ASSET PROTECTION 101

Enhance your value to wealthy clients by showing them how to hold on to their wealth in an increasingly litigious society.

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Illustration: Steve Feldman

Your affluent clients depend on you to be a source of information on a wide variety of complex topics. They assume you are at least informed about every area even marginally related to your core business. One such area is asset protection.

As a financial advisor, you seek to create steady growth of your clients' assets and help them avoid losses and exposures to things like market risk and income and estate taxes. A natural extension of this stewardship is making sure the growth you are fostering, as well as the balance of your clients' assets, is safe from exposure to an increasingly predatory and hostile litigation system. Some of your clients have obvious exposures, such as a physician's potential malpractice exposure or the enduring liability that a large commercial contractor faces. Other sources of exposure are more insidious, such as merely being wealthy and visible, owning income property, or something as simple as owning and driving a car every day. We are at a point in our litigation system at which we have over 70,000 lawsuits filed per day, many without any real merit. Unfortunately being "right" is not enough to keep our clients safe.

The need for concern

As illustrated in Figure 1, awards continue to spiral out of control, fueled by litigation attorneys who have become partners in lawsuits and are economically incensed to create and magnify adversarial relations between parties who might otherwise reach some reasonable, if not amicable, settlement.

What you and our clients must take to heart is that litigation attorneys are in business. Just like any business, they have weekly meetings during which they examine growth, cash flow, revenue goals and new leads or opportunities. This economic motivation explains in part why we see awards rising and why plaintiffs' attorneys regularly seek and obtain awards above the limits of applicable liability insurance policies.

FIGURE 1

FAST FACTS

- 70,000 lawsuits are filed each day, many without merit.
- The average medical malpractice award is $3.9 million.
- The average legal costs of settling a frivolous lawsuit is $91,000, plus the actual settlement amount itself.
- The average sexual-harassment suit against a small business produces a verdict of $530,000. Employees are suing more often, winning more often and winning proportionally larger judgments. They win 75 percent of the time.

What about insurance?

Insurance is OK but it's impossible for your client to insure himself against every possible contingency or exposure. There will always be many exposures for which no insurance exists or which are not adequately covered by the amount of coverage the client has or can afford.

Also, you and your clients rarely understand the holy grail of the "umbrella policy" and policy limits. To your clients, "umbrella" means "everything," while to the insurance company, it means specific occurrences to specific limits under specific conditions. Add to that the fact that many liability insurance polices are inclusive of defense costs and the actual amount left for the award is reduced, again exposing the insured person personally. For example, your physician or small-business owner client has a $1 million liability policy in place and gets sued. The insurance company spends $400,000 on defense costs and loses, resulting in an award of $1.2 million to your client. In this scenario, only $600,000 is available from the policy to put toward the claim itself.

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What you should do

As your client's financial advisor, you should find out the type of defensive planning he has explored or done. What level of planning and forethought has he invested in insuring his net worth? Typically very little forethought, other than liability insurance, has gone into this area. This lack of planning can be disastrous, especially for clients who have reached the pinnacle of their career and are looking toward retirement.

For example, what option would your 58-year-old client have if he were to lose a substantial portion of his net worth to a car accident in which there was a fatality because his child had a party and another teenager died or was injured, or because he was accused of sexual harassment by a disgruntled employee? A great deal of defensive planning involves the proper titling and compartmentalization of your client's assets into acceptable

FIGURE 2

COMMON FACTORS OF THOSE AT RISK

- They are high net-worth, high liability or will be soon (e.g., a new doctor).
- They are highly visible and traceable.
- They have assets that would be difficult to replace if lost or reduced.
- They have employees.
- They own their own businesses.
- They have professional liability.
- They own liability-generating assets, e.g., rental property.
- They have children.

and easily manageable units of risk.

As illustrated in Figure 3, moving the title of assets to various appropriate and legitimate entities can dramatically reduce the amount of exposure your client faces and can actually help make the liability insurance he has more effective. This is because it removes the economic incentive to pursue him beyond the limits of the policy and forces settlements into a reasonable range.

In most cases, collectible assets can be sheltered or reduced by over 90 percent with the use of well-tested and established tools like LLCs, limited partnerships, asset-protection trusts and receivables and income-protection plans.

As you can see from Figure 3, most of the client's collectible assets are accounted for and sheltered. The best tools used, such as an asset-protection trust or an FLP, are legal, tax neutral and have a legitimate business purpose. The numbers scale easily up or down. Remember that what each client has is all he has, so his $500,000 may be as important to his long-term goals as another client's $5 million is to him.

Common misconceptions

Some advisors think owning a revocable living trust is enough to protect their client. This is not true. An RLT is a wonderful estate- planning tool, but like most tools, has a specific purpose. In this case, it is used primarily to avoid probate and estate taxes.

