending upon the law in your state, you may have a need to protect equity over the homestead amount.

An FLP or LLC cannot be used to protect the family home. The tax advantages you are permitted for your home, such as the mortgage interest deduction and the exclusion from tax of \$250,000 in gains per spouse, will not be allowed in an FLP or LLC.

One alternative is a Personal Residence Trust (PRT). This is a grantor-type trust, specifically permitted under the Internal Revenue Code. Protection against claims is afforded while the tax benefits of ownership are preserved. A strong degree of control and enjoyment over your home can be maintained, depending upon the terms of the PRT which you establish.

Family Savings Trust

The Family Savings Trust (FST) describes a trust designed to hold almost any type of asset, including ownership of FLP or LLC interests.

It can be flexible in form and should be crafted to accommodate your criteria for control and access to your savings. For instance, some individuals need current income from their assets to meet living expenses. Others, such as physicians with sufficient current income from their practice, can afford to “put away” savings until retirement. The FST can usually accommodate either circumstance.

Offshore Trusts and Offshore LLCs

Those in the high-risk medical specialties and those for whom insurance coverage is unavailable or inadequate often enhance their asset protection plan with an offshore trust or offshore LLC. Although there are some technical and practical distinctions in the way each operates, the underlying premise of both is similar: Most prospective plaintiffs and their contingent fee attorneys will be discouraged from filing a case if collection of a judgment is difficult or impossible. An Offshore Trust or LLC can force a plaintiff to litigate in an “unfriendly” foreign jurisdiction with laws designed to support common asset protection goals. The ability to move funds out of the jurisdiction of the U.S. court system may be a powerful weapon in litigation, but there are certainly risks and security issues which must be addressed and resolved.

Limitations on Asset Protection Planning

There are important limitations on the value and effectiveness of asset protection plans which should be considered.

Costs

The diagrams above illustrate asset protection plans that are fairly easy and straightforward to implement. There are many permutations and variations which grow increasingly complex and sophisticated, depending upon the amount and type of property which is owned. Added complexity means greater initial expenses for establishing the plan, higher maintenance costs and additional paperwork burdens. The value of the property you wish to protect must be balanced against your liability risk and the expense of establishing the plan.

Timing

An asset protection plan must be created in advance of any claim or threatened litigation. The law in every state prohibits the transfer of property if the goal is to defeat the claim of an existing or anticipated creditor. If you know or have reason to believe there may be a case against you, the other party has the right to set aside any transfers which you attempt. Asset protection will not be effective against a pending claim.

Offshore Tax and Security Issues

A plan which involves an overseas account, such as an offshore trust or offshore LLC requires significant caution. Despite strong and tempting asset protection features, key issues must be resolved. How will the plan be treated by a U.S. court? How can you protect the security of the funds in an overseas bank? What is the tax treatment of the structure? Additionally, the degree of experience and competence of your advisor, the foreign trust company and overseas bank, should all figure prominently in your decision

Hospital Privileges, Damage Caps and Costs of Defense

If insurance coverage is available to you, dropping a costly policy to adopt an asset protection plan has certain ramifications. Many hospitals require specified amounts of insurance coverage to enjoy hospital privileges. It may be necessary to negotiate an arrangement such as a security bond or other financial guarantee to maintain your privileges. Sometimes minimal coverage together with an asset protection plan to cover excess liability will be an acceptable solution.

Along the same lines, in several states which have adopted caps on non-economic damages, physicians without insurance are not entitled to the protection of the cap. By dropping your insurance coverage you may be trading a limited and insured liability for an uncapped damage award, to be collected from your future earnings.

The cost of defending a lawsuit, the legal fees, and court costs will be carried by you, instead of your insurer if coverage is abandoned.

These amounts can be significant, ranging from \$25,000 to \$200,000 or more in a complex case. Most physicians, without coverage, attempt to self-insure by contributing regularly to build a reserve a sufficient amount to pay these costs. Whether this plan will be successful depends on luck and timing. If litigation arrives early, before you have had a chance to fully fund a reserve, the costs of defense will be financially painful.

Conclusion

There are many techniques available for asset protection and we have provided just a brief introduction. There are limitations on the planning with costs and timing our primary concerns. If asset protection is adopted as an alternative rather than a supplement to existing coverage, you will have potential issues with hospital privileges, damage caps, and the costs of a lawsuit defense. Asset protection may provide an excellent solution to the liability and financial risk faced by many physicians

Coping With the New Estate Tax

By Robert J. Mintz

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The estate tax looks like it's here to stay, so for most, careful planning to minimize the impact should be considered. The political shift in Congress has likely doomed any hope for complete repeal of the estate tax and now the issues on the table are who should be taxed and how much.

Under the peculiar current scheme, estates under \$2 million are exempt now with this threshold rising to \$3.5 million in 2009. The following year there is no estate tax. But then, starting in 2011, the full tax is back with rates ranging from 50-60 percent for estates over \$1 million. This is a challenging landscape to navigate for planning purposes since the rate and the amount of tax is based on multiple uncertain variables like how long you live and what the tax will be.

Perhaps Congress will provide some relief and adopt a new permanent exemption of some amount. Our concern remains that when the value of your home, life insurance, retirement plans, and investments is added together, the tax applied at some point in the future may cut away a large piece of what you have saved. The most cautious approach may be that those who are likely to have taxable estates should put together a sound tax planning strategy and those with smaller estates just need to make sure that the basics are properly covered.

Can the estate tax be avoided? Depending on the type of assets you have and what your future needs will be, estate planning can indeed create some very large tax savings. Strategies vary from traditional to highly aggressive. The specific requirements for avoiding a tax on particular assets may be set out directly in the Internal Revenue Code or sometimes the rules may be subject to interpretation, bending and creative construction. Depending on what you want to accomplish and the amounts involved, you and your advisors can determine how far your planning should go.

What Is Taxed in Your Estate?

The estate tax applies to everything “owned” at death. Initially the concept is pretty simple because it certainly includes all property and accounts in your name. It gets a little fuzzier though because the term “owned” also includes property you’ve given away, when you have retained the right to use it or control it in some manner. A common example is giving money or property to your kids but retained too much control over how it’s used or spent. If too many strings are attached, this property is included in your estate and subject to tax.

Another example involves life insurance. Even though you might not get any benefit from your life insurance policy, you are considered the owner if you are able to change beneficiaries or exercise other particular powers. It doesn’t matter whether the policy is term or whole life or variable, the full amount of the proceeds is added to your estate. Most of my clients have million dollar plus policies calculated to protect family members but if more than 50 percent of the proceeds is lost in taxes, the balance may not be sufficient to meet family needs.

Three Techniques to Consider

There are hundreds of strategies which effectively reduce or eliminate estate taxes but for now I'll mention three popular and longstanding vehicles which you can investigate further: 1) the Qualified Personal Residence Trust (QPRT); 2) the Irrevocable Life Insurance Trust (ILIT); and 3) the Family Limited Partnership (FLP).

Qualified Personal Residence Trust. The family home often represents a large part of the nest egg and you can judge whether it may be worth considerably more at some point in the future. A QPRT removes the value of the property from your estate and at the same time provides excellent asset protection. There is a detailed article about the workings of the QPRT at www.nysscpa.org/cpajournal/2005/1205/essentials/p52.htm.

