TEXAS
ASSET PROTECTION
HANDBOOK

Protecting Your Wealth from Predators, Creditors and Deadbeats

The Wiewel Law Firm

The Peace of Mind People®

AUTHORS' NOTE

Asset protection is a contact sport. No one leaves the process without bruises and sometimes bleeding. Stopping the beating before it begins is laudable. Unfortunately, you cannot stop a moving train or a lawsuit heading in your direction. You should take the Boy Scout Motto very seriously:

BE PREPARED

This book is about the preparations you need to take to maximize your chances of preserving your wealth in an assault from predators, creditors and deadbeats.

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DEDICATION

This book is dedicated to all of the successful and not-so-successful entrepreneurs who, at great personal, financial and legal risk, have tried and succeeded at making Texas and our country the envy of the world.

QUOTES

You aren't paranoid when they really are out to get you.
Anonymous

Come to terms quickly with your accuser while you are going with him to court, lest your accuser hand you over to the judge, and the judge to the guard, and you be put in prison.
Matthew 5:25
English Standard Version (ESV)

Peace of mind is priceless.
Brad Wiewel

INTRODUCTION

Asset protection is little more than an after-thought for most people. The average person has more mundane and "urgent" concerns. In addition, the majority of Texans are immune from liability issues and "judgment proof" due to the small size of their personal estates.

For individuals with more wealth, however, the current climate has heightened their exposure to catastrophic loss for a number of reasons. First, in a challenging economy, many people see winning a lawsuit as akin to winning the lottery. And, with lawyers willing to take cases on a contingency fee basis, there is no financial risk for a plaintiff to press forward with a claim whether it is meritorious or not. Second, with the number of lawyers rising, unemployment is a huge problem within the legal community, and as one wag noted, there is nothing more dangerous than an unemployed lawyer! Finally, the more money someone has, the bigger the target for lawsuits they are; achieving a degree of success in life, can bring them unwanted attention.

This book is written for smart people; people who do not naively assume that their financial security will never be threatened by a lawsuit gone wrong. It is written for people who cherish their accomplishments and who do not want to lose what they have worked hard for in unforeseen litigation. Hopefully, you will find information and ideas in this book that will convince you to take action now to preserve and protect your assets so that if you are sued, your estate can continue to support you and your family for years and, perhaps, generations to come.

CHAPTER 1.

ASSET PROTECTION BASICS

This chapter introduces you to the basics of asset protection planning. It explains exactly what asset protection is, provides an overview of the planning process together with examples of the more common tools used in that process, and highlights the limits of asset protection planning. The chapter also alerts you to common asset protection scams and debunks many myths.

In subsequent chapters you will learn more about the different techniques that are used in asset protection planning. These range from the simple to the complex and from the inexpensive to the expensive. You will also discover specific asset protection tools you may want to use to protect your family assets particularly if you are a real estate investor, business owner, physician or other professional. For additional information about any of the topics in this book, schedule an appointment with a board certified estate planning attorney.

What Asset Protection Planning Is and Is Not

Asset protection planning is a proactive process that anticipates and prepares for catastrophic lawsuits and protects your property from the consequences of any judgments that may result from those lawsuits. Planning options may include: maximizing your legal exemptions, having the appropriate types and amounts of liability insurance, and creating certain entities such as a limited partnership, limited liability company or an asset protection trust.

Threats to your assets usually arise because someone alleges that you injured him or her, damaged their property, did not live up to the terms of a contract that you entered into, and so on. The plaintiff (legal term that describes the person or entity that initiates a lawsuit) might be:

- **A secured creditor.** A secured creditor is a creditor that has collateralized (secured) your debt by agreeing that it can put a *lien* on one or more of your assets. For example, if you have a mortgage on your home. The mortgage lender has a lien on that asset, and if you have an auto loan, the lender has a lien on your vehicle. A lien entitles the creditor to take its collateral – the asset with the lien on it – without having to sue you should you default on your debt. For example, if you do not pay your mortgage, your mortgage lender may foreclose on your home, and if you fall behind on your auto loan, the lender may take back your vehicle through repossession.

    Warning! If the value of your collateral is less than the amount of your debt, the creditor may be able to sue you for the difference, or *deficiency*.

- **An unsecured creditor.** An unsecured creditor is a creditor that has no collateral. If you default on an unsecured debt, the creditor may sue you with the goal of winning a judgment against you. The judgment would require you to pay the creditor a certain amount of money. If you do not pay the judgment, the creditor can try to enforce or collect on the judgment by going after one or more of your *nonexempt* assets. A nonexempt asset is an asset that a creditor is legally entitled to take from you. You may also own *exempt* assets, which are assets that creditors generally cannot take from you. Exempt and nonexempt assets are discussed in the next chapter. Most unsecured creditors are contractual creditors, which means that when you fail to pay the debt you owe to them, you have broken a contract. Credit card companies are the most common contractual unsecured creditors.

- **A business creditor.** A business creditor is a type of contractual creditor. If a business gets a judgment against you – maybe because you defaulted on a business contract you entered into – the business is likely to have more resources to pursue a lawsuit than you do. Therefore, the business will be well positioned to collect on its judgment.

- **A tort creditor.** A *tort* is a civil wrong as opposed to a contractual or criminal wrong. Examples of civil wrongs include personal injury, negligence, slander, battery, sexual harassment, and so on. If someone feels that you have harmed them, they may sue you in civil court, and if the court awards them damages, you will be legally obligated to pay the amount of the damages.

- **A government creditor.** The IRS and property tax authorities are both examples of government agencies with which you may have an outstanding debt. Owing money to a government agency like the IRS can be dangerous because many of the laws that limit what other kinds of creditors can and cannot do to collect money from you do not apply to the IRS. In other words, the federal government is a "super creditor." For example, the government can garnish your wages if you owe past due federal income taxes or if you have defaulted on your federally-guaranteed student loan even though wage garnishment is generally prohibited in Texas. It can also seize your exempt assets (such as your home) even though most creditors are prohibited from taking that step to collect a debt you may owe to them.

How Asset Protection Works

Asset protection planning helps protect your assets by:

- **Discouraging lawsuits.** A well-crafted and correctly implemented asset protection plan may deter the filing of a lawsuit against you. This is because potential plaintiffs will have problems finding attorneys willing to represent them once the attorneys realize that your plan will make it difficult, if not impossible,for them to collect on any judgments they might obtain against you. In large part this is because many attorneys who represent plaintiffs in personal injury, property damage and other kinds of civil lawsuits normally charge their clients on a contingency fee basis rather than asking their clients to pay them an up-front or hourly fee.

Attorneys who charge a *contingency fee* get paid for their services by taking a percentage of whatever money they win and collect for their clients. Therefore, they have a strong incentive to take a case only when there is a good likelihood that they will either be able to negotiate out-of-court settlement with a defendant or to win in court and collect on the judgment should the lawsuit go all the way to trial.

Discouraging lawsuits is important because even if a lawsuit that is filed against you has no merit, you will still have to hire an attorney to help you resolve it, and being involved in any kind of lawsuit is stressful. Furthermore, unless the claim against you is covered by insurance, you will have to pay out of your own pocket the amount of the court's judgment, or the amount of any out-of-court settlement you may agree to as well as the cost of your attorney's fees and expenses. You also could be responsible for paying the legal fees and expenses of the plaintiff in the lawsuit too!

Discouraging lawsuits also eliminates the "time" problem. In addition, to seemingly endless attorney meetings and depositions, if a lawsuit ends in a trial you will have to be in the courtroom throughout the trial. The trial could last anywhere from a day or two, to even a month or more, and during this time, you will not be able to work. As a result, you may lose income, and, if you are a business owner, your business may suffer because of your absence.

*Please see **"Anatomy of a Lawsuit," Analysis 1.1**, for an outline of the basic steps involved in a lawsuit.*

> **Tip:** Asset protection planning may help you ensure that you do not lose assets that you want to hold on to if you get divorced. Chapter 2 explains how to do that using a prenuptial or a postnuptial agreement.

> **Warning!** Ordinarily when you are sued, the plaintiff in the lawsuit cannot put a lien on any of your assets unless you lose the lawsuit. In some instances however, a plaintiff may be entitled to put *prejudgment liens* on some of your assets, which will make it easier for the plaintiff to collect on its judgment should it win the lawsuit. Also, when there is a lien on an asset that you own, you will not be able to sell that asset, borrow against it or transfer it to someone else until the lawsuit is concluded. Asset protection planning can help you avoid prejudgment liens.

- **Making it harder to collect from you**. When a lawsuit is resolved through a trial and ends with the court awarding the plaintiff a judgment against you, a good asset protection plan will make it difficult for the plaintiff (now referred to as the *judgment creditor*) to take your assets. Eventually, the judgment creditor may give up trying to collect from you, especially if the amount of the judgment is small, or it may agree to let you settle the judgment for less than the full amount.

> **Tip:** The essence of <u>all</u> asset protection is to reduce the settlement amount to as low an amount as possible.

Warning! If all of your assets are protected from your creditors, you are considered to be *judgment proof*. Many people are judgment proof because they have minimal assets. However, if you already have substantial non-exempt assets or if you acquire, are given, or inherit additional assets you must have an asset protection plan in place; and if you have not revised the plan to protect any new assets, those may be vulnerable too. It's critical, therefore, that you keep your plan up-to-date.

