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It's About the Result

Client Alert

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What is Asset Protection Planning?

Lawsuits can arise from many sources, such as business or professional activities, operation of a motor vehicle, ownership of real estate, and divorce. Today our society is more litigious than ever before. However, many individuals give little thought about safeguarding their assets from possible future litigation.

1. What is Asset Protection Planning?

Asset protection is risk management planning. It is designed to discourage a potential lawsuit before it begins or to promote a settlement that is most favorable to the defendant. The primary goal of asset protection planning is to avoid or minimize litigation with little or no loss of personal wealth or disruption to a business or professional practice. However, such planning can not be a means to engage in fraud of creditors or to conceal assets from creditors.

2. Insurance Adequacy Analysis

Adequate insurance can serve as a critical "first line of defense" against claims of creditors. We recommend to our clients that they seek the advice of an experienced insurance consultant to conduct an insurance adequacy analysis. This should include a review of a number of types of insurance coverage, including homeowners, auto, "umbrella" coverage, business risk, professional malpractice, directors and officers liability, health, disability, life and long term care.

However, insurance is not available to cover every potential risk. In addition, insurance policies have dollar limits on coverage and exclude certain types of risks. Insurance companies can also be subject to financial problems. Prudent planning should take into account the limitations of and the potential risks in relying solely upon insurance for asset protection.

3. Traditional Asset Protection Techniques

Significant asset protection can often be achieved in a simple and inexpensive manner by taking advantage of some 'traditional" techniques available under state law. For example, in Pennsylvania, assets jointly held by spouses are generally protected from the creditors of one spouse. Also, as long as you hold funds in qualified employer-provided retirement plans or in IRAs, your creditors generally cannot reach these funds. Pennsylvania law also provides protection for life insurance policies and annuities.

These traditional techniques, however, can have limitations. For example, assume your creditor obtained a large judgment against you, but your assets have initially been protected because they have been held in joint names by you and your spouse. Unfortunately, your spouse then unexpectedly passes way, and all assets immediately pass to you alone as the surviving owner. Your creditor can then immediately take your assets to satisfy the judgment.

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The above described result could have been avoided if the jointly held assets had been transferred during your spouse's lifetime from joint names to your spouses name alone. Then your spouse's will could be amended to provide that upon your spouse's death the assets, rather than passing to you outright, would pass to a trust for your benefit with asset protection provisions.

4. Use of Trusts

A trust can be designed to be a source of funds for the reasonable needs of a beneficiary of the trust, but at the same time, can protect the assets which remain in the trust from that beneficiary's creditors. You can transfer assets to such a trust which benefits your family members either during your lifetime or upon your death. In this manner, the assets can also be protected from being dissipated as a result of the marital problems of a family member. You can also design such a trust to insure that assets which are not needed by the current beneficiaries will pass to future generations of your family.

However, if you create a trust where you make yourself a beneficiary, then effective asset protection might not be achieved. This type of trust is often referred to as a "self-settled trust." The Pennsylvania Uniform Trust Act provides that the creditors of the person establishing the trust (the settler) can reach the maximum amount of the trust assets that can be distributed to or for the settlor's benefit. For example, assume you set up a trust under Pennsylvania law which gives the trustee of the trust the discretion to distribute all or any portion of the trust assets anyone in the group of beneficiaries consisting of you and your children. Under these circumstances, your creditors can reach all the assets of the trust. This result would occur because under the provisions of the trust the trustee could have distributed all the trust assets back to you.

Some states have in recent years enacted laws which grant asset protection to self-settled trust. For example, Delaware has authorized the use of the Delaware Asset Protection Trust, which is an irrevocable, self-settled trust designed to provide the settlor with protection from the claims of future creditors even though the settlor is a beneficiary of the trust. You do not have to live in Delaware to effectively set up such a trust.

