Why Is Asset Protection Planning Important?

RONALD SCHREIBER  
Seyfarth Shaw LLP  
KATHLEEN EGGERS BUCHAR  
The Northern Trust Company  
Chicago

I. [1.1] Introduction

II. Areas of Potential Liability and Concerns To Be Considered
   A. [1.2] Contract Liabilities
   B. [1.3] Employer Liabilities
   C. [1.4] Professional Liability
   D. [1.5] Other Negligence Claims
   E. [1.6] Real Estate Developers and Owners
   F. [1.7] Marital and Family Issues
   G. [1.8] Other Factors Adding to the Need for Asset Protection Planning
   H. [1.9] Duty To Provide Asset Protection Planning Advice

III. [1.10] Conclusion
I. [1.1] INTRODUCTION

The goal of protecting assets from potential creditors is not a new concept. In the past, however, asset protection planning was viewed negatively, both inside and outside the legal community. It was perceived as distasteful, possibly fraudulent, maybe even against public policy, and beneath many practitioners.

Over the past 25 years, however, various societal factors have unleashed many new threats against personal wealth. There has been an exponential rise in the number of lawsuits filed. New theories of liability have been advanced, and the size of jury awards has escalated, often based on subjective injuries such as emotional and psychological distress. Juries are also more willing to impose punitive damages than they were in the past. As a result and despite the stigma of the past, asset protection planning has quickly gained acceptance as a legitimate objective for clients with property and businesses to protect against unexpected contingencies and future risks and is becoming an integral part of estate planning.

Some degree of asset protection has always existed under various statutes designed to exempt specific assets from the claims of creditors without the need for any extraordinary planning. For example, under federal law, any retirement plan governed by the Employee Retirement Income Security Act of 1974 (ERISA), Pub.L. No. 93-406, 88 Stat. 829, is completely exempt from creditors. This includes all plans that fall under §401(a) of the Internal Revenue Code, such as pension, profit-sharing, and stock plans and annuities. Individual retirement accounts (IRAs), which are not covered by ERISA, are also protected, to a limited extent, under federal bankruptcy law and, in varying amounts, under state law. In Illinois, for example, 735 ILCS 5/12-1006 provides that IRAs are completely protected from judgment creditors, but other states limit protection to a fixed dollar amount or to an amount reasonably necessary for a debtor’s support.

Social security benefits, unemployment compensation, public assistance benefits, and disability payments are not subject to collection under Illinois law. Alimony, support, or separate maintenance is also exempt. In Illinois, life insurance proceeds payable by reason of the death of the insured to a spouse, child, parent, or other person who is dependent on the insured for support are also exempt from the claims of creditors. 735 ILCS 5/12-1001(f).
Most states also have bankruptcy laws that entitle a debtor to certain exemptions, particularly for his or her homestead, although in Illinois it is a meager $15,000. 735 ILCS 5/12-901. A number of states, including Illinois, allow resident spouses to hold title to their primary residence as “tenants by the entirety.” This unique form of joint ownership cannot be unilaterally severed and is therefore protected from the claims of the creditors of only one spouse, although it is subject to the claims of a creditor of both spouses and the claims of the surviving spouse’s own creditors after the death of the first spouse to die.

Some asset protection is also available by virtue of the laws governing various forms of business entities. Investors and business owners may limit the exposure of their personal assets to the claims of the creditors of a business by utilizing a corporation, limited liability company (LLC), or limited liability partnership (LLP) as the entity for the business venture. Under these arrangements, the owners generally cannot be held personally liable for the debts of the business. The degree to which the business owner is protected depends on whether the owner observed the formalities of conducting business through the separate business entity; in some cases, the courts have allowed plaintiffs to “pierce the corporate veil” and pursue the personal assets of the business owner.

This chapter serves as an overview of the many areas of potential liability and concerns to be considered in assessing the asset protection planning needs of clients. The ensuing chapters focus on implementing asset protection planning through specific techniques and strategies. Sections 1.2–1.9 below discuss some of the many areas of potential concern for clients.