Irrevocable Life Insurance Trust. The ILIT is a special trust, designed to hold your policies so the proceeds that go to your designated beneficiaries will pass free of estate taxes. You can read a more complete discussion of this at www.rjmintz.com/life-insurance-trust.html.

Family Limited Partnership. Think of the FLP as your holding company, to own and consolidate your investments. Interests in the FLP can be passed to your children or other family members at a discounted value which can produce very significant tax savings. It also has very strong asset protection features. A great amount has been written about the unique role of the FLP as a strategy to accomplish a variety of planning goals as you can see at www.rjmintz.com/appch5.html.

Conclusion

There are certainly other planning vehicles and possible solutions with varying levels of sophistication and complexity. Consider the amounts involved, your tolerance for risk and how a strategy impacts your current living standard and future goals.

*Avoid Estate Taxes with Family Limited Partnerships:
New Cases Provide Guidelines for Tax Benefits*

By Robert J. Mintz

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In our previous articles in this series about asset protection we discussed the unique liability risks faced by physicians. Our intent in these articles is to provide you, as a physician, with a clear understanding of the most important asset protection issues and the guidelines you should follow in developing your plan to protect business and personal assets from these risks.

In the March 2004 issue of MDNetGuide we broadly and briefly described some of the popular legal strategies for asset protection. In this article we will focus more closely on one of these techniques, known as the Family Limited Partnership (FLP). This strategy has been popular for asset protection and tax planning for many years but the full scope of what could be accomplished has always been a source of debate among legal professionals and some of the case law has lacked a desirable level of clarity and direction. On the tax side, the IRS has consistently challenged the available tax benefits—losing most of the time—but with just enough success to add a dose of uncertainty into the planning process.

All this is now changed. In the case of *Kimbell v. United States*, decided May 20, 2004, by the Fifth Circuit Court of Appeals, the arguments by the IRS have been soundly rejected and the court has created definitive law and clear instructions for achieving remarkable tax savings and asset protection. Because of the important opportunities now available it will be helpful to explore the background of the case and develop an understanding of the rules and framework for planning strategies with the FLP.

Family Limited Partnerships—Background

A complete discussion about FLPs can be found on our Web site at www.rjmintz.com/appch5.html. Stated briefly, an FLP is a type of limited partnership that is formed by an official filing with the Secretary of State where it is to be created. The FLP is a separate, legal entity, with its own tax identification number. Any income or loss flows through to the partners and is reported on their tax returns. The key provisions for accomplishing asset protection, tax savings and asset protection are set forth in an FLP agreement prepared by your legal advisor based upon your particular circumstances and objectives.

Usually family savings, investments, and ownership of business and real estate interests are transferred into the FLP. When properly structured, these assets are protected from potential claims and lawsuits. A plaintiff with a judgment is not permitted to reach into the FLP to seize this property. The ownership of the interests in the FLP is usually protected in a trust designed for this purpose. (See www.rjmintz.com/ownership-trust.html.)

In addition to these significant asset protection advantages, sophisticated tax advisors have incorporated FLPs into strategies designed to accomplish a variety of estate planning and tax reduction goals. In a typical case, limited partnership interests in the FLP are gifted to children or other family members. The value of these gifted interests are then discounted for estate tax purposes.

Tax Savings

For example, parents transfer assets worth \$1 million to an FLP, then give 40 percent of the limited partnership interests to their children. This allows the parents to maintain full control over the property. Because of this, these gifted FLP interests are not valued at \$400,000 for tax purposes. Instead, since these limited partnership interests cannot control or affect management and cannot be sold or otherwise converted into cash, the tax law says that they are not worth \$400,000. They're worth something less, maybe \$250,000. By using this technique the parents have transferred \$400,000 in value out of their estate, to their children, and reduced future estate taxes by as much

as \$75,000 or more. Depending upon the actual value of the assets transferred into the FLP and the size of the gifting program adopted and the amount of the discount applied, many wealthy individuals have avoided the impact of the estate tax.

As might be expected the IRS has consistently opposed this strategy, although the results in court cases has been mixed. Generally, when an FLP was established near the time of death for the sole purpose of reducing estate taxes, or when the FLP was treated like the owners personal pocketbook, without regard for legal formalities, the challenge by the IRS has been successful (See *Albert Strangi* (TC Memo 2003-45 rem'd by 293 F3d 279 (5th Cir. 2002)) In *Strangi*, the Tax Court ruling significantly restricted the circumstances under which the FLP could achieve meaningful tax reduction. Many advisors felt that the new burdens imposed by the Tax Court would dampen the use of the FLP for these purposes.

Kimbell v. United States

Then came the *Kimbell* case and the Fifth Circuit Court of Appeals handed the IRS a massive defeat. The court stamped its approval on the basic FLP strategy, extended the range of available planning options, and paved the way for sophisticated taxpayers to eliminate or substantially reduce the estate tax burden.

The case illustrates the savings which can be produced by FLP planning in even the most basic form. Mrs. Kimbell, a ninety-six-year-old woman, transferred property worth \$2.5 million to a newly created FLP in exchange for a 99.5 percent limited partnership interest. Her son Bruce (through a Limited Liability Company) was the general partner with the right to manage partnership assets. He had managed his mother's financial matters prior to the time the FLP was established. Mrs. Kimbell retained the right to remove the general partner and replace him with anyone else (including herself), since she owned almost all of the limited partnership interests. As recited in the Kimbell FLP Agreement, the stated purpose of the FLP was to:

“ . . . increase Family Wealth; establish a method by which annual gifts can be made . . . continue the . . . operation of the Family Assets and provide protection to Family Assets from claims of future creditors against a Family member.” (Emphasis added.)

When Mrs. Kimbell died, soon after creating the FLP, her estate valued the 99.5 percent limited partnership interests at \$1.25 million—a 50 percent discount from the value of the property she transferred—claiming that the lack of control and marketability associated with limited partnership interests reduced their value significantly. The court did not discuss the specific amount of claimed tax savings, but in general, a reduction in value of this amount saved the estate approximately \$500,000 in taxes.

The IRS took the position in the case that Mrs. Kimbell had not engaged in a significant business transaction and that she had merely changed her form of ownership over the property. According to the IRS, Mrs. Kimbell did not relinquish any substantive management or control over her property and therefore the transfer to the FLP should be disregarded for tax purposes.

Kimbell Guidelines

The court disagreed with the IRS and held that Mrs. Kimbell’s estate was entitled to the full benefit claimed. The court detailed the analysis to be applied in these cases and the rules which must be followed:

- The limited partnership interests in the FLP which Mrs. Kimbell received were proportionate to the amount of her contribution. If you form an FLP and contribute \$90 and your children contribute \$10, you must receive a 90 percent interest in the FLP. The records of the partnership must properly account for the contributions of each partner.
- Partnership formalities must be satisfied. The FLP must be properly organized, the FLP Agreement must specify the rights and responsibilities of the partners, and assets contributed to the FLP must be properly and legally transferred.