Amazing Examples

Asset protection planning is especially important in today's litigious society where people sue one another, often for the slightest indignity. We all remember the woman who won a substantial judgment against McDonald's because she ordered hot coffee at the restaurant and then was burned after spilling some of it on herself. Or how about this? According to Reuters, a Florida man, who had had too much to drink climbed an electrical transformer, which sent 13,000 volts of electricity coursing through his body. He subsequently sued not only the bars that sold him alcohol the night of his accident, but also the Tampa Electric Company, claiming that the utility did not do enough to prevent him from gaining access to the electrical transformer! Here is another tragic example: Two friends were driving in a car in California and ended up in a serious accident, which caused their vehicle to burst into flames. Although the driver was able to get out of the car, the passenger was trapped inside. The driver pulled her friend out of the car, saving her from burning to death; but in the process, the driver so badly injured the other woman that her friend was left permanently paralyzed. Subsequently,the woman who was paralyzed sued the driver for causing her paralysis.

The other woman challenged the right of the injured woman to sue her by invoking California's Good Samaritan Law. A "Good Samaritan Law" is designed to provide a liability shield to people who try to help out in an emergency. The case went all the way to the California Supreme Court, which ruled that the law did not protect the driver of the car and so the lawsuit against her moved forward. Whether that would be the result in Texas is as yet to be determined.

> **Warning!** Some people may view filing lawsuits (with the possibility of ending up with a large settlement or judgment) to be an alternative to winning the lottery!!

> **Warning!** The wealthier you are, the more of a target you become.

What Asset Protection Is Not

Asset protection planning is not about trying to avoid paying your legitimate debts or shirking your responsibility when your actions (or inactions) cause harm to someone or someone else's property. Rather, it is a means of protecting yourself from a devastating loss of your hard-earned assets if you are sued and ordered to pay a judgment which is so excessive that it exceeds the maximum coverage your liability insurance provides or if the loss is not covered by your insurance. Liability insurance is discussed in the next chapter of this book.

> **Warning!** If a lawsuit is dismissed because it has no basis in law or in fact, the court may require the plaintiff to pay the defendant's attorney's fees. While that order may make you "feel good," it is doubtful that you would ever receive any money from the plaintiff.

Who Needs an Asset Protection Plan?

You need an asset protection plan if you own any significant assets and you want to protect them from claimants. Significant assets include a business, cash, real estate, stocks, bonds, mutual funds, oil and gas interests, fine art, fine jewelry, antiques, and so on. If you are sued and you have not done the proper planning, you will be at risk for losing a substantial portion of the assets that you worked hard to acquire and that you may be counting on to help fund your children's college educations, pay for your retirement, and/or that you want to pass on to your loved ones when you die.

Asset protection planning is not just for the wealthy; it is for middle class people too. In fact, it can be argued that asset protection planning is as important for someone of relatively modest means as it is for someone who is truly wealthy. This is because proportionally, a judgment will take a bigger bite out of a modest estate compared to a large estate. Here is an example that illustrates that fact: Bob and Sue Kramer have an estate that is worth $350,000 and Jim and Suzette Johnson's estate is worth $2.5 million, not including the couples' homes and retirement accounts. The two couples are each sued and the judge in both lawsuits awards $500,000 to each of the plaintiffs. The judgment against the Kramers is for more than they are worth, so even after paying everything they could, they still owe money to the judgment creditor. However, the judgment against the Johnsons represents only 20% of their estate's total value, so after they pay the judgment, most of their estate is still intact.

Asset protection planning is especially important if you:

- Own risky assets. A risky asset is an asset that is more prone to lawsuits. Rental property is an example of a risky asset; swimming pools are another.

- Are a business owner. Without the appropriate planning, your personal as well as your business assets could be at risk if your business is slapped with a lawsuit and loses. Chapter 4 discusses asset protection planning when you are a business owner.

- Are about to marry. If you are marrying for the first time or remarrying, you may be coming into your marriage with assets that you do not want to lose should your marriage end in divorce, or if you have assets that you want to ensure go to your children from your prior marriage, if you die before your spouse does.

- Are in a high-risk profession – one that is that particularly prone to lawsuits. For example, you are a doctor, dentist, architect, attorney, CPA, or engineer.

- Have minor children – children who are under the age of 18 in Texas. You can be held financially responsible for their actions if your minor children harm someone or damage someone else's property, regardless of whether their actions were deliberate or not.

*Please see **Analysis 1.2 The Actions of Your Minor Children Could Cost You**, for a discussion of potential liability.*

When to Put Your Plan in Place

The sooner you implement your asset protection plan, the better. If you delay your planning, your finances could be devastated by the very kind of problem your plan could have protected you from, and you have no way of knowing ahead of time when such a problem might occur. Furthermore, if you implement your plan after you have been sued and the plaintiff formally contests its validity, the court is likely to treat your plan as *fraudulent*. Should that happen, the court could reverse your planning, making the property you tried to protect vulnerable to loss.

The law provides for a *look-back period*, which may be as short as one year or as long as ten years. During the look-back period, judgment creditors who were unable to collect on a judgment against you because your assets were protected can ask the court to reverse the transfer of any assets you may have disposed of for less than their *fair market value*. (Fair market value is what the assets were worth at the time that you sold them, not what you bought them for or think they will be worth someday.) Also, those creditors can ask the court to undo the transfer of any *nonexempt assets* you may have owned during that same period that became *exempt* because of the transfer. The court may comply with these requests if it believes that when you sold or transferred your assets your goal was to hinder or delay the creditors' ability to collect on their judgments.

> **Warning!** No matter how good your plan may be, it will not, (with one extremely rare exception), protect your assets *after* a potential legal issue has arisen. Also, it may not protect your assets from any

problems that you expected, were threatened with, or that were pending at the time you implemented your plan. In other words, *procrastination is perilous*.

Asset Protection Myths

There are many misconceptions about asset protection planning. Here are some of the most common ones together with the actual facts about each:

- **Myth:** Asset protection is illegal or unethical.
  Fact: Asset protection planning, when done right, is a 100% legal and ethical process. In an era of frivolous lawsuits and outsized court judgments, protecting your assets makes good sense.

- **Myth:** Asset protection planning is all about hiding assets and trying to dupe creditors and claimants.
  Fact: Asset protection planning makes it more difficult for creditors and claimants to get to your assets and reduces any unfair advantages they may have over you.

- **Myth:** Only rich people need an asset protection plan.
  Fact: Anyone with assets that they do not want to lose should do some sort of asset protection planning. However, people of modest means will probably have simpler plans than people who are wealthier or who own complex or risky assets (or who have "lightning rod" jobs).

- **Myth:** I can do asset protection planning after I am sued.
  Fact: You must begin your planning before you are sued and before you believe that you may be sued. If you do not and the legal validity of your plan is challenged, a judge may undo your planning, which could result in the loss of your assets.

- **Myth:** I will lose control of my assets if I put an asset protection plan in place.
  Fact: A well-designed plan will not affect your ability to control your assets.

- **Myth:** I do not need an asset protection plan because I have never been sued and do not ever expect to be. I maintain a low profile in life and try not to make people angry.
  Fact: In our litigious society, you never know when you might be slapped with a lawsuit regardless of how you live your life. It is foolhardy not to prepare for that possibility.

- **Myth:** Asset protection planning will help me lower the amount of money I have to pay in federal income taxes.
  Fact: Anyone who tells you this is misinformed or trying to "pull a fast one" on you!

- **Myth:** I have a revocable living trust and it shields my assets from my creditors.
  Fact: A revocable living trust does not prevent your assets from being seized by your creditors.

An Overview of the Asset Protection Planning Process
A good asset protection plan is not a one-size-fits-all process. To be effective, your plan must reflect the realities of your life , your finances, including the size and nature of your estate, and the risks you face (Do you own a business? What is your profession? Do you own rental property? Do you have minor children?).

> **Tip:** Your asset protection plan should be coordinated with your estate plan, which almost always will need to be updated and upgraded.

Your attorney will begin the planning process by taking into account all relevant factors in your life and by reviewing any asset protection planning you may have done already to determine whether it has been done effectively and to make sure that you are receiving maximum benefits from that planning. Once your attorney has completed his analysis, he will prepare a written plan detailing his recommendations regarding specific asset protection planning tools he believes you should use. Then, after you have signed off on the plan, your attorney will help you implement it. The next section of this chapter highlights the most common asset protection tools. You will learn more about them in subsequent chapters of this book.

> **Warning!** Trying to prepare your own asset protection plan is penny-wise and pound-foolish. If you go it alone with a software plan, for instance, you are likely to end up with a plan that will not do an adequate job of protecting your assets. Also, steer clear of asset protection scams.

Please see ***Analysis 1.3 Beware of Asset Protection Scams*** *for highlights of the most common scams.*

The Tools of Asset Protection

The tools of asset protection planning range from the simple to the complex. The simpler asset protection tools include:

- Taking full advantage of the property exemptions in Texas because your creditors cannot take your exempt assets. Each state establishes its own exemptions and the exemptions in Texas are among the most generous in the nation. Exempt assets are discussed in detail in Chapter 2.

- Purchasing the right kinds and amounts of liability insurance.

- Preparing a prenuptial agreement. You and your future spouse will negotiate this agreement before you get married.