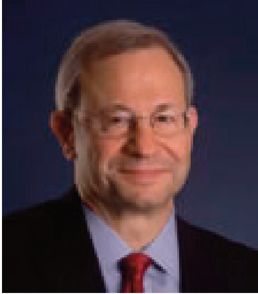
5. Structure and Operation of Business Entities

The use of business entities such as corporations, limited liability companies, limited partnerships and limited liability partnerships is a common asset protection planning technique. The business entity should be structured (1) to avoid exposing the business owner personally to the creditors of the business, and (2) to avoid exposing the assets of the business to the claims of an owner's personal creditors which are unrelated to the business.

Business entities can also be used to contain risks within separate entities. Whenever possible, valuable assets should be owned in a separate entity where liability is not likely to arise. For example, a corporation which operates a construction business should not also own valuable real estate, and a limited liability company that owns commercial real estate should not also own a large portfolio of marketable securities.

It is also critical that business owners enter into well written shareholder agreements, partnership agreements and/or operating agreements with protective asset protection provisions. Such an agreement among co-owners of a business should contain, among other things, restrictions on the subsequent transfer of ownership interests by any owner. Such restrictions can significantly limit the rights of the future creditors of the owners.

Finally, the effectiveness of a business entity in providing asset protection can be compromised unless certain "formalities" are regularly followed, such as keeping separate



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books and records, having a separate business bank account, not intermingling business transactions with personal transactions, executing legal documents in the proper manner and keeping regular corporate minutes.

6. Fraudulent Transfers

Asset protection planning is effective when it is implemented to obtain protection from possible **future** creditors. Transferring assets to avoid the claims of your **existing** creditors is not an effective way to shield yourself from liability. Fraudulent transfer laws are designed to give creditors the power to challenge and reverse transfers which are intended to conceal assets from them.

The Pennsylvania Uniform Fraudulent Transfer Act (UFTA) is very broad. Anyone with a right to payment, even if contingent or disputed, is a creditor under the UFTA.

The UFTA has a general limitations period of four years from the date of a transfer within which a creditor seeking to challenge the transfer must file a claim. In some cases, the UFTA provides for a limitations period of one year from when the transfer should have been discovered by the creditor which applies to transactions involving "insiders".

The value that the debtor received in exchange for the asset that was transferred is examined. The key is to insure that reasonably equivalent value is received in exchange for any transfer. The conservative route is to try and make all transfers for full fair market value.

You should not make a transfer that causes you to become insolvent. The UFTA deems a debtor insolvent if the debtor's debts exceed the debtor's assets, based on a fair valuation. An important reason to maintain insurance is that the face amounts of liability insurance policies are normally included as assets in a UFTA solvency analysis if the policy proceeds would be available to pay the creditor's claim. Alternatively, a debtor is insolvent for UFTA purposes if the debtor cannot pay his or her debts as they become due.

If a claim is made within the limitations period and the debtor was solvent or was insolvent but received reasonably equivalent value, the final battle may be fought over the issue of intent. A court will determine whether a transfer was made with a "bad intent" to hinder creditors. These circumstances are known as "badges of fraud."

Over the years the courts have identified literally dozens of circumstances of badges of fraud, including these most common ones: Was the debtor insolvent at the time of the transfer or soon afterward? Did the debtor know or suspect that a claim existed? Was reasonably equivalent consideration received by the debtor for the transfer? Was the transfer concealed from creditors? Had the debtor recently incurred a substantial debt? Was the transfer of all or most of the debtor's assets? Was the transfer directly or indirectly to an insider? The weight to be given to any of these factors depends on the given case.

From the debtor's standpoint, the goal is to fashion transfers that are justified by legitimate economic reasons and that do not appear to be a transaction meant to hinder creditors.

Asset protection planning involves a number of areas of law, including business law, estate planning, taxation, litigation, bankruptcy, real estate law, divorce law. Therefore, our firm has taken a multi-disciplinary approach by forming an asset protection planning group which includes attorneys with expertise in a number of different areas of law.

For more information, please contact Jon Samel at 215-661-0400 or JSamel@HRMML.com