- The FLP must serve a valid business purpose such as asset protection. The court noted that the FLP was established because Mrs. Kimbell's "... living trust did not provide legal protection from creditors as a limited partnership would. That protection was viewed as essential by (Mrs. Kimbell's business advisor) ... because she was investing as a working interest owner in oil and gas properties and could be possibly liable for any environmental issues that arose in the operation of those properties." Other business purposes besides asset protection could be the desire to consolidate management of family assets and to provide for a continuity of ownership for younger generations.
- To avoid weakening the FLP for tax, business and asset protection purposes, assets and income from the FLP should not be used for personal or household living expenses. Use the income from your practice or set aside sufficient other assets to meet recurring expenses. Don't put assets such as your residence, jewelry and personal effects into the FLP.
- An additional point is that Mrs. Kimbell did not give away her ownership of the limited partnership interests. No transfer to her children took place (as reported in the case). She transferred substantially all her assets into a newly formed FLP, then claimed that the limited partnership interests which she received in exchange were 50 percent less than the property itself. We will need to see how this issue is handled by other courts in the future but for the present it represents a loophole of such significant proportions that the estate tax can almost be said to be voluntary in its application.

When the guidelines offered by the court are followed and a solid business purpose such as asset protection is the foundation of the plan, the Family Limited Partnership may serve as the cornerstone for most advanced financial plans.

*Protecting Your Assets
under the New Bankruptcy Act*

By Robert J. Mintz

Published in "MDNetGuide" November 2005

Strategies for protecting homes and savings from lawsuit risks have been impacted by sweeping changes in the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. For physicians, concerned with the issue of minimizing legal exposure, some of the changes are positive and others are clearly unfavorable to certain types of plans. Since asset protection is an important topic, in this article we'll look at the key points in the new law which may affect your current or future planning.

Protecting Your Home

The biggest impact concerns the amount of equity in your home which can be protected from a judgment. We have discussed before (see MDNetGuide May 2005 article "Protecting Your Home From Lawsuit Risk") that most states allow some or even all of the equity in a principal residence to be shielded from a lawsuit judgment. This is called the homestead amount and it varies considerably from state to state. For example, Maryland has no protected amount. In New York, it is just \$10,000 while Nevada exempts up to \$200,000. Massachusetts is among the more liberal, allowing \$300,000 to be protected. Several states, namely, Florida, Texas, Kansas, Iowa, and Oklahoma allow an unlimited exemption.

This unlimited homestead has long been a sore point with the banking industry and many trial attorneys, who were often frustrated in their attempts to collect on their judgments. An individual, suspecting that he might be facing financial problems or a large damage award, was able to move to Florida or another unlimited homestead state and plow all of his savings into a residence. As long as legal residency was properly established, the equity was then protected—without any

restriction on the amount. For instance, Dr. A lives in West Virginia and owns a house worth \$300,000 and \$700,000 in savings and other property. He is named in a lawsuit with big potential damages but the West Virginia homestead protects only \$25,000 of home equity. As a result, Dr. A is at risk for most of what he owns. Instead, of risking everything on an uncertain outcome to the case, he moves his family to Florida and buys a home for \$1 million. The intent is to use the Florida homestead exemption to free him from the threat of the existing lawsuit.

These unlimited homesteads were always viewed as an effective and popular worst-case scenario. Moving the family and practice to another state may be inconvenient, but if it's the only choice, it is better than handing over everything to the plaintiff's attorney. During the past ten years, this so called "Florida Option" has been the choice of many prominent CEOs as well as others attempting to avoid financial ruin.

The new law, which applies to bankruptcy filings, curbs this perceived abuse by limiting the exemption to \$125,000 for amounts invested in a home within the prior forty months. Even if the state homestead amount is more than that or is unlimited, amounts invested within the forty-month period can only be shielded to a maximum of \$125,000. That time period is therefore critical. Someone who develops business problems or fears a lawsuit with substantial damages won't be able to escape the judgment by sinking large amounts of cash into a homestead protected house. Anything above \$125,000 will remain available for the creditor. Only those with enough foresight or luck to invest in a residence more than forty months before a judgment will be able to take advantage of the full exemption.

Even if you are already a long-term resident of an unlimited homestead state, if you buy a new, more expensive house, the additional investment, beyond the \$125,000 is not protected. For example, Dr. X has lived in Florida for twenty years. In 2006 he sells his home for \$1 million and buys a new home for \$2 million. He loses a lawsuit in 2008. His new investment of \$1 million within the previous forty months is only protected to the limit of \$125,000. Similarly, using

savings to pay down a mortgage to obtain homestead protection for the funds won't help if it's done within the forty-month window.

The Impact of Bankruptcy Laws

Under what circumstances would these changes in the bankruptcy law be important to you? The new law on the homestead exemption and the other matters discussed below will only affect you in a bankruptcy situation. For example, if there was a judgment against you or other debts you couldn't pay, bankruptcy generally allows you to eliminate the amount of these claims. You would have to forfeit all of your assets that were not exempt or otherwise protected in an asset protection plan, but "cleaning the slate" with this strategy would permit you to earn an income in the future, free of all judgments and other debts. Whether bankruptcy is a good legal strategy usually depends upon a careful analysis of the amount of the debt or judgment, the amount of unprotected assets—subject to seizure—and the future income available to you.

A couple of examples can illustrate the point. Dr. Z has income of \$200,000 per year; a home with \$125,000 of equity and a recent judgment against him for \$500,000. If he does not file for bankruptcy, his house will be protected to the extent of his state homestead exemption. He may not lose that equity, but his future income and any amounts he saves will be subject to collection by the judgment creditor. Since a judgment is generally enforceable for twenty years, Dr. Z faces a rather bleak financial future. Alternatively, he can file for bankruptcy, protect his home under the homestead exemption, extinguish the outstanding judgment, and whatever he makes or saves in the future won't be jeopardized. From a financial and legal standpoint, without considering other business factors, a bankruptcy filing is most likely the correct strategy in this case.

In other situations the analysis might be more difficult. What if Dr. Z also had \$300,000 of cash savings? If he were to file bankruptcy he would lose all of his savings in exchange for a discharge of the judgment and to free his future earnings. The correct move in this case is no longer perfectly clear. Maybe he can avoid bankruptcy altogether by

negotiating a satisfactory settlement. Perhaps there are asset protection techniques that are still available. Bankruptcy issues and maximizing asset protection are often fairly complex matters and tax, legal, and business considerations should be carefully balanced.

Other Planning Factors

There are a number of other important changes in the law which might be significant for your asset protection planning. We will cover these issues in more detail in our future columns but some key changes to note are:

All qualified retirement plans are fully exempt in bankruptcy. IRAs are now also shielded, up to a maximum of \$1 million plus any amounts rolled over from a qualified plan. With this new level of protection, designing an appropriate retirement plan may be an important part of an asset protection strategy.

A popular asset protection technique, known as a self-settled asset protection trust, can be set aside in bankruptcy if it was established within ten years and intended to hinder, delay, or defraud a creditor. These types of trusts are typically Delaware or Alaska trusts or sometimes created as Offshore Trusts. The planning may be very sound when established early and with the proper motivation but existing self-settled trusts should be reconsidered with proper regard for the new law.