Also, an RLT is revocable during the client's lifetime. This means that during his lifetime, he can easily be ordered to revoke the trust and tender trust assets for the payment of a judgment by a court. This is a common occurrence. The trust becomes irrevocable only upon the client's death. Thus, during the client's lifetime, it does not shelter him from any lawsuit exposure. Conversely, asset protection does not replace or duplicate good estate planning but rather works in conjunction with it.

Action steps

Here are a few steps your client should take to protect himself now:

- **Realize his value as a target and do something now.** He cannot do any effective or legal planning after a lawsuit has been filed or a demand has been made.
- **Be realistic about the possibility of exposure and the effect a six- or seven-figure judgment could have upon his financial plan.** The most common mistake made by advisors is to tell their clients who are

FIGURE 3

Before—EXPOSED

Home	$1 MM Equity	own name
2nd home	$500 K Equity	own name
Office	$375 K Equity	in RLT
Cash	$100 K	own name
Securities	$500 K	in RLT
Art & Jewelry	$275 K	own name
Receivables	$2 MM	in SIngle member LLC
Personal Ck	$50 K	own name
Ins. Cash	$1 MM	own name
Qualified	$400 K	in plan
Net Worth	$6,650,000	COLLECTABLE $6,250,000

After—PROTECTED

Home	$1 MM Equity	in AP Trust
2nd home	$500 K Equity	in AP Trust
Office	$375 K Equity	in LLC owned by FLP
Cash	$100 K	in FLP
Securities	$500 K	in FLP
Art & Jewelry	$275 K	in FLP
Receivables	$2 MM	in AR Program
Personal Ck	$50 K	own name
Ins. Cash	$1 MM	AR Program
Qualified	$400 K	in plan
Net Worth	$6,650,000	COLLECTABLE $50 K

Find out the type of defensive planning your client has explored.

worth "only" a few million dollars that they are not big enough to justify doing this kind of planning.

• **Use the right tools.** Asset protection is part art, part science. There are certain methods and tools that work and others that do not. Each asset-protection tool has a specific business purpose that protects specific types of property.

• **Realize that Nevada corporations do not work.** In fact, they are increasingly viewed as presumptively fraudulent due to a long history of abuse and tax fraud. Thousands of consumers have purchased them under false promises of secrecy, bearer-share anonymity and tax advantages. Almost all these promises are fictional. Our information shows that the term "bearer shares" does not even exist in the statutes of the state of Nevada. Unless your client lives in Nevada, does business primarily from or in Nevada and has the assets in question housed in the state, a Nevada LLC will not help him, especially if it lacks a real business purpose, as explained below.

• **Maintain a legitimate business purpose for all legal tools.** To take advantage of the full protection the law affords, the client must maintain an essential business purpose for the tools used. Limited partnerships for investment management and LLCs to hold investment or commercial real estate are two examples of well-proven and tested business uses.

• **Transfers to a spouse, child or relative are not effective.** This is especially true if the transfer is made after an exposure has occurred. A thinly disguised "gift" will easily be reversed and the property will be seized by the court in the event of a judgment. Further, these types of transfers are rarely legitimized by the appropriate recording and tax- reporting formalities.

• **Just creating an S-corporation or an LLC is not enough.** Single-member or closely held corporations with just one or two owners are the types of entities commonly referred to in the phrase "piercing the corporate veil." If a business has only one or two owners who closely manage and control the operations of the business daily or even worse, has owners who are also directly responsible for a harm or injury, it is relatively simple for a court to pierce the veil and grant access to the owner's personal assets.

• **The legal tools used are typically tax neutral.** Don't try to combine tax planning with asset protection. In most cases, the tools used are tax neutral and do not provide a tax advantage or tax liability. Many times, abusive tax structures are disguised as asset protection, often promising tax-free growth offshore in various trusts or captive insurance plans. As a financial professional, you know that putting money into a plan tax-free, growing it tax-free and pulling it out tax- free are rarely, if ever, possible. The one general exception to this rule is in the application of certain receivables-protection plans.

• **Don't forget income and receivables—protect the source.** Many affluent clients often have fixed business and personal overhead commitments based on the expectation of a certain income level. If this cash-flow

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tap were turned off, they would be unable to sustain their monthly expenditures and could be forced into either selling assets, going into qualified plans early or making substantial lifestyle changes. There are options available for qualified clients who can securitize that income stream.

• **Don't attract liability.** In many cases, clients unintentionally escalate their value as a target. For instance, how many of your clients have vehicles that they or their spouse drive titled in the name of their business? Which of the following three defendants do you think is the most attractive to a plaintiff: John Smith, Dr. John Smith or Smith Chiropractic? The corporate defendant is often the most exciting, the one perceived as having the "deepest" pocket. To fix this problem, transfer the vehicle back to the client's name and have him take a car allowance from the business. AT

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