II. AREAS OF POTENTIAL LIABILITY AND CONCERNS TO BE CONSIDERED

A. [1.2] Contract Liabilities

Some potential liabilities arise out of contractual transactions and can be anticipated. These claims include breach of contract, loan obligations, consumer debt, and other common commercial liabilities. Often, however, the principal owners of a business are required to give a personal guarantee for the company’s obligations in order to entice outside parties to provide services, lend capital, rent property, or sell goods to the com-
pany. If the company defaults on its obligations, the principal becomes personally liable and, suddenly, the careful planning in the selection of an entity for the business can be rendered meaningless.

B. [1.3] Employer Liabilities
Employers face liabilities from a myriad of issues. Aside from liability for the actions of employees while performing their work (e.g., making a faulty repair or being involved in an accident with a company vehicle), employers may also face liabilities for (1) wrongful termination; (2) sexual harassment; (3) discrimination based on sex, religion, age, or race; or (4) failure to comply with the Americans with Disabilities Act of 1990, 42 U.S.C. §12101, et seq.

C. [1.4] Professional Liability
Doctors are not the only professionals threatened with malpractice suits. Architects, lawyers, accountants, insurance agents, financial advisors, and engineers are also common targets. With the advent of the Sarbanes-Oxley Act of 2002, Pub.L. No. 107-204, 116 Stat. 745, directors and officers of corporations or other business entities are also faced with new obligations and responsibilities that can lead to liability.

D. [1.5] Other Negligence Claims
The least foreseeable events triggering losses are claims arising from accidents and other tort claims. While tort reform legislation has been talked about for years, it has found very limited success, and large jury awards continue to be a threat.

E. [1.6] Real Estate Developers and Owners
Clients with real estate holdings, construction companies, and other real estate-related businesses face a number of risks. The liability for unseen construction defects caused by subcontractors can continue for many years after a project has been developed, completed, and sold. Often, real estate developers are required to sign personal guarantees in order to obtain funding for their company’s projects.

Landowners (individuals and businesses) are also subject to regulatory liability imposed by the federal government, as well as the states, for environmental hazards and problems arising from their property. Under
the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (CERCLA), 42 U.S.C. §9601, et seq., the government has the power to identify contaminated property and force the current landowner to pay for the cleanup. Such cleanup is often very costly, and it is not uncommon for cleanup costs to exceed $20 million per site. Full liability under CERCLA can be assessed against a landowner regardless of whether the landowner created or contributed to the environmental hazard. A landowner who acquired contaminated property without knowledge of the environmental problem can also be held liable.

F. [1.7] Marital and Family Issues

The high divorce rate, which continues to be over 50 percent, is a popular impetus for asset protection planning. Wealthy individuals need to consider the possibility of divorce for themselves, as well as for their children and grandchildren. Premarital agreements can often provide some degree of limited security, but a court may choose not to enforce such agreements for a multitude of reasons (e.g., the court finding that certain formalities were not observed, one party was under duress or not represented by counsel, inadequate disclosure of assets, or the agreement to be unconscionable). Even carefully negotiated premarital agreements may be subject to adjustment in divorce court. In addition, courts have become more willing to award damages for interspousal torts (e.g., intentional infliction of emotional distress) that would not be governed by a premarital agreement. See Duncan E. Osborne et al., Asset Protection Trust Planning, PLANNING TECHNIQUES FOR LARGE ESTATES (ALI-ABA Apr. 2001).

While divorce is often the main consideration for asset protection planning in the marital context, individuals should also consider how to protect their assets, or the assets they wish to give to their spouse at death, against the claims of their spouse’s creditors. This is especially true when the parties marry late in life—the surviving spouse could be liable for the medical expenses of someone to whom they were married for only a short period of time and who is not the parent of his or her children. Another estate planning issue to consider is the possibility that a surviving spouse could renounce the share that he or she receives under the deceased spouse’s will in favor of the statutory share of the estate as the surviving spouse. In determining a surviving spouse’s renunciatory share, some states (such as Illinois) do not include assets that were transferred to the

Other family concerns may also trigger the need for asset protection planning. Parents worried about the gambling addiction, substance abuse problems, or uncontrolled spending of their children often rely on trusts with spendthrift provisions to restrict the children’s access to funds held for the children’s benefit. These same restrictions also help protect trust assets from the claims of the children’s creditors. However, these trust protections can disappear if trust assets are distributed outright to the children pursuant to the terms of the trust (e.g., after a child reaches a certain age). Additional asset protection strategies may be necessary to shield assets intended to benefit a disabled family member (e.g., a “special needs” trust to benefit the disabled person without affecting his or her eligibility to receive governmental aid).