Conclusion

The new bankruptcy law creates some changes in the asset protection landscape by favoring particular strategies such as retirement plans while making the homestead exemption more complex and subject to delicate timing issues. Asset protection planning should always consider the impact of bankruptcy law in determining the techniques which will be effective in the widest variety of circumstances

*Asset Protection and the New Bankruptcy Act:
Retirement Plans and Asset Protection Trusts*

By Robert J. Mintz

Published in "MDNetGuide" January 2006

In my last column I wrote about changes in the law affecting your ability to protect the equity in your home from a potential judgment ("Protecting Your Assets Under the New Bankruptcy Act" in this chapter). The new law is part of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 which became effective in October 2005. In addition to the rules covering the homestead exemption the act impacts the treatment of retirement plans and certain types of trusts used as a part of many asset protection strategies.

Retirement Plans

The Act is very favorable for corporate and individual retirement plans and protects them from almost any claim or judgment. For ERISA qualified defined benefit and profit sharing plans, the rules are clarified. Any amount, without limit, in these plans, is entirely exempt in a bankruptcy collection action. The new law codifies this protection and extends the protection, in general, to all company plans-even those not previously covered.

The biggest change applies to IRAs and SEP-IRAs. Generally, these accounts have had limited and varying degrees of protection. In most cases, the exemption only applied to amounts deemed necessary for the defendant's basic necessities, which could be any amount at all based upon the standards applied by the judge. In many cases, because the defendant was able to continue working and provide his own support, the entire IRA amount was made available for the creditor. The outcome turned on a subjective judicial evaluation of the defendant. Since the determination of an individual's financial needs and earning capabilities were always uncertain, the results were unpredictable and

varied widely from case to case. Proper protection planning for this, sometimes significant asset was often a matter of guesswork.

The Act favorably resolves this uncertainty by providing that all contributory IRAs (including Roth IRAs) are now protected up to one million dollars. Additionally, any amounts which have been rolled over into an IRA from a company plan have the complete exemption. So, for any IRA account, the amount now shielded is all contributions and earnings up to \$1 million plus an unlimited amount of any rollover. Educational Saving Accounts and Section 529 college savings plans are also exempt from collection except that amount contributed within a year of a bankruptcy filing is limited to \$5,000.

These clearly favorable new rules should be carefully considered in your asset protection planning. Moving savings into a sheltered retirement plan or IRA makes sense if the economic factors (number of covered employees and tax consequences) are justified.

Asset Protection Trusts

On the eve of passage of the Act, a *New York Times* article claimed that the law was biased toward the wealthy and contained unfair loopholes for the rich. According to the article, individuals with resources and access to legal talent could shield their assets prior to a filing by using “asset protection trusts” to avoid the harsh impact of bankruptcy.

The specific concern addressed is what are known as “self-settled” trusts—those in which the person creating the trust (the “settlor”) is also the primary beneficiary. For example, if you put all of your savings into a trust, reserving the right to use the income and principal, that is considered to be a self-settled trust.

Though often useful for estate planning (such as the popular Living Trust), traditionally self-settled trusts have had little role in asset protection. The law has always been that amounts placed in trust by a settlor for his own benefit will not be protected from the claim of a creditor. Over the past ten years, however, in an effort to attract banking and trust services, a number of states including Alaska, Delaware, Nevada, and six others attempted to alter this rule. They each passed

legislation which protects amounts in self-settled trusts, formed in their states, if certain specific rules are followed.

In practice, because their legal viability was always in doubt, these self-settled domestic trusts were rarely used for asset protection planning. But Congress, in response to the *New York Times* article, reacted to the perceived abuse by hastily amending the Act. New language was included to provide that a bankruptcy trustee could set aside any self-settled asset protection trust which had been formed within the previous ten years for the actual purpose of hindering or defrauding a creditor.

Although we know that the Act now covers the self-settled trusts developed by the various states, the extent of the impact is far from clear. Does it mean that after ten years these trusts are good and valid and will effectively protect assets against any claims? Also, what does an “actual intent to defraud” mean in this situation? Would it apply to a patient who is first treated after the trust is formed? Over time, these issues are likely to be resolved but for now the law regarding self-settled trusts remains murky. The most sensible approach for now may be to stick to the traditional planning strategies and, as always, seek competent professional advice to ensure that these important issues are handled correctly.

Asset Protection for Patients

By Robert J. Mintz

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In a new and ironic twist, a growing number of individuals are now legally protecting themselves from their doctors. The idea may be surprising, but with rapidly disappearing health coverage, medical expenses are now a realistic and high probability threat to the lifetime savings of millions of Americans. Just as physicians have been diligent about planning to minimize their malpractice liability risks, now

patients are anticipating and protecting themselves against the serious financial consequences of unforeseen medical expenses.

No one doubts that there's a monumental crisis in healthcare coverage. Forty-five million Americans have no medical insurance and even those with group or private policies are sometimes stuck with unexpected and unpayable bills. Higher deductibles and co-pays can easily balloon out-of-pocket costs beyond anything anticipated. Even those who think they have solid insurance, in a good plan, may find out, when it's too late, that their coverage means a lot less than they thought. Every day we hear stories from clients and in the news about insurers refusing payment during or after treatment. In a recent CBS News report about one of the nation's largest insurers, Richard Blumenthal, Connecticut attorney general, declared that "The company [Assurant Health] offers the illusion of coverage while challenging any large claim." In the report, a former claims adjuster revealed that it was company policy to scrutinize any significant claim, often manufacturing excuses to avoid payment. Unfortunately, despite a few notable fines and lawsuit settlements, these hardball tactics appear to be the normal course of business for at least some insurers.

When Patients Can't Pay

What happens when a large medical bill can't be paid? Usually the outcome is a lawsuit filed by the hospital or collection agency with a judgment and a lien filed against the patient's home and accounts. In most states, a percentage of the debtor's employment earnings can be garnished. Generally, before this point is reached, the patient files a personal bankruptcy to stop the wage garnishment and wipe out the medical bills and other accumulated debts. But that requires that he give up all of his assets including savings accounts, real estate, and equity in his home. These assets, except those that are specifically exempt, are turned over to the court and divided among the creditors.

According to a 2005 study by Harvard University, about half of the 1.5 million annual bankruptcy filings are caused by illness and medical bills. And surprisingly, three fourths of those had health insurance at

the start of the illness which triggered the filing. “Unless you’re Bill Gates, you’re just one serious illness away from bankruptcy,” said Dr. David Himmelstein, the study’s lead author and an associate professor of medicine. “Most of the medically bankrupt were average Americans who happened to get sick.”

How Patients Protect Themselves

The high level of financial risk posed by an unpredictable medical event is now leading patients to take steps to protect their savings from this threat. For instance, I met with Mr. and Mrs. X last week, a couple in their early 1950s. They have about \$300,000 of equity in their home and \$200,000 in savings. Mr. X is self-employed, and Mrs. X works for a small company. Both are covered under her group plan, but, with rising costs, the company might cut back or terminate the plan sometime soon. Individual policies may be available at that point, but the cost and extent of the coverage is unknown. The goal of their planning is to protect their savings from large, unexpected bills at any point in the future. Asset protection, using techniques such as a Family Savings Trust (MDNetGuide, March 2004) can effectively shield savings from these events, but the planning must be completed before the fact. If bills have been incurred, or expenses loom, planning is too late at that point.

Conclusion

Of course the real solution to the problem is for everyone to have affordable insurance which covers any healthcare costs. However, it’s almost impossible to imagine a scenario in which competing financial and political interests are able to agree and implement a worthwhile plan, at least for the foreseeable future. For now, many believe that their only reasonable choice is asset protection to minimize these risks.

New Case Highlights LLC Dangers

By Robert J. Mintz

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In a surprise move last month, the Florida Supreme Court overturned key features of the state's Limited Liability Company law, leaving many experts scrambling for explanations and raising the issue of how particular asset protection strategies may be impacted by the decision. In this article we examine the legal developments leading up to the court's decision and pose the question of the proper role LLCs should play in your business and asset protection planning.

You Can't be Sued for Inside Liability

Since LLCs were widely adopted by the states in the early 1990s most lawyers agree that this entity is often a convenient and efficient vehicle for operating a business or holding investment real estate. It is designed to provide more realistic liability protection than a corporation, without the formalities and tax issues which often make corporations difficult and expensive to operate and maintain.

As its name makes clear, the legal purpose of the LLC is to protect you from legal liability for any debts or obligations associated with the particular venture or property within the LLC. If you operate a business in an LLC and the business goes broke, you're not responsible for paying any of the outstanding bills. The same is true when you put an investment property in an LLC. If a tenant gets hurt on the property you cannot be held legally responsible. These types of risks—which arise out of the operation of a particular business—are known as "inside liabilities." The law in every state is very specific that you cannot be sued for any liability of your LLC. You may lose the business or the property in the LLC, but your personal loss is limited to the amount of your investment. Your other assets are not at risk for the debts of the company (unless you personally guarantee the obligation.) Unfortunately physicians and other professionals can't shield themselves from

malpractice claims by operating as an LLC, but for related activities, not requiring a professional license, the LLC works very well.

Shielding Personal Assets with LLCs

Besides this protection from inside liabilities, LLCs have sometimes been used as a strategy to shield personal assets from other types of claims “outside liabilities” not associated with the particular business activity. For example, you may own an investment property which represents a substantial portion of your savings. Your idea is that you would like to insulate and shield that valuable property from any future claims against you associated with your business activities. Your goal is simply to shield your savings from the risks of your business. To accomplish this sensible goal, you transfer the property to a newly formed LLC. After the transfer, you and possibly other family members would own the membership interests in the LLC rather than the property itself. Have you achieved any asset protection benefits with this plan?

Charging Order Protection

When most of the LLC legislation was passed by the states in the early 1990s it was believed that LLCs could provide some good asset protection in situations like this because the membership interests were protected by a “charging order” in the same manner as partnership interests. Those membership interests in the LLC that you received were protected from foreclosure by a creditor under the original law. A judgment creditor was not legally permitted to seize LLC interests as he could with shares of stock or other property you own. The most the creditor was permitted was to wait for any distributions to come out of the LLC. There was no right to vote or control the LLC in any manner—just the right to wait for the possibility that someday you would distribute income or sales proceeds out of the LLC into his eager hands. Fat chance right? And that’s why the charging order remedy of the creditor was viewed as weak and ineffective and that was why you chose to transfer your property into the LLC as a part of your plan. It is certainly far better to attempt to limit a judgment creditor to a hypothetical claim against future distributions than to risk losing your

valuable property and your savings nest egg right in a future lawsuit. Many early asset protection plans were established based on this fairly simple plan: 1) transfer property or investments into an LLC; and 2) hold all the LLC membership interests and maintain complete control and all the benefits of the property while limiting the creditor to an ineffective charging order remedy.

Olmstead v. FTC

In June of 2010 the Florida Supreme Court surprised many experts by holding that the Florida LLC Act does not make the charging order the exclusive remedy available against an LLC membership interest. Instead the court ruled that an LLC membership interest is subject to seizure by a creditor in the same manner as corporate stock. As a result, a creditor of a member of either a single member LLC or a multi-member LLC is permitted to seize a membership interest under Florida law. Although this decision is consistent with some recent court cases as well as the governing law in California and several other states, it was a surprise to those in the so-called asset protection friendly states such as Florida, Nevada, Delaware, and New Mexico where it was believed that the charging order protection in state law could be relied on as the foundation of the asset protection planning.

Future Planning with LLCs

The Florida court's decision did not impact the usefulness of LLCs as strong business vehicles to protect against business risks and claims—what we have called the inside liability of the business. If you are operating a business or holding risky assets such as investment property, the LLC will often be the most effective choice of business entity.

If you create an LLC to hold assets, this decision, as well as existing law in California and other states, holds that your membership interests are vulnerable to seizure by a judgment creditor. This rule applies whether your LLC is a single member or a multi-member company. Although Florida may now amend its LLC law to counter the impact of *Olmstead*, owning LLC membership interests in your name is unlikely to provide any significant asset protection for you.

ASSET PROTECTION

In order to avoid a potential foreclosure of the LLC interests and an outcome similar to the *Olmstead* case, many lawyers have been recommending that clients put their membership interests into a protective trust to achieve the level of asset protection desired. (For more detail see www.rjmintz.com/recent_developments1.html.) For example we have been using a Family Savings Trust for this purpose for many years.

CHAPTER TWELVE

BUSINESS AND FINANCIAL PLANNING

Pros and Cons of Professional Corporations: What's Best for Your Practice?

By Robert J. Mintz

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One of my clients recently asked about the best way to conduct his medical practice. For a number of years he had been in solo practice but was now considering joining with another physician. He wanted to know how to organize the new practice—what were the available options and what was the “right” way to do this? Does a professional corporation offer advantages over a Limited Liability Company or some other form of doing business?

Since many states now offer a wider range of choices for operating a medical practice, the “right” choice question comes up frequently in our client meetings. This column gives us a good opportunity to discuss the pros and cons of each alternative from the standpoint of liability protection and tax efficiency.

Professional Corporations

The most popular and well known choice is certainly the Professional Corporation (PC) which, is permitted in every state. A PC allows a licensed professional to conduct his practice in corporate form and be treated under state and federal tax rules as a corporation. Does a corporation provide any significant tax benefits? Not much any more. Back in the 1970s when physicians first gained the right to incorporate, the benefits were substantial. In particular, the prized tax advantage of corporations was the ability to establish a corporate retirement plan—allowing large amounts to be saved tax free each year. There was no comparable plan for non-incorporated individuals. IRAs had minimal contribution limits and Keogh plans (for the self-employed) were only slightly better. Corporate retirement plans were the holy grail of tax planning because they generated large immediate deductions and the funds in the plan could be borrowed back for any purpose or invested in almost any manner.

Over the years, Congress and the IRS eliminated almost all of these advantages. Although corporate retirement plans are still excellent savings vehicles, the same types of plans and most other benefits are now permitted for non-corporate practices as well. So, incorporating your practice to gain supposed tax advantages just doesn’t make much sense anymore.

What about legal benefits? Are PCs useful for lawsuit protection? The basic rule is that a corporation won’t insulate you from your own malpractice or from that of your employees. PCs, unlike general business corporations, do not legally shield the owner from a negligence claim. As a result, for those in solo practice, the PC offers no legal advantage. Every individual physician is liable for his own negligence, whatever the form of his practice.

However, a PC can be important for those who practice in a group or with another physician. In this situation, the use of a PC can protect against personal liability for the negligence of a partner. That's a good reason why group practices are often structured as a single PC or as a partnership of PCs with each physician owning his own corporation. As I said, it won't shield you from your own malpractice but it should insulate you from your partner's negligence and that is certainly an important accomplishment.

Professional Limited Liability Companies

In addition to PCs there are two other entities, both relatively new, which can accomplish the same degree of liability protection in a joint practice arrangement. The Professional Limited Liability Company (PLLC) and the Limited Liability Partnership (LLP) both provide similar benefits. Although not permitted in every state, the idea behind these entities is that they are both efficient, easy to administer, and free of the tax problems often associated with corporations. While corporations, (particularly C corporations) require careful attention to recordkeeping, accounting, and tax details to avoid potentially disastrous consequences, no such problems exist with the PLLC or LLP. The income of either of these entities is simply passed through to the member or partner who reports his share on his personal tax returns.

How to Choose

Now, getting back to our original question of the "best" way to organize a practice our conclusions are:

1. Those in solo practice have no malpractice lawsuit protection or material tax benefits from practicing as a corporation, Professional Limited Liability Company, or Limited Liability Partnership. These entities may avoid personal liability for company debts such as leases, loans or other obligations which are not personally guaranteed. In some situations those may be legitimate concerns.

2. In a joint practice, any of these entities may be appropriate (depending on state law) to shield you from the malpractice of a partner. A PC accomplishes this but comes with a fairly high administrative burden and a variety of tax traps for the inattentive. Using an S Corp, rather than a C Corp can avoid a number of potential tax problems and is usually the proper choice if a PC is the only option. If you practice in a state which permits the formation of PLLCs or LLPs, the liability protection and easy maintenance may make this the best legal arrangement for the practice.

Professional Corporations no longer hold a tax advantage over other forms of practice and your choice of an entity, or solo practice, should be based on your particular liability risks. For convenience, ease of administration, and tax efficiency a PLLC or LLP, if available in your state, may be preferable to a traditional PC.

Unique Issues for Physicians in Marital Dissolutions

By Robert J. Mintz

Published in "MDNetGuide" May 2006

A few weeks ago I was researching some divorce issues for a physician client. I was looking at the financial impact of various settlement alternatives—the amount of continuing family support; how to divide marital property; and the procedures for determining the value of a medical practice. I was surprised about the general lack of clear and accurate information about such important matters. After all, the financial consequences arising from a divorce may be more severe and more probable than the risk of loss from a malpractice case and unfortunately there is no insurance available to cover potential losses from this type of disaster.

With this in mind and the understanding that libraries are filled with volumes of cases and codes and that every state varies in their specific treatment of divorce matters, I think it's worth a try to present, in our asset protection column, some key issues on the topic with special importance to physicians. This month we can consider spousal support awards, then in future columns we'll cover other major items such as property divisions and valuing a medical practice.

Spousal Support

Physicians as a group are generally highly compensated relative to the earnings of their spouse. It's probably a good guess to say that the greater the income of one spouse, the more common it is for the other to stay home with the kids—an option not often available in lower and middle income families.

This wide discrepancy in earnings becomes particularly significant in a divorce situation. An important factor in determining the amount of the spousal support award (alimony) is the difference between what each spouse earns. As a broad example, assume that Physician Spouse (PS) earns \$20,000 per month, Non-Physician Spouse (NPS) earns zero. The court finds that an award creating a 60 percent/40 percent split of total income is appropriate. This would result in monthly alimony payments of \$8,000 by PS. If instead, NPS was working with an income of \$5,000 per month, then the award would be only \$5,000 ($.40 \times \$25,000$ less \$5,000). The greater the earnings of the NPS, the less the award must be to create the intended balance.

The question of how much and for how long alimony is to be paid is usually based upon the judge's evaluation of particular factors which typically include the length of the marriage, the earnings of each spouse, and the marital standard of living. Some states, such as California, specifically list the items which must be considered by the court in determining the amount of the support award. The California Family Code, as an example, enumerates more than fifteen factors which must be taken into account.

Whatever amount is ultimately decided is then subject to continuing supervision and modification after the judgment. If one spouse's needs

increase or annual earnings go up or down, or either party's circumstances change, the amount of the award can be modified to be more or less based on the new circumstances, as determined by the court.

Like all litigation, battling in court over the amount of alimony can be time consuming, expensive, and emotionally draining for both parties. Because the initial support award and subsequent modifications depend upon the court's discretion and the subjective evaluation of each spouse's needs and ability to pay, the results and the financial consequences to each side are never settled, fixed, or finalized. This lack of certainty, for both parties, as to future income and obligations makes ordinary financial planning, decisions about savings, investments and life style difficult.

Written Agreements

To avoid this extended period of financial limbo and allow each spouse to proceed with their life and their plans, well advised spouses often attempt to negotiate their own agreement on future support payments. Although neither side can accurately foresee all or much of what may occur personally or financially, the certainty of a specified arrangement is usually preferable to the uncertainty of relying on the vagaries of judicial process. Each side usually gets less than they want, essentially paying a premium in exchange for the certainty and stability of fixed payments over a predetermined number of years. In many states, California included, the law specifically allows the parties to reach their own agreements and removes from the courts the power to modify or extend the support amount if the parties reach their own agreement and state clearly in writing that they do not wish the agreement to be subject to modification. This language must be very clear, and if both spouses desire to make a deal that will not be subject to change by a court, then there must be very specific language in the contract stating this intention.

Anything less than 100 percent, incontrovertible clarity in the agreement, may open the door to future litigation with one or the other spouse attempting to get more or pay less when faced with a claim of changed circumstances at a later date.

Conclusion

Physicians confront a unique variety of complex financial issues when dissolving a marriage. Of particular note, if both parties to a divorce desire to establish a certain financial outcome, avoiding future litigation and disruption, it is important that the drafting of the settlement agreement accurately sets forth what each side is trying to accomplish. Naturally, these issues depend on the law of the state where you live and the matters here are intended for speculation and discussion purposes only.

Valuing Your Medical Practice: How to Avoid Dangerous Traps and Pitfalls

By Robert J. Mintz

Published in "MDNetGuide" July 2006

In the last issue of MDNetGuide I discussed some of the issues associated with determining the amount of spousal support which might be awarded in a divorce. Now let's look at how a medical practice is valued and the hidden pitfalls which can produce unintended and dramatic financial consequences for the unwary.

Valuing Assets

Stated broadly, property accumulated during a marriage is valued and divided in some fashion in the case of a divorce. Some states require an "equal" division while others impose an "equitable" division (which may be greater or less than half, depending on all the circumstances). Certain assets, such as publicly traded stocks, mutual funds, and retirement plans are easy to value and can usually be divided without much difficulty. Real estate may present valuation problems because each property is unique, to some extent, so appraisals and expert testimony may be necessary.

Determining the proper value for a medical practice is often a subject of heated litigation. There have been many appellate court

decisions and countless trials over the issue of the “proper” manner and amount to be used in calculating a value for the practice. However it is reached, the value is then divided as community or marital property with the professional spouse paying the non-professional spouse with cash or other assets. Although the law may vary significantly from one state to another I’ll try to lay out some general guidelines, but make sure you check with a local attorney to see how the rules apply in your circumstance.

Real Estate

Computing the value first involves adding up the hard, tangible assets such as real estate, equipment, furnishings, and supplies used in the practice. The term “value” that I’ve been using here refers to “Fair Market Value” which, for legal purposes generally refers to the price that a buyer would pay for the item without subtracting associated expenses such as taxes or selling costs. For example, if you can sell your medical office condo for \$500,000, that’s the value that will generally be used. An award of 50 percent to your spouse will be \$250,000. This may not be a fair result since all of the taxes and expenses are then paid from your side of the ledger. For example, if taxes on the sale are \$50,000 and commissions and other costs of sale are \$30,000, you will wind up with \$170,000 versus \$250,000 for your spouse.

Accounts Receivable

A division of the value of accounts receivable may produce even more dramatic and unbalanced results. A client of mine had \$500,000 of collectible accounts receivable. The obligation to her spouse would have been half of this or \$250,000. Although her spouse would receive this amount by law, that’s much more than my client would have received. We calculated that as she collected the \$500,000 in the course of her practice she would have roughly \$200,000 in office expenses and taxes. So, out of the original \$500,000, she would have to pay \$250,000 to her spouse and \$200,000 in expenses-leaving her with a net of only \$50,000. That’s certainly not an equal division. Even if the receivables were to be valued after subtracting taxes, the associated office expenses

would still have to be funded out of her share, creating a huge disparity in what each side gets.

Goodwill

The final step after these tangible assets are calculated is determining and adding in the so-called “goodwill” of the practice. The most common technique for valuing goodwill is known as the “excess earnings” approach, best explained by an example. In short, if the average cardiologist in your area earns \$250,000 per year and you earn \$350,000, the amount of the excess earnings is \$100,000. That number is then multiplied by a “capitalization” of between one and five (depending on various factors) to arrive at the value of the goodwill in the practice. In this example, goodwill is some amount between \$100,000 and \$500,000

As a practical matter, since most practices cannot be sold and have no value apart from the services of the particular physician, there really is no goodwill value to be considered and divided. The real source of any “excess earnings” in your practice is the fact that you work harder than most; have greater skill or experience or a wider range of referral sources than other physicians in your specialty. As obvious as this may be to you and me, goodwill is calculated in every medical practice and the non-physician spouse is awarded his or her share of whatever value is determined.

Conclusion

Valuing a medical practice in the case of a divorce often creates a substantial windfall for the non-physician spouse. Assets of the practice such as real estate, equipment, accounts receivable, and goodwill are loaded with potential traps, producing unanticipated losses and obligations.

Why Hedge Funds Are a Losing Bet

By Robert J. Mintz

Published in "MDNetGuide" September 2007

Are hedge funds a smart choice for today's investor? Hedge funds have certainly been in the news a lot lately. You've no doubt heard about the woes of the subprime market, but no one knows at this point how wide and how deep this iceberg will turn out to be. Hedge funds have invested hundreds of billions of dollars in subprime loans by buying packages of these loans from the original lenders. But now, with homeowner default rates skyrocketing, the value of these portfolios have been decimated. Some of the largest hedge funds have already filed for bankruptcy and many others are on their way to a similar fate. Although the smart and the lucky may have already taken their money off the table, new investors are pouring in daily. For example, the Teacher Retirement System of Texas recently announced that it will shift about one-third of its \$112 billion in assets to hedge fund investments, hoping to boost its returns.

What Are Hedge Funds?

The number of hedge funds has exploded over the last five years, doubling to nearly 10,000 funds managing more than \$1.7 trillion in investments. A hedge fund is like a mutual fund, but with several key differences. Hedge funds are largely unregulated and are open only to wealthy individuals and institutions. Unlike mutual funds, they often rely on leverage—plenty of borrowed funds—in order to juice returns. Also, instead of just investing in stocks or bonds, hedge funds use a variety of exotic contracts and specialized loan arrangements called derivatives, which are not traded on any market. Most importantly, while mutual funds generally charge investors a service fee of 1-2 percent, hedge funds charge both a management fee and a performance fee. That is, they get 2-3 percent of invested assets as well as 20-30 percent of the annual net profit. Investors make this deal hoping for

above average returns, even after deducting the large performance fee. A hedge fund that earns 20 percent in a year, less a 20 percent performance fee, still gives the investor a 16 percent return. Not bad when risk-free government bonds are paying less than 5 percent.

Performance Fees

The problem is that the performance fee paid to the hedge fund manager creates a serious conflict between the ambitions of the manager and the goals of the investors. The overriding concern of the hedge fund manager is to make a big profit for the year because his performance fees are calculated on an annual basis. That means that he wants to make trades that have a high probability of short-term success regardless of the ultimate outcome. For the investors, however, short-term profits are meaningless if their entire investment is at risk. A compensation system skewed to short-term profits creates an incentive for managers to adopt trading strategies that may work spectacularly well for a few years but eventually lose far more money than they ever made. I'm sure most managers would prefer trades that make money for themselves and their investors, but that is not an easy task. So most will settle for the next best thing, and as they say in the business "One out of two ain't bad." Four or five good years can set up a manager for the rest of his or her life, so seeking good returns in the first few years becomes very attractive and can trump concerns for the long-term prospects for a fund's strategy.

Hedge Fund Strategies

The most popular of these short-term strategies is known as a "carry trade." The hedge fund borrows money at a low rate, say 5 percent, and invests in securities paying a higher rate, maybe 7-8 percent. With the expanding world economy there is no shortage of potential borrowers in the U.S., China, India, and Latin America. Banks and other financial institutions earn their fees by originating these loans with borrowers and then selling them to the hedge funds. Knowing that they always had a ready buyer to assume the risk, the lenders continually lower their credit standards until no standards exist. During the last five years, virtually anyone wanting to borrow money for business or real

estate has been handed a blank check. The highest-risk loans, with the greatest chance of default, were then handed off to the hedge funds, which were guaranteed huge profits as long as interest rates held steady and economic conditions were perfect.

The New World

But now conditions are not so perfect and it's starting to appear that scooping up all the risky loans in the world may not work out so well for the hedge funds. The declining real estate market is causing record foreclosures, and the hedge funds holding these mortgages have been decimated. Hedge fund managers—at least those who got in early enough—made spectacular profits, but most of the investor money has been wiped out. It's too early to know what the larger impact of these losses will be and whether the subprime debacle will spread to other types of loans and other markets around the world. It is clear that, for those looking for big and fast returns, the easy money days are history and the smart approach is to sit on the sidelines and wait until the smoke lifts to see the shape of the new investment horizon

How to Avoid Common Pitfalls When Buying Life Insurance

By Robert Mintz

Published in "MDNetGuide" January 2008

Life insurance can be a key element of an effective estate tax strategy. However, when devising estate plans with clients we often find their current policies accomplish little or nothing in terms of future tax savings. It is not uncommon to find that the actual benefits provided by their policies are not at all what the clients thought. Often, people do not review their policies until it's too late, only to find they may have misunderstood the terms or their insurance agent may have misrepresented or poorly communicated essential features.

Know What You Have

Recently, I was working with a client to develop a strategy to minimize his estate tax liability and preserve his business and savings for his children. We estimated that the total estate would likely grow to \$10 million over the next fifteen years. He planned to partially cover the potential estate taxes of \$4 million with a \$2 million “term” life insurance policy he had bought years earlier.

These popular policies are intended to pay at face value if the policy holder dies within the period of coverage. Premiums can be fixed for ten to twenty years and sometimes can be renewed, with new premiums set by the company at that time. For example, a twenty-year policy for \$2 million might cost \$10,000 per year at age 45. Depending on the policy, you may have the right to renew for another ten or fifteen years, but the premium will be reset by the insurer based on your new age. At 65 or 70, the annual premium might increase to several hundred thousand dollars per year.

Coming to “Terms” with Your Policy

Term policies have an important and specific purpose: to replace lost income from a premature death. If you should die before your anticipated retirement date, how much insurance would be necessary to replace for your spouse and children all or a portion of your lost income? If the answer is “a lot,” you are probably a good candidate for term insurance—it’s the best solution because it offers the most insurance for relatively low premiums.

What you probably won’t get from term insurance is any actual money paid out. Remember, these are low-cost policies until you get older, at which point the premiums often skyrocket. Hardly anybody renews or keeps them in force for the rest of their life. It’s too expensive to maintain a term policy as you reach age 65 and older. Term insurance effectively covers the risk of lost income for a set number of years, but it doesn’t build wealth for the future. When we looked closely at my client’s policy, we discovered that it had fixed premiums until age 70, at which point he could renew, but the increased annual premiums

would make the policy effectively unaffordable. We could see that unless he died before age 70, there wasn't going to be any insurance to accomplish his goals. That was certainly not what he intended or understood when he bought the policy. He knew that his business would increase in value and he needed a source of funds to pay estate taxes without selling the business, so he had purchased the policy the agent recommended and didn't look too closely at the details.

Permanent Policies

Because your current term policy probably will be insufficient if you anticipate paying sizeable estate taxes or you want to leave money to your family, you'll need a "permanent" life insurance policy that lasts for your lifetime. There are many varieties of these policies, but they are often described as "Whole Life" or "Universal Life." In addition to paying the specified death benefit, these policies also work like savings accounts, building cash value that you can borrow against or redeem. They also get a big tax break because the earnings on the savings are not subject to income tax at any time.

Conclusion

Term policies and permanent policies meet important but different financial needs. Term life insurance efficiently and inexpensively protects against the risk of lost income for a specific number of years. Permanent policies are designed to last for a lifetime; they effectively guarantee that a specified amount of wealth is accumulated for whatever family, charitable, or estate tax needs you might consider. The caveat is that there are huge differences in benefits and costs among all of the available plans.

Key Issues in Physician Partnerships

By Robert J. Mintz

Published in "MDNetGuide" July 2008

If you have partners in your medical practice, it's a good idea to decide now, how the value of the practice will be divided if a partner leaves for any reason. There are a host of circumstances which can disrupt a partnership, including death, retirement, business disputes, disability, and divorce. And each event can have a powerful financial impact on the business of the partnership. How should the business be split up or paid out in these situations? Similar issues arise outside of your medical practice for business ventures or real estate investments with any co-owners. Planning in advance, with a written and detailed Buy-Sell Agreement which addresses each possible scenario, can help avoid costly litigation and financial loss in the future.

Events Triggering Buyout

The first issue to consider is what events should be covered by the terms of the Buy-Sell Agreement. Under what circumstances should a partner, have the right to be bought out? Certainly, death and long-term disability would be included, as well as planned retirement. Equity in the practice may be a big part of your savings nest egg, and you, or your family, are likely to need it under these circumstances.

What happens if a partner quits, is "fired," or wants to sell his interest to a third party? What rules should govern each of these instances? We often consider whether the buyout amount can be reduced in these situations. Although everyone may agree that it's fair to pay a "full" share on death, disability, or retirement, a partner who leaves voluntarily might face some type of penalty, such as valuing his share less generously, if the withdrawal creates a financial burden on the remaining partners.

Valuing a Partner's Share

In addition to defining the specific events which are covered, the Buy-Sell Agreement provides a method for valuing each share in the practice and how much will be paid under each circumstance. Sometimes valuation is pretty straightforward. In many medical practices accounts receivable and equipment represent a significant portion of the assets and the amount of these assets is easily determined. More difficulty is faced in a practice with substantial goodwill—an earning power apart from the services of a particular physician. This intangible asset is often difficult to value and there are a variety of techniques and formulas which can be used (see “Valuing Your Medical Practice” MDNetGuide article, July 2006, at www.rjmintz.com/pdf/medicalpractice.pdf).

A partner's share of accounts receivable is usually discounted for collection losses and an amount of the liabilities of the practice directly associated with these assets. For example, Dr. A owns a 25 percent interest in a medical partnership which has \$1 million in receivables. When he retires, his \$250,000 share of the accounts receivable might be discounted by 20 percent (based on collection experience). Then, consider what share of other liabilities of the practice should reduce the payout. Is there an outstanding line of credit which Dr. A should pay back? Should overhead costs of labor and rent associated with the collection of the receivables be considered? Also, if there are possible charge-backs from Medicare or other insurers, who will be responsible for those payments? There are no right or wrong answers to these questions. Everyone involved should simply consider the economic impact of each decision and an appropriate “formula” should be devised. We've seen Buy-Sell Agreements which did not factor in liabilities and the costs of collection and the remaining partners were stuck with much higher costs than they anticipated.

Payment Terms

Once the amount of the buyout has been determined, how should that amount be paid? Will it be all cash or payment over a period of time? That issue often turns on the timing of the partnership's cash flow and whether the buyout event has been funded. A buyout due to the

death of a partner can be funded with insurance so that a cash payout is feasible. If the buyout is based on a partner's voluntary withdrawal, unless the partnership has accumulated a reserve for the payments, immediate cash may not be available. Often, a payout schedule over a period of months can be tied to the collection of the accounts receivable so that the impact on cash flow is minimized. If goodwill is included in the buyout amount, the payout may be deferred for a number of years unless adequate insurance or a reserve fund has been maintained.

Conclusion

Buy-Sell Agreements are an important legal component of every medical partnership. You should understand your rights and obligations so that you can properly plan this aspect of your financial future.

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Robert J. Mintz is a practicing attorney in California and a nationally recognized expert with more than twenty-five years of experience in asset protection, estate planning, and tax planning. He is a member of the California Bar with offices in San Diego and the San Francisco Bay Area. Mr Mintz received his undergraduate degree from the University of California, Berkeley, his law degree from the University of San Diego School of Law, and a master's in taxation (LLM) from the Boston University School of Law.

Mr. Mintz has written extensively and taught in the areas of asset protection, tax planning, and estate planning. He is the author of three popular and influential books on these subjects: *Lawsuit Proof: Protecting Your Assets from Lawsuits and Claims* (1991, 1996); *The Privacy Plan: How to Keep What You Own Secret from High-Tech Snoops Lawyers and Con-Men* (1998); and *Asset Protection for Physicians and High-Risk Business Owners* (2003, 2011). He also writes a regular column for MD NetGuide on asset protection and legal matters for physicians.

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ROBERT J. MINTZ is a practicing attorney in Del Mar, California, and a nationally recognized expert with more than twenty years of experience in asset protection and tax planning. He is the co-author of two other books, *Lawsuit-Proof* and *The Privacy Plan*, and has written and lectured extensively on these subjects.

Francis O'Brien & Sons Publishing Company

1615 South Mission Road, Suite C
Fallbrook, California 92028

800.223.4291 www.rjmintz.com