- Writing a postnuptial agreement. You and your spouse will negotiate this agreement during your marriage.

More complicated (and more expensive) asset protection planning tools include:

- Transferring your assets to a limited partnership, a limited liability company or a corporation that you set up.

- Setting up and funding a domestic asset protection trust.

- Setting up and funding an offshore asset protection trust.

What an Asset Protection Plan Cannot Do

No matter how good your asset protection plan may be, it cannot provide you with 100% protection against the loss of your assets, in large part because there are legal limits on exactly what you can and cannot do to protect the property that you own. For example, you typically cannot:

- Put a plan in place after you have been sued, been threatened with a lawsuit, or once you know that you are likely to be sued. If you do, the plaintiff will probably ask the court to undo the plan. If the court agrees to do so, your assets will be vulnerable to loss.

- Transfer (sell or give away) assets to your spouse, a relative, a trust, and so on with the goal of *hindering, delaying or defrauding* one of your creditors. If a creditor formally accuses you of making a fraudulent transfer and the court concludes that you have, it will reverse the transfer. In certain circumstances, the court may also charge you with a crime. In Texas there is a one-year *statute of limitations* on fraudulent transfer claims, which means that a creditor generally must file a claim to undo a transfer within one year of the transfer's completion or their learning about it. In bankruptcy court, however, this period may be up to ten years.

  Some of the factors that a judge will consider when determining whether or not a transfer was fraudulent include whether:

- You transferred the asset immediately after you learned of a potential lawsuit.

- You made yourself insolvent as a result of the transfer. You are insolvent if the total value of your debts exceeds the total value of your non-exempt assets.

- You did not receive *full and adequate consideration* for the transfer from the person or legal entity to which you gave or sold the asset you were trying to protect. For example, you sold the asset for less than its fair market value.

- You gifted (gave away) the asset to someone else.

- You concealed the transfer.

- The transfer was completed too close to the time that the court entered a judgment against you.

- You were evasive or dishonest with the creditor about the transfer.

- You (or a member of your family) continue to benefit financially from an asset that you transferred to someone else.

Why Not Do It Yourself?

Do it yourself law is like do it yourself surgery. It does not cost a lot, but you will not know the results until much later, usually with disastrous consequences. The adage “penny-wise and pound foolish” applies here too. Asset protection is not something to dabble with in your spare time! It is about protecting your property from a potentially very strong, smart and savage “wolf at your door.” Therefore, relying on asset protection planning software or an on-line program to protect your assets is short-sighted and dangerous. Also, legal document creation systems marketed by companies like LegalZoom and Nolo offer very limited direction, and some of what is available from non-lawyers may be erroneous. Furthermore, these services make it clear that there is no “legal advice” involved, which is another way of saying that after you print their documents you are “on your own” without any effective guarantee. And, if problems develop after you develop your plan using the documents, who do you call? Certainly not the company that sold you the documents because, as the websites make clear, the company cannot represent you or even answer your legal questions. While there is nothing wrong with being cautious about how you spend your money, *proper asset protection is not an expense, it is an investment*, and no one wants to make a foolish investment!

Analysis 1.1. Anatomy of a Lawsuit

Here is an overview of how the typical lawsuit works:

1. **Demand:** You receive a demand letter from the attorney representing the person or company that believes you have harmed it in some way. The letter asks you to pay that person or entity a certain amount of money for the harm you caused. At this point you should contact your insurance agent, assuming you have insurance that may cover the problem. You should get in touch with an attorney, too.

2. **Served with Papers:** You are sued because you or your insurance company refuse to pay the money you have been asked to pay or because the injured party is unwilling to settle for less than the amount specified in the demand letter. You will be formally notified of the lawsuit when you are served with an official notice from the court called a citation. If you are served with a *citation*, contact an attorney <u>immediately</u>, if you are not already working with an attorney.

3. **Answer Filed:** Your attorney will file an answer to the lawsuit on your behalf. An answer is a formal written response to the lawsuit. If you do not file an answer by the required date,

the court will award the plaintiff a *default judgment* against you and you will be legally obligated to pay the full amount of the judgment without ever having had an opportunity to put on a defense.

4. **Settlement Attempts:** With your approval, your attorney will contact the plaintiff's attorney to try to settle the lawsuit. You may agree to a settlement even if you know that you are in the right, so you can avoid the cost, hassle and stress of a trial. Your lawyer could opt to make a "qualifying settlement offer" which may force the plaintiff to either accept the offer or risk being forced to pay more litigation costs. (Many unworthy cases are settled for the "nuisance value" which is the price the plaintiff will accept just to go away!)

5. **Discovery:** If you and the plaintiff are unable to reach an out-of-court settlement, both attorneys will begin preparing for trial using the formal discovery process. During that process they'll use one or more of the following tools of *discovery* to gather the facts needed to build their cases:

- **Interrogatories.** Interrogatories are sets of written questions that you and the plaintiff must respond to in writing under oath.

- **Depositions.** If the plaintiff's attorney deposes you, you will be asked a series of questions outside of court that you also must answer under oath. A court reporter will create a written record of the questions and your answers. The deposition may also be videotaped. Your attorney may depose the plaintiff and both attorneys may depose other people (including "experts") who are believed to have information that would be helpful to the case. This is a very explosive and expensive part of the lawsuit process.

- **Requests for Production.** Both attorneys may use these formal written requests to obtain documents related to the lawsuit.

- **Requests for Admissions.** A series of formal written statements sent by one side in a lawsuit asking the other side to confirm or deny the accuracy of each statement.

- **Subpoenas.** Written notices issued ordering someone to appear for questioning on a certain date either in court or outside of court. Subpoenas are also used to obtain documents.

6. **Pre-Trial Motions:** Both attorneys will file pre-trial motions in response to issues in the lawsuit and there will be hearings in front of a judge on each motion.

7. **Mediation:** The attorneys will continue trying to resolve the lawsuit outside of court. If they cannot find a solution that satisfies you and the plaintiff, the attorneys will recommend (or the court may order) that the case go to mediation, which is a non-court dispute resolution process. During mediation, a trained mediator will facilitate a discussion between you and the plaintiff with the goal of helping identify a mutually satisfactory resolution to the dispute. The mediator will not take sides. (It's not unusual for courts to refuse to give a court date to the parties in a lawsuit until they have attempted mediation.)

8. **Trial Set:** If mediation does not work, one of the attorneys will ask the court to set a trial date. Years have often passed before a trial date is set.

9. **Trial:** At the start of the trial, the two attorneys will select a jury, if you or the plaintiff ask for a jury trial. A judge will decide the outcome of the trial otherwise. In the past, potential jurors came from the voter registration rolls because it was assumed that registered voters were more responsible citizens and thus would make better jurors. Now, however, jurors come from driver license records, which in the opinion of many legal experts, has lowered the quality of juries.

10. **Testimony:** During the trial, each attorney will have an opportunity to question witnesses and present other evidence. You and the plaintiff may both have to take the stand to testify and you may be cross-examined by each other's attorney.

11. **Judgment:** After all of the evidence has been presented and both attorneys have made their closing statements, the judge or jury will announce a verdict. The verdict may come on the same day that the trial ends or sometime later. If you lose the lawsuit, the judge will tell you how much you must pay to the plaintiff – the judgment. In certain types of lawsuits, you may also be ordered to pay the plaintiff's attorney fees and expenses. Assuming you have adequate insurance, your liability insurance may cover everything, but if it does not, you will have to come up with the difference between the amount of the judgment and the amount that your insurance company pays.

12. **Request for New Trial:** If the trial was a jury trial, the losing side may ask the court to reverse the jury's verdict by filing a *Motion for Judgment N.O.V.* Otherwise, the losing side will probably file a motion to request a new trial. There will be a hearing on whatever motion is filed.

13. **Appeal:** If you appeal the verdict, you must pay a special bond to ensure that the plaintiff will not try to enforce the court's judgment during the appeal process. Post-judgment interest will also begin to be added to the amounts you owe!

14. **Asset Seizure:** If you lose your appeal, you must pay the full amount of the court's judgment plus interest. If you do not, the judgment creditor can try to collect its judgment from your personal assets. For example, it may put liens on one or more of those assets. If that happens, you will not be able to transfer the assets, sell them or borrow against them until you have paid the full amounts of the liens. Eventually, if you do not pay the judgment, the judgment creditor can *foreclose* on the lien and force the sale of the assets.

Analysis 1.2. The Actions of Your Minor Children Could Cost You

Texas law says that if you are the parent of a minor child, you have a duty to control that child and to provide him/her with *reasonable discipline*. If you do not and your child damages someone else's property, you can be held personally liable for the damage. Specifically, you can be sued for:

- The negligent acts of your minor child, if those acts are *reasonably attributable* to your failure to exercise your parental responsibilities. For example, you allow your underage daughter to drink at your home and then drive her car and she ends up wrecking someone else's vehicle.

- Your child's *willful and malicious conduct*, if your child is between ten and seventeen years of age. For example, your child trashes a hotel room where he is attending an after-prom party. Texas law, however, limits a parent's financial responsibility for such conduct to actual damages of no more than $25,000 per act plus attorney's fees and court costs.

You could also be found liable for *negligent entrustment* if you provide your child (or anyone else) with a dangerous *instrument* and someone is harmed by it. For example, even though you know that your 19 year-old son is a bad driver, you let him drive your car and he causes a serious auto accident, or even though you know that your son has a bad temper and can be violent, you let him borrow your handgun and he shoots someone with it.

Analysis 1.3. Beware of Asset Protection Scams!

Rather than working with a reputable estate planning attorney who has experience helping individuals protect their assets, some people fall prey to asset protection scammers who promise a lot but do little more than take their money. Here are examples of some of those scams:

- **Asset Protection Seminars.** Although some asset protection seminar organizers are on the up and up, others charge attendees a bundle of money for what amounts to little more than an opportunity to buy worthless do-it-yourself asset protection kits.

- **Pure Trusts.** This is a widespread scam. A pure trust may also be marketed as a business trust, constitutional trust, common law trust, patriot trust, or as a foreign common law trust. Sellers of these trusts claim that once you have transferred all of your assets to the trust, the assets will not only be shielded from your creditors, and, in addition, also you will never have to pay taxes again on any income the assets may generate for you. By the way, in an effort to collect unpaid taxes, the IRS is very aggressive about going after these kinds of trusts.

- **Under Reporting Income.** Asset protection planners or consultants who recommend that you under-report your income to the IRS or not report it at all. If the IRS discovers what you have done, you will owe the agency all of the taxes you did not pay plus interest and penalties. Also, you may be charged with tax evasion, which is a federal crime.

- **Secret Offshore Accounts.** The IRS moves very aggressively against secret accounts held in Switzerland, the Caribbean, and other tax havens. If you have such an account, you could be required to pay stiff fines and penalties. You might face jail time, and the account assets that you thought were completely safe will be at risk. Only a carefully crafted offshore trust will adequately protect your property.

"I'm bankrupt, but am
suing <u>several</u> wealthy individuals."

NOTES

Chapter 2.

Simple Ways to Protect Your Assets

You will learn about the simplest tools you can use to protect your assets in this chapter. Those tools include:

- Taking full advantage of the property exemptions provided by Texas law.

- Having the right types and amounts of liability coverage.

- Negotiating a prenuptial agreement before your marriage.

- Working out the terms of a postnuptial agreement after your marriage.

The chapter also explains how each technique works and its limitations.

Take Advantage of Property Exemptions

One of the easiest ways to protect your assets is to maximize your use of the property exemptions you are entitled to under Texas law. As you learned in the previous chapter, with some exceptions, an *exempt asset* is one that a creditor cannot take from you to satisfy a judgment it has against you.

Every state has a list of the types of assets it treats as exempt. The list of exemptions available to residents of Texas is especially generous. The federal government has its own list of exemptions which applies when a person files for bankruptcy. Some states, however, including Texas, let debtors choose between the federal exemptions and their state exemptions when they file for bankruptcy.

The discussion of property exemptions in this section of the chapter reviews the various exemptions you are entitled to in Texas and highlights actions you can take to maximize the benefits you receive from them. At the end of the discussion, Analysis 2.1 summarizes how the federal bankruptcy code will affect the exemptions you are legally entitled to should you file for consumer bankruptcy (or should your creditors put you into bankruptcy).

Please see ***Analysis 2.1. How the Federal Bankruptcy Law May Affect Your Exemptions****.*

The Homestead Exemption

In Texas, your *homestead*, or primary residence, is exempt from most creditor claims, regardless of whether the home is worth a hundred thousand dollars or is a multi-million dollar mansion. In other words, with a very few exceptions, claimants cannot put a lien on your homestead or force you to sell it to satisfy any claims they have against you. The *When Your Homestead is Not Protected* section of this chapter explains which claimants *can* take your homestead and under what conditions. Texas law does, however, place limits on the geographic size of the homestead you can exempt. You can fully exempt:

- An urban homestead with as much as ten acres of land on one or more contiguous lots and all improvements on the land, regardless of whether you are married or single. In other words, if your urban homestead is larger than ten urban acres, the additional acreage is *not* exempt.

- A rural homestead of 200 acres of land or less for a family or up to 100 acres of land for an individual.

Tip: Your homestead exemption applies if you rent out your home temporarily.

Tip: If you sell your homestead, a creditor cannot seize the sales proceeds for six months after the official date of the sale. The protection *only* applies if you invest the funds in a new primary residence for yourself. During those same six months, avoid mixing the sales proceeds with any non-exempt funds you may own, like the money in your bank account. Otherwise, you may unintentionally turn the sale money into a non-exempt asset.

When Your Homestead is Not Protected

Although your homestead is fully protected from most creditors, you will put it at risk if you fall behind on your mortgage, home equity loan, or home equity line of credit. That's because your home secures (collateralizes) such debts. If you fall behind on the payments you are obligated to make on these types of debts, you should expect the creditor to go after your homestead eventually. Your homestead will also be at risk if you do not pay the property taxes that you owe on it, if you fall behind on your income taxes, or fail to keep up with any homeowners' association dues you may be obligated to pay. Similarly, a home improvement contractor who follows all the right steps may also put a lien on your homestead if you fail to pay for that work.

If you believe that you may be at risk for losing your homestead, get in touch with a consumer bankruptcy attorney immediately. The attorney will review your situation and may advise that you file for bankruptcy. The bankruptcy will stop all creditor collection actions and give you time to determine what to do about the debt your home secures.

> **Warning: Read Analysis 2.1** for the affect of bankruptcy on your homestead.

Other Texas Property Exemptions

Texas law offers many other property exemptions in addition to the homestead exemption. They include:

- **Personal Property -** your vehicle, jewelry, clothing, home furnishings, athletic and sporting equipment, a burial plot, health aids, two horses, mules or donkeys, a saddle, bridle and blanket for each, 12 head of cattle, up to 60 of other types of livestock, 120 fowl (no kidding!), and pets.

- **Life Insurance -** The present or cash value of the life insurance policy and any proceeds you may receive as the beneficiary of a life insurance policy.

- **Annuities -** Any commercial annuity (but not "charitable or private annuity).

- **Support -** Any court-ordered spousal support and maintenance payments you may be receiving.

- **Wages -** Your earned but unpaid wages, unless you owe past due court-ordered child support.

  Warning! Your wages may be garnished (seized) if you fall behind on your court-ordered child support and/or spousal support obligation, your federal taxes, or your federally-guaranteed student loan payments.

- **Retirement Accounts -** The funds in your Individual Retirement Accounts (IRAs) – traditional and Roth – as well as the money in your SEP (simplified employee pension), if you are self-employed. Federal law also exempts all Employee Retirement Income Security Act (ERISA)-qualified retirement plans you may be participating in, including 401k and 403b plans, pension benefits, profit sharing plans and other types of tax-deferred, employer-sponsored benefits.

Warning! Only the contributions that were tax deductible are protected.

Warning! The money in your retirement account is generally not protected once the funds are distributed.

Tip: Retirement funds are lawsuit protected when they are inherited by someone after your death in Texas.

- **529 Accounts -** The funds in any prepaid college savings plans you set up for your children or grandchildren.
- **Tools and Vehicles -** The tools of your trade, like farming or ranching vehicles, implements and tools, equipment, motor vehicles and boats, and books.
- **Benefits -** Federal benefits like Social Security payments, Veteran's benefits, Railroad Retirement benefits, military annuities, and survivor benefits, among other federal benefits.

Warning! Although federal law exempts Social Security benefits from seizure, it does not protect those payments from seizure by federal government agencies, like the IRS. However, there is a limit on how much the IRS can take from each of your Social Security checks.

Maximizing Your Exemptions

The attorney you hire to prepare your asset protection plan should make sure that you take full advantage of all of the property exemptions to which you are entitled. Among other things, your attorney should suggest that you:

- Turn your nonexempt assets into exempt assets, if possible. For example, your attorney may recommend that you use the cash in your bank account, which is not exempt, to purchase a cash value life insurance policy or an annuity, or that you invest the cash in your retirement account (up to the deductible limit).

- Maximize the amount of equity you have in your homestead by paying down your mortgage with cash and/or by paying off the outstanding balance on your home equity loan or home equity line of credit (HELOC).

- Make annual gifts of money to your children or grandchildren by contributing to their prepaid college plans. Not only will you be protecting your assets and helping your children or grandchildren fund their college educations, but you will also be reducing the size of your taxable estate, which will help minimize the amount of money you may owe to the IRS when you die.

- Maximize your participation in tax-deferred retirement plans.

- Purchase additional liability insurance.

Transfer Property Out of Your Name

Another way to protect certain types of assets is to transfer their ownership out of your name and into the name of someone else. For example, you may decide to give your daughter the title to your lake house and your son the title to your sailboat. Once you do, any creditors trying to collect from you should not be able to take those assets because you no longer own them.

> **Warning!** If you transfer one of your secured assets to someone else, the lien on that asset does not go away and could trigger a foreclosure or repossession!

> **Warning!** Any transfer after a claim against you is pending, expected or threatened could be a fraudulent transfer and be voided by a Court.

Although making someone else the legal owner of your property may seem like a good idea, it has some significant drawbacks. For example:

- You will give up the legal right to control the assets you give away.

- You may disagree with how the new owner manages the assets, which could create friction or even a rift between the two of you. For example, you give your daughter your lake house with an agreement that you would be able to use the house whenever you wanted while you are alive. After the gift, if you don't like the way she redecorates the house, or she decides to turn the house into a rental property or sell it you would not be able to stop her.

- The new owners could lose the assets you've given them to their own creditors. For example, your son defaults on a large line of credit and as payment, the bank takes the sailboat you gifted to him.

Warning! Gifts can also trigger Gift Taxes!

Another way to get an asset that you want to protect out of your name is to transfer it to an asset protection trust, which is a type of irrevocable trust. As you will learn in Chapter 3, however, asset protection trusts are not right for everyone, and they have drawbacks as well.

Purchase Liability Insurance

Homeowners insurance and auto insurance are the two most common types of liability insurance. (You will learn about other kinds of liability insurance later in this chapter.) Liability insurance protects you when you are responsible for injuring someone or for damaging his or her property. For example, a guest at your home falls down the wobbly staircase leading to your patio and is hospitalized with a broken back, or a large tree in your back yard falls into your neighbor's yard, ruining his fence, crushing his lawn furniture and badly damaging the roof on his home.

Liability insurance pays the costs associated with injuries or accidents covered by a policy, up to a maximum dollar amount, less the policy deductible. The items covered may include replacing or repairing damaged property, medical and rehabilitative expenses associated with an injury you have caused, the lost wages of the injured party, and so on. If you are sued because of an accident or injury, your liability insurance will also pay for the cost of your defense and for any judgment the court may order you to pay up to the value of the policy if you lose the lawsuit. Without insurance, you would have to pay these costs yourself.

> **Warning!** It is not uncommon for judgments in lawsuits to exceed the maximum coverage provided by a basic liability policy. If a court orders you to pay more than the maximum your liability insurance covers, the judgment creditor may look to you to pay the excess.

> **Tip:** The essence of good asset protection planning is driving the settlement value of a lawsuit down to the amount of insurance that you carry and then let the insurance company pay the claim. The *Stowers Doctrine* is a Texas legal tenet that protects you from your own insurance company if it acts unreasonably in refusing to settle a lawsuit against you.

*Please see **Analysis 2.2** for a discussion about **The Stowers Doctrine and Your Liability Insurance***

Liability Insurance Has Its Limits

There are limits regarding the kinds of damages that a basic homeowners or auto liability insurance policy will cover. For example:

- A basic auto liability policy won't cover any damage done to your *own* car in an accident that you cause or any injuries you may suffer as a result of the accident. Also, the policy won't cover any damage done to your vehicle that is not the result of a collision – a dead tree limb falls on your car badly denting its roof and hood and breaking its front window, for example. You'll need *collision and comprehensive insurance* to get those problems covered.

- A basic homeowner policy protects you from losses that are caused by fire, lightning, storms, hail, vehicles and theft, among other things. However, most basic homeowner policies written in Texas do not cover damage caused by:

    - Floods or earthquakes
    - Termites and other insects
    - Rats or mice
    - Continuous water seepage
    - Pipes that froze while your home was unoccupied unless your home was heated or the water was turned off when they froze
    - Done to your landscaping by wind or hail
    - That is the result of normal wear and tear on your home
    - That occurs while your home is unoccupied for at least 60 days

Read your homeowner and auto insurance policies carefully so that you know exactly what these do and do not cover. If you do not understand something, call your insurance agent. Also, be sure that you understand the specific type of homeowner insurance you have – actual *cash value* or *replacement value* insurance. In the event of a loss, if you have actual cash value coverage, your insurance company will pay you the amount of money it is going to cost to repair or replace your home and its contents in today's market, *after* depreciation. In other words, you will receive the equivalent of what you could get for your home and its contents if you sold them at the time of your loss (sometimes garage sale prices). On the other hand, if you have replacement value insurance – the better and more expensive type of insurance – your policy will pay you however much it will cost to repair or replace your home and any of its contents without taking depreciation into account. Compared to actual cash value coverage therefore, you will receive more money for your loss.

If you own assets like fine jewelry, fine art, computer equipment, a rare stamp or coin collection, and so on, you can purchase additional insurance for those items over and above what your basic homeowner policy provides. The additional coverage is referred to as an *endorsement*.

In addition to making certain that you have the right kinds of liability insurance, it is also important to be sure that you have the right amount of coverage. Being under-insured could be devastating to your finances, while paying for more insurance than you really need is a waste of money. Consult with your insurance agent to confirm that you have right amounts of coverage.

You and your agent should also review your insurance coverage on a periodic basis to ensure that you continue to have the right mix and amounts of insurance. Over time, your insurance needs may change. For example, the value of some of your assets may increase or decrease, you may gain or lose assets; you may give some of your assets away, receive an inheritance, and so on.

Tip: Talk with your insurance agent if you begin working at a new job that puts you at greater risk for a lawsuit. The agent may recommend that you purchase professional liability insurance. For example, if you begin working as a physician or a dentist, you'll need malpractice insurance, a special kind of professional liability insurance that is discussed in Chapter 4.

Warning! If you serve on any board, corporate or non-profit, directors and officers insurance is advisable. "D & O" insurance is discussed in Chapter 4.

Purchase an Umbrella Policy

Umbrella insurance is a kind of liability insurance that provides additional coverage over and above that provided by your basic homeowner and auto policies – usually between $1 million and $5 million of additional coverage – for a relatively small premium cost. It also pays for court expenses that may exceed what your regular policy covers. In other words, an umbrella policy acts as an insurance safety net. Here's an example of how it works: *You cause a two-car accident and the passenger in the other car is seriously injured. Although your auto policy provides you with $500,000 worth of coverage, the injured party's medical expenses amount to $850,000. Therefore, your basic liability policy pays the first $500,000 of the $850,000 and the remaining $350,000 is covered by your umbrella policy.* Without the second policy you would have had to come up with the $350,000 yourself. Also, if you were sued over the car accident and the plaintiff won a $1.2 million judgment against you, your regular policy would pay the first $500,000 of that judgment and the umbrella policy would pay the balance, or $700,000.

> **Warning!** Your umbrella policy will probably not cover you against punitive damages or intentional actions. It is also unlikely that it will cover any business-related liability you may incur. For example, if you have a home business and someone is injured on your property while making a delivery to your business, an umbrella policy may not cover that liability.

Other Kinds of Insurance You May Need

Life can be full of unexpected and sometimes very expensive problems so there are other kinds of insurance you should purchase. They include:

- **Health insurance.** Having adequate insurance is essential given the cost of being hospitalized, treated for a chronic illness or injury on an outpatient basis as well as the cost of prescription drugs. In fact, unpaid medical bills are one of the leading causes of personal bankruptcy. If you do not have employer-provided insurance, talk with your insurance agent about purchasing individual coverage.

> **Warning!** Medical providers, including doctors and hospitals, have become much more aggressive about collecting past due medical bills. This means that if you have any unpaid medical bills, those past due accounts are likely to be turned over to debt collectors who may sue you for the money you owe. If they win, they will go after your unprotected assets.

- **Disability insurance.** Disability insurance replaces a portion of your lost income when you are unable to work because of a serious illness or injury. Without it, you may have to deplete your assets to pay your bills and living expenses. If you have disability insurance through your employer, read the policy carefully so you understand when the policy payments will kick in and how much they will be. You may want to purchase an individual policy that complements the group policy. If you do not have employer-provided disability insurance (or are subject to a possible lay-off) or if you are self-employed, it is a good idea to purchase an individual policy.

  Warning! According to the US Census Bureau, you have an estimated one in five chance of becoming disabled during your lifetime.

- **Long-term care insurance.** Long-term care insurance covers the cost of care in a nursing home, assisted living facility or with some policies even the cost of at-home assistance to provide for day-to-day living tasks, such as dressing, bathing, eating, and so on. Traditional insurance plans, including Medicare, do not cover these expenses. Therefore, without long-term care insurance, the costs of your care could put a substantial dent in your estate, leaving much less of it for you to pass on to your surviving spouse or partner, your children, and so on. Long-term care insurance is sometimes referred to as "net worth" insurance.

Protect Your Assets With a Prenuptial Agreement

Texas is a community property state. This means that if you are married, ordinarily you and your spouse each have an equal undivided one-half interest in any assets either of you may acquire and any income either of you earns during your marriage. Those assets and income are referred to as *community property*. This is true regardless of whose name is on the title of the account or other asset.

The assets that you bring to your marriage, that you acquired in a non-community property state, that you inherit while you are married, or that are gifted to you during your marriage, are your separate property. However, in Texas, any income or dividends earned while you are married, will be considered community property, and your spouse could be entitled to a portion of it should your marriage end. Also, if you commingle your separate assets with the assets that you and/or your spouse earn during your marriage, you may have unwittingly "changed" all or a portion of your separate assets into community property unless you can prove which of those assets still represent your separate property by "Clear and Convincing Evidence" (a very expensive and often impossible undertaking).

> **Warning!** All property owned by either spouse is presumed to be community property.

In the event of divorce, one of the biggest challenges is determining each spouse's portion of the assets. As noted above, making that determination could be very costly, especially if your divorce is contentious. Also, an asset that was acquired in a non-community property state that would have been community property had you been in Texas when you acquired it, is deemed to be community property in a divorce proceeding. Furthermore, the final outcome of the dispute could dramatically impact your post-divorce finances, possibly leaving you with far less to live on and pass on to your heirs than you had before your divorce. These same types of problems can occur at the death of a spouse, particularly if there are stepchildren involved.

One way to avoid these and other asset-related problems that might develop from a divorce or death is to anticipate and resolve potential problems before you marry by negotiating a legally binding prenuptial agreement with your future spouse. Among other things, you can use a prenuptial agreement to:

- Ensure that the separate property each of you brings to your marriage will remain your separate property in the event of your divorce or deaths.

- Predetermine the community and separate character of any assets either or both of you may acquire during your marriage or of any income you may earn rather than allowing those assets or income to be divided between the two of you according to Texas community property law should your marriage end or should you predecease your spouse.

- Make certain that the control, ownership and management of your family business will stay with your family if you and your spouse get divorced.

- Re-characterize assets that are your separate property into your spouse's separate assets to protect them from the impact of any potential claims against you. You might do this, for example, if you are a doctor, a dentist, an attorney or some other type of profession at high risk for being sued personally. Chapter 4 discusses professional liability lawsuits. This strategy works because your spouse's separate property cannot be seized if a judgment is rendered against you.

  Warning! If you divorce, the court will be unable to award you those assets because they are your spouse's separate property.

- Decide ahead of time how you will handle debts and taxes from your marriage should you and your spouse get divorced.

- Ensure that certain assets you own will go to your children from a previous marriage in the event that you predecease your spouse. If your spouse ended up with those assets he or she might be free to leave them to whomever he or she wanted, including his or her own children, rather than yours.

  Tip: It is especially important for older people who are remarrying and bringing significant assets to their new marriage to have prenuptial agreements.

  Warning! Approximately 50% of all marriages end in divorce. The rate is even higher for second and third marriages.

Making Your Prenuptial Agreement Legally Valid

You and your future spouse will negotiate the terms of your prenuptial agreement and both of you must agree to everything in it before the agreement can be finalized. Also, your prenuptial agreement may not be legally valid (binding) in Texas unless:

- You and your future spouse are both represented by attorneys. You should never share an attorney.

- You both enter into the agreement freely without feeling any pressure or duress to agree to certain terms.

- You both fully disclose all of your assets and debts to one another.

- The agreement is fair to both of you.

- The agreement is in writing.

> **Tip:** The closer to the date of your marriage that you sign, the greater the likelihood that the validity of the agreement will be challenged.

> **Tip:** It is a good idea to get your prenuptial agreement notarized, although Texas law does not require it.

Protect Your Assets With a Postnuptial Agreement

A postnuptial agreement is very similar to a prenuptial agreement, except that it is negotiated after you are married. You and your spouse can use a postnuptial agreement to:

- Change the nature of all, or some, of your income and assets, i.e. turn community property into separate property, or separate property into community property.

- Define the terms of your possible separation or divorce.

- Amend your prenuptial agreement.

- Decide how any existing and future debts and taxes from your marriage will be paid.

The requirements for a legally valid postnuptial agreement mirror those that apply to prenuptial agreements in Texas. For example, you and your spouse should be represented by your own attorneys, even if all the attorneys do is review what the two of you work out on your own. Also, the agreement must be fair to both of you, and neither of you can have pressured the other to sign it.

> **Tip:** A postnuptial agreement that divides your current and/or future community property and income into the separate property of one spouse and that protects one spouse's assets from the creditors of the other is referred to as a *partition agreement*. A postnuptial agreement that takes separate property and converts it to community property is called a *transmutation agreement.*

Analysis 2.1. How the Federal Bankruptcy Law May Affect Your Exemptions

If you develop serious financial problems and file for personal bankruptcy (or if your creditors put you into bankruptcy), you will not lose all of your assets to your creditors. This is because you will be able to exempt some of those from your bankruptcy, and if you owe any secured debts, you may be able to hold on to your collateral (the assets that secure those debts) by *reaffirming* the debts. When you reaffirm a debt you agree to continue paying on it. However, the federal bankruptcy law puts limits and restrictions on some of the exemptions you are entitled to. Although you should meet with a consumer bankruptcy attorney to find out whether bankruptcy is the right option for you and to learn exactly how you will be affected by the new limits and restriction if you do file, here are highlights of how the law affects many key exemptions:

- Your homestead will not be fully or immediately protected unless you purchased it at least three years and four months (a total of 40 months) prior to the start of your bankruptcy. If you file before you have reached this milestone, any equity you may have in your homestead that is in excess of $125,000 (as adjusted for inflation) will not be exempt. (This rule does not apply to farmers.) Also, the

$125,000 cap is not applicable to any money you may have invested in your homestead that you received from the sale of your previous homestead, assuming you purchased that other residence outside the 40-month period. However, the bankruptcy court may agree to increase the $125,000 cap if an increase is *reasonably necessary* to support you and your dependents. If you want such an increase, your bankruptcy attorney must formally petition the court for it and prove why it is necessary.

- You will receive no protection beyond the $125,000 cap if you have been convicted of a felony for abusing the bankruptcy system or if any of your outstanding debts are related to violations of federal securities or civil RICO (Racketeer Influence and Corrupt Organizations) laws. The same is true if you purchased securities through fraud, deceit or manipulation or if sometime during the five years preceding the start of your bankruptcy, your conduct caused someone to suffer serious physical injuries.

- If you moved to Texas sometime during the two years prior to the start of your bankruptcy, the state exemptions you are entitled to will be based on where you were living during the six months immediately preceding the beginning of the two-year period. So, for example, if you were living in New York during those six months, you would be entitled to that state's exemptions, not the exemptions available in this state, even if you were living in Texas when you filed. But, if you lived in Florida for one year during the two-year period, moved to Texas and filed for bankruptcy one year later, you won't be eligible to claim the exemptions in either Florida or Texas. Instead, the exemption law of the state where you were living for the larger portion of the six-month period before you moved to Florida will apply.

- There are limits on how much of the funds in your traditional IRA, you can protect if you are in bankruptcy. A 401k and 403b plan is fully protected.

- Generally, the funds in an education IRA (or some other tax-deferred retirement plan that benefits your child/stepchild or grandchild/step-grandchild) are exempt in bankruptcy, but there are exceptions.

- Any entity that you may have created to protect your assets prior to the start of your bankruptcy – an asset protection trust for example – may be subject to scrutiny by the bankruptcy court, assuming that the entity was created during the 10-year *look back period*, i.e. during the ten years before your bankruptcy began. At least one court has ruled that this applies to a domestic asset protection trust which is discussed in the next chapter.

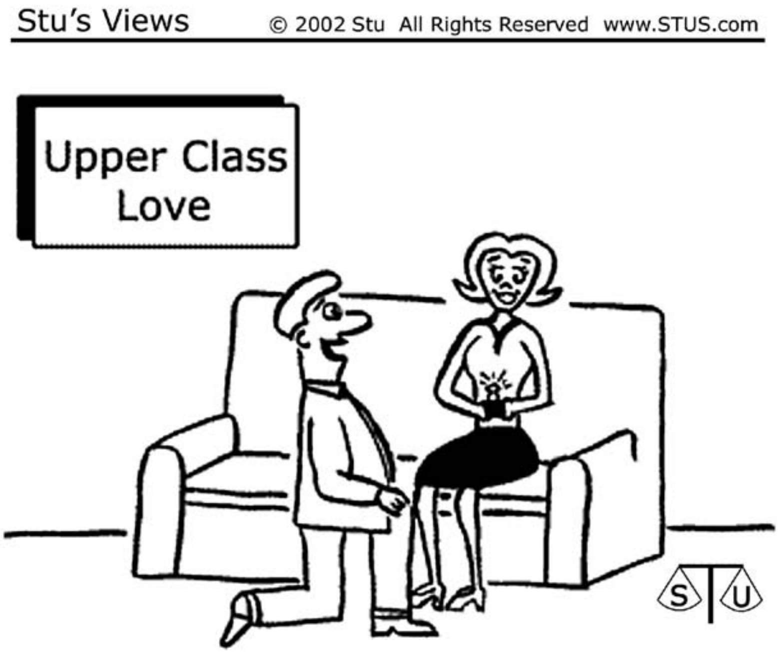
Analysis 2.2. The *Stowers Doctrine* and Your Liability Insurance Company

The *Stowers Doctrine* is named after an important legal case in Texas, *Stowers Furniture Co. v. American Indemnity Co.* The doctrine creates an incentive for insurance companies to pay claims within policy limits. Under the doctrine, a plaintiff makes a "Stowers" offer if the plaintiff in the lawsuit offers to settle her claim against the insured within the limits of the liability insurance policy After a Stowers offer has been made, if the insurance company refuses to pay the settlement amount, (which causes the lawsuit to move forward), then the insurance company must pay the full amount of the judgment against the insured even if the damages exceed the policy limits. The rationale behind this doctrine is that if an insurer does not agree to settle a claim when a plaintiff is willing to settle within the limits of a policy, the company is not acting in good faith. Therefore, the doctrine encourages insurance companies to settle and avoid lawsuits.

Here is a true story that helps illustrate the power of the Stowers Doctrine: *A man was driving his car and obeying all of the traffic laws when he hit a pedestrian who had walked out in front of him. Although all witnesses to the accident agreed that the pedestrian was at* *fault, the pedestrian sued the driver for well over $10 million, which happened to be the driver's net worth. (In preparation for the lawsuit, the pedestrian's attorney had hired a private detective to investigate the driver's assets.) At the time of the accident, the driver had $5 million worth of umbrella liability insurance, which proved to be his salvation.*

The driver's insurance company had three options for responding to the lawsuit. It could have written the driver a $5 million check – the amount of the driver's insurance; it could have defended the driver in court; or it could have settled the case and avoided a trial. The company decided to allow the lawsuit to move forward and defend the driver.

After much time consuming discovery (and sleepless nights), the two parties in the lawsuit went to mediation to try to resolve their differences in an effort to avoid a trial and during mediation, the plaintiff in the lawsuit (the pedestrian) made a Stowers Offer. In other words, the pedestrian offered to settle the case within the limits of the driver's insurance, or for $5 million, and the insurance company decided to accept that offer. By doing so, the insurance company avoided the imposition of the Stowers Doctrine, and the possibility that it might have had to pay far more than $5 million should the lawsuit have moved forward and the plaintiff had won a much larger judgment.



"Of course you can consult with your attorney."

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CHAPTER 3.

ADVANCED ASSET PROTECTION PLANNING

Depending on the types and size of assets that you own, the degree to which you are at risk for being sued, and your asset protection goals, your attorney may recommend that your asset protection plan include one or more advanced planning tools in addition to at least some of the simpler tools that are described in Chapter 2. For example, your attorney may recommend creating a Limited Liability Company (LLC) or a Family Limited Partnership (FLP).

Your attorney may also suggest setting up a domestic or an offshore asset protection trust. However, only a limited number of states have adopted legislation allowing for the creation of a domestic asset protection trust. Further, there are only a handful of countries outside the U.S. where you should form an offshore asset protection trust.

This chapter introduces you to each of these advanced asset protection tools and explains their benefits as well as their limitations and drawbacks. If you want to know more about any of these tools or if you want to know if any of them are right for you, consult with a board certified estate planning attorney.

Protecting Your Family Assets

A LLC or a FLP are two excellent asset protection options for your family assets when you want to ensure that you and your spouse can continue to benefit from the assets while you are alive and that other generations of your family can benefit from them for years to come. Of the two, a LLC is the simple and less expensive type of entity to establish. Therefore, a LLC is generally your best choice when your assets are relatively modest. For example, if you own a couple of rental properties or small oil and gas leases, and/or an investment account and their combined total is less than $1 million, a LLC may be an appropriate choice.

When you own more substantial assets, a FLP may be a better choice. This is because FLPs have been used much longer than LLCs, so they are more time tested and that fact alone may provide your family with greater protection. Limited partnerships have been used in this country since the 19th century, while the first state law providing for LLCs was passed in 1977.

Similarities Between LLCs and FLPs

Although there are differences between a LLC and a FLP, they share many of the same characteristics. For example, both asset protection entities will help:

- Protect your family assets from the repercussions of a divorce within your family. You get this protection by including in the document establishing your LLC or FLP a provision stating that the ownership interests that are gifted to your family members cannot be transferred outside your family.

- Protect your family assets from any court judgments against you, or against any of the other *members* (owners) of your LLC or *partners* (owners) of your FLP. The general rule is that a judgment creditor cannot try to enforce its judgment by seizing any assets that are held by one of these entities. Instead the creditor must ask the court for a *charging order*, which only entitles the creditor to satisfy a judgment by taking any distributions from the LLC or FLP that might be made to the person who has the judgment against him/her. Under that circumstance, you can prevent the creditor from receiving *anything* from the LLC or FLP simply by not making any distributions.

- Reduce the size of your taxable estate for estate planning purposes by making annual gifts of interests in your LLC or FLP (not the actual assets that are in those entities) to your children and/or grandchildren without your losing control of the assets in the entity. See Chapter 4 for more information on Limited Partnerships and LLCs.

To help illustrate the value of putting your family assets in a LLC or a FLP (in combination with purchasing substantial amounts of liability insurance) here is an example based on an actual situation that happened to someone who did neither. (The name and specific details have been changed): *Dr. Smith was a successful cardiologist. He owned $7 million in assets, but only had a $1 million umbrella policy. He anticipated that those assets would take care of his needs and those of his wife while they were alive and that once they were both deceased, their children and grandchildren would benefit from the assets for years to come. Although his attorney had repeatedly advised him to put his assets in a FLP and to purchase additional liability insurance, Dr. Smith ignored those recommendations. Then one evening, disaster struck. Dr. Smith was at a party, had a few too many drinks, decided to drive home, and ended up causing a deadly car accident that killed two teenage sisters. The parents of the girls sued him for the value of his estate. Dr. Smith's insurance company wrote him a $1 million check (the amount of his umbrella policy) and walked away because it had fulfilled its obligation to him with the check. Meanwhile, because he had not followed the advice of his attorney, Dr. Smith faced the possibility of losing nearly everything that he and his wife owned.*

In the end, luck was not on Dr. Smith's side. He lost the lawsuit and the court ordered him to pay the girls' parents $7 million – the amount they had asked for. Although Dr. Smith had the $1 million that the insurance company had paid him, he had no other means of coming up with the remaining $6 million he owed other than to liquidate most of his assets, leaving he and his wife with a far smaller *estate than they had enjoyed before the lawsuit. Sadly, if Dr. Smith had followed his attorney's advice, his assets would have been protected from the court's judgment and he would probably have had enough insurance to cover the amount of the judgment.*

> **Warning!** Never mix safe assets, (like stocks, bonds, mutual funds, and so on) with risky assets (usually real estate) in the same LLC or FLP. It's always best to put risky assets in one LLC or FLP and safe assets in another. Also, if you own different types of risky assets, each class should be in its own separate LLC or FLP.

Setting Up and Managing a LLC

If you and your spouse decide to set up a LLC, the two of you can be its only members; alternatively just one of you can be a member. You can also add your children as members. If you do add your children, you can structure the company so that you may continue making all decisions related to the assets you have transferred to the LLC, including when, and if, the income of the LLC will be distributed to the other LLC members as well as the amount of those distributions. (This chapter assumes that those other LLC members are your children although other individuals could be members too.) If you would like, you can involve your children in the management of the LLC to take advantage of any special skills or knowledge they may have and to help prepare them to eventually manage the assets without your active involvement.

All of your LLC's members personal assets will have limited personal liability protection for any claims against the LLC itself. The only way a claimant can try to take a member's personal assets, would be if the member individually created the risk – for example, the member drove a vehicle owned by the LLC and injured someone in a wreck. In that case both the LLC's assets and that member's personal assets would be at risk in the subsequent lawsuit.

Setting Up and Managing a FLP

Due to the personal liability concerns, your attorney will probably recommend that you make a limited liability company or an irrevocable trust the FLP's general partner with you in control of that LLC or trust. Irrevocable trusts are discussed in the following section of this chapter. Corporations are discussed in this book's next chapter.

> **Warning!** If you and your spouse are "individual" general partners of a Family Limited Partnership, you will have unlimited personal liability for any lawsuits arising from the assets held inside the FLP. Therefore, if a judgment is entered against the partnership and the claimant cannot satisfy it by going after the FLP's assets, including collecting from its insurance, the claimant can try to collect the judgment by going after *your* personal assets. For this reason, an entity is used as the general partner and, although it's assets could be seized, that entity holds very few small assets.

Transfer Your Assets to an Asset Protection Trust

A trust is usually viewed as an entity that you (or you and your spouse) set up to hold assets for the benefit of one or more individuals, who are referred to as the trust *beneficiaries*. When you set up a trust you are referred to as the *grantor (settlor/ trustor/ trustmaker)* and the person (or company) that you designate to manage the trust assets according to your written instructions is called the *trustee*.

A trust can be revocable or irrevocable. If you establish a revocable trust, you can serve as your own Trustee and beneficiary, change the terms of the trust whenever you like, add or remove assets from the trust, change beneficiaries, and cancel or *revoke* the trust at any time and for any reason. Unfortunately, the assets in a revocable trust <u>will not be protected</u> from your creditors.

Under Texas law however, those same assets would be protected if they were transferred to an irrevocable trust for the benefit of someone else – your children, for example – but not for your own benefit. In many cases, if you transfer the assets to an irrevocable trust, you may no longer have the right to control them or serve as trustee; the trustee of the trust will control them although you can retain the right to replace the trustee. With careful planning, however, your adult child (and even your spouse) can be the trustee of a trust you create for them.

> **Tip:** If you transfer a FLP, LLC or some other type of business entity to a trust, those assets in the entity will continue to have whatever asset protection the law provides even if owned by a revocable trust.

An asset protection trust is a specific type of irrevocable trust. It can be a domestic asset protection trust (DAPT) or a foreign (or offshore) asset protection trust. A very limited number of states have passed laws allowing for the creation of a domestic asset protection trust. At the time this book was written those states were: Alaska, Delaware, Idaho, Missouri, Nevada, New Hampshire, Rhode Island, South Dakota, Tennessee, Utah and Wyoming. However, you do not have to be a resident of one of these states to set up an asset protection trust there.

If an asset protection trust is located offshore – outside the United States – the laws of the country where the trust exists govern it. Many offshore trusts are set up in Nevis or the Cook Islands. The trustee of an offshore trust must either be a resident of the country where the trust is located or qualified to do business in that country.

> **Warning!** Offshore trusts are not used as frequently as DAPTs because many people are reluctant to have their assets controlled by an entity that is located in a foreign country.

In addition to being irrevocable, an asset protection trust in some states (but not in Texas) is technically referred to as a *self-settled, spendthrift trust*. The term *self-settled* means that you are both trustmaker and beneficiary of the trust. In other words, you set up the trust by putting your assets into it *and* you are the trust beneficiary. The term s*pendthrift* means that there is a clause in the document creating your asset protection trust directing the trustee to use the trust assets and income for the health, education, maintenance and support of the trust beneficiary, but prohibiting the transfer (voluntary or involuntary) of any of the trust assets or income to someone else. Therefore, if there were a judgment against you sometime after the trust was set up, the trustee would be prohibited from giving any of the trust income or assets to the judgment creditor. More importantly, a court may not order the trustee to deliver the assets to your creditor.

> **Warning!** Do not attempt to set up your own asset protection trust. The help of a board certified estate planning attorney is essential. Otherwise, the trust may not do what you intended and you may be in for an unpleasant surprise if you are sued, lose the lawsuit and then your assets as a result.

> **Warning!** If you file for bankruptcy after you have funded a domestic or offshore asset protection trust, the bankruptcy court will view with suspicion any transfers you may have made to the trust during the ten years prior to the start of your bankruptcy. It will be up to you to prove to the court that you did not make those transfers with the goal of defrauding your creditors. If the bankruptcy court decides that you were trying to defraud your creditors, the assets you transferred to the trust during the ten-year look-back period will be included in your bankruptcy and you could lose them as a result. (At least one court has held that a Domestic Asset Protection Trust could be breached in bankruptcy.)

Domestic Asset Protection Trust

The laws in states that allow for the establishment of a domestic asset protection trust (DAPT) vary somewhat, but in general they all:

- Require that the trust be irrevocable.
- Prohibit the trustmaker from controlling the trust assets. In other words, you cannot be the sole trustee of the trust.
- Require that whomever you designate as a trustee be a trust company or a resident in the state where the trust is located and that at least some of the trust assets also be located there.
- Require that distributions from the trust be made at the discretion of the trustee. In other words, you cannot demand that any distributions be made to yourself or to anyone else.
- Prohibit fraudulent transfers into the trust.
- Limit the amount of time your creditors have to challenge any transfers you make to the trust.
- Require you to swear under penalty of perjury that you are currently solvent (able to pay your debts as they become due).

> **Tip:** In some states with laws permitting the establishment of a DAPT, the trust can be used to protect your assets against the claims of a future spouse. In

> these states, if you were to remarry and one or both of you did not want a pre-nuptial agreement, a DAPT would be an alternative means of protecting your assets from the claims of your spouse should your marriage end in a divorce.

A unique aspect of a DAPT is that if the trust assets are threatened, rather than any trust income or principal going directly to you, the trustee can use the trust assets to purchase items or make payments for you – pay your mortgage or your rent, for example.

Here is an example of how a DAPT can be an effective tool for protecting your assets against the claims of future creditors: *David is a successful OB-GYN who practices medicine in Texas. David knows that OB-GYNs are one of the most frequently-sued kinds of doctors. Although he is excellent at what he does, David worries about being sued and possibly losing all or a portion of the stocks in his considerable portfolio given that stocks are not exempt assets in Texas. After talking over his options with his estate planning attorney, David decides to protect that portfolio by establishing a DAPT in Delaware, one of the states with a law providing for the establishment of that kind of trust, and transferring his stocks to the trust. David likes the idea that as the trustmaker, he will be able to remove the trustee of his DAPT if he wants, and that he will also be able to direct his investments, receive income and principal from the trust while he is alive, and determine what will happen to the trust assets after his death. David also feels more comfortable transferring his stocks to a trust located in another state rather than to a trust in a foreign country.*

*Please see **Analysis 3.1** for a diagram on how a **DAPT** works.*

Offshore Asset Protection Trust

In the early years of asset protection planning, the offshore trust was one of the few tools available to planners. However, over the past several years, the laws surrounding offshore trusts have added substantial complexity to their use, resulting in their diminished appeal. Furthermore, for a variety of reasons, the use of an offshore trust, which is often formed in such jurisdictions as the Cook Islands, Nevis, the Cayman Islands and the Isle of Man, carries a substantial price tag.

Although an offshore asset protection trust is more complicated and expensive to create and fund than a DAPT, when you compare the benefits and protections offered by each type of trust, you may decide that an offshore trust is worth the additional cost and hassle. For example, here are some of the distinct advantages of an offshore trust:

- Countries that permit offshore trusts don't recognize money judgments that have been handed down by U.S. courts. Therefore, if your assets are in an offshore trust, a creditor who goes to the trouble of getting a judgment against you in this country will have to spend additional money suing you all over again in the country where the trust is located.

- Countries that permit offshore trusts do not allow attorneys to charge contingency fees to represent their clients in personal injury and property damage cases. As a result, their clients must pay their attorneys (attorneys who practice law in the country where the offshore trust is located) an up-front fee, which may make suing you financially out of reach for some of your creditors. Also, if the creditor loses the lawsuit, the creditor can be forced to pay your attorney fees, too.

- The laws in countries that permit offshore trusts are debtor-friendly, so a plaintiff's chances of prevailing in a lawsuit filed in one of those countries is much less certain.

For all of these and other reasons, when your assets are in an offshore trust, a judgment creditor is more likely to decide to settle with you for considerably less than the amount of the judgment it obtained against you in the U.S. However, these protections bring an added measure of burden and risk. For example:

- The IRS has consistently scrutinized the use of offshore trusts. In particular, the IRS is convinced that offshore trusts used in conjunction with LLCs have been used as income tax dodges. In fact, offshore trusts are under such scrutiny that specific questions about them have been added to the IRS Form 1040. While there may be some truth to the IRS's concern regarding offshore trusts and tax dodging, the IRS has imposed a very complex and sophisticated regime for the income taxation of foreign trusts in response to that concern. As a result, the IRS has made the administration of an offshore trust for legitimate asset protection purposes more costly than otherwise necessary.

> **Warning!** Offshore trusts are NOT tax dodges and any income they earn must be fully disclosed to the IRS.

- When assets are put in an offshore jurisdiction, they are subject to the rules of that jurisdiction. This can be of real concern given that in some instances the financial and banking markets of jurisdictions that permit offshore trusts are not as developed and carefully controlled as those in Europe or the United States. Case in point: Alan Stanford of Stanford Financial established his own bank in Antigua, the Stanford International Bank. It was a central tool in Stanford's scheme to defraud his clients, costing them millions of dollars. In a more developed jurisdiction, the banking regulators might have detected such a scheme earlier and been able to prevent many people from losing their life savings.

- Some offshore jurisdictions may be subject to political instability. For example, as some of you may remember, American deposits in Cuba were confiscated when Castro seized control of that country in the 1950s. Almost none of the confiscated deposits were returned to the rightful owners.

- The asset protection value of an offshore trust is only as powerful as the resolve of the trustmaker. This is because although U.S. courts do not have jurisdiction over the Trustee of an offshore trust as discussed above, they do have jurisdiction over the U.S. trustmaker who establishes the trust. In some cases, for example, a court may be willing to order the trustmaker to tell the trustee to return assets, and in those instances, if the trustmaker refuses to do so, or is unable to do so because of the trust terms, he may face the wrath of the court. Generally, this means the trustmaker may be held in contempt of court because he or she had the ability to comply with the court order, but did not do so. Being found in contempt of court is a serious matter because the individual can be fined and spend time in jail. Moreover, unlike actual criminal penalties, the trustmaker may be held in contempt of court indefinitely. Consider the case of Beatty Chadwick, an extremely successful Philadelphia attorney, who held a large portion of his estate offshore in Gibraltar. During his second divorce, he refused to turn over information about his holdings to his wife's attorney despite a court order to do so. In 1995, the court held that Chadwick was in contempt of court and he was jailed. Even so, Chadwick continued to refuse to turn over the information. Fourteen years later, in 2009, he was released and held to be no longer in contempt of court. So, although his planning worked because Chadwick was able to keep the assets in his offshore trust out of his divorce, the planning cost Chadwick a large portion of his life as a result of a sentence that was longer than many felony sentences.

Although the costs may seem high, the flexibility and protections of an offshore trust are very attractive to many people. Although there is some difference among jurisdictions, the flexibility and protections of an offshore trust generally include the following:

- You can be the trustee of the trust in some jurisdictions, but you will need to designate another trustee in the country where your trust is located with the understanding that if any claims against the trust assets are anticipated, the trustee will fire you and begin managing the assets.

- You can benefit from the trust and you can even be its only beneficiary.

  Tip: Your trust document should not *require* the trustee to distribute any funds or assets from the trust to you or to any other beneficiaries. This is because any distributions that are made will be fair game for your creditors. As with a DAPT, however, the offshore trustee *can* pay your expenses and purchase items for you that remain owned by the trust.

- You can combine your offshore trust with such domestic asset protection entities as a FLP or a LLC. Doing so can provide more protection for assets like real estate that are located in the U.S.

- Your trust document can provide for a *trust protector* and spell out the powers of the protector. (A few states permit trust protectors as well.) Typically, the trust protector — someone you are personally close to, and not a bank or trust company — will be responsible for ensuring that the trust is managed responsibly and that its assets are protected. Generally, the trust protector can:

- Fire the trustee, if necessary. Some countries allow a trust protector to appoint a new trustee when