G. [1.8] Other Factors Adding to the Need for Asset Protection Planning

One reason for the rapidly growing number of lawsuits filed is the ability to quickly and inexpensively obtain personal financial information about potential defendants. Much of this information, previously difficult to assemble if personal wealth consisted of real estate owned in different counties and states or was spread out among several financial institutions, is now readily accessible through the Internet and public databases. Many clients who consider their wealth to be safe because they avoid high-risk activities may not realize that their wealth alone may make them a “deep pocket” and a potential defendant in a lawsuit. Some asset protection planning techniques may be effected by simply adding layers to the asset discovery process that can deter would-be claimants and make it harder to discern any information about a client’s assets.

Changes to the federal bankruptcy laws made by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), Pub.L. No. 109-8, 119 Stat. 23, have imposed limits on the assets that a debtor may declare exempt. For example, IRAs are now exempt only up to $1,171,650 ($1,000,000 adjusted for inflation since 2005). There is also now a $146,450 ($125,000 adjusted for inflation since 2005) limit on homestead exemptions, except in states that have unlimited homestead exemptions, such as Texas and Florida. However, a debtor must now reside in his or her homestead in these states for at least 1,215 days prior
to the filing of the bankruptcy petition in order to claim full exemption. Furthermore, the full homestead exemption is limited to $146,450 (as adjusted; see above) if the debtor’s insolvency is a result of violating federal or state securities laws, civil penalties under the Racketeer Influenced and Corrupt Organizations Act (RICO), 18 U.S.C. §1961, et seq., or a criminal act, intentional tort, or willful or reckless misconduct causing serious physical injury or death to an individual. Assets transferred by a debtor to a “self-settled trust or similar device” established by the debtor and of which the debtor is a beneficiary during the ten-year period preceding bankruptcy may be set aside by the bankruptcy trustee if it can be proved that the debtor made the transfers with the actual intent to hinder, delay, or defraud a creditor.

Insurance can be purchased to protect against many types of risk and is an important part of any asset protection plan. However, the insurance purchased may not cover the full amount of monetary damages or the claim may be denied by the insurance company based on the terms of the policy. Insurance premiums have become much more expensive, and it may not be cost effective to purchase insurance against every possible risk. Some may find their policies canceled after filing a single claim. As the recent financial crisis has shown us, concerns about the stability and solvency of specific insurance companies and the industry as a whole are justified; therefore, clients would be wise to implement other asset protection planning devices in addition to purchasing insurance. As with any plan, multiple strategies work best.

As life expectancies increase and healthcare costs continue to rise, there is greater concern about how to qualify for governmental aid programs such as Medicaid and Medicare. At the same time, however, governmental budget deficits are increasing and resources to fund these programs are dwindling. Consequently, efforts to seek reimbursement for these programs from the assets of a deceased individual who received aid will only intensify.

H. [1.9] Duty To Provide Asset Protection Planning Advice
As asset protection planning becomes more common and is viewed more favorably, a number of commentators have suggested that the pendulum of public opinion may swing so far that estate planning attorneys may have a duty to include asset protection planning as a standard part of the services they provide to their clients. In fact, one commentator has gone
so far as to state that the “failure to so advise a wealthy or at risk client may constitute malpractice if the client’s assets are needlessly exposed to a subsequent judgment or other legal claim.” Mario A. Mata, *Asset Protection Planning for the Family Business Owner, ESTATE PLANNING FOR THE FAMILY BUSINESS OWNER* (ALI-ABA July 2005). The authors of another article have hinted that the “next wave of creative malpractice actions could well be against estate planning attorneys who fail to advise clients about asset protection alternatives.” Duncan E. Osborne and John A. Terrill, II, *Fundamentals of Asset Protection Planning*, 31 ACTEC J. 319, 320 (2006).

III. [1.10] CONCLUSION

This chapter is not intended to serve as an exhaustive list of all the potential threats to a client’s wealth. However, as liability and bankruptcy laws change and as business transactions become more complicated, clients will face greater exposure and risk in personal and commercial endeavors, which in turn will increase the demand for incorporating asset protection planning techniques into their estate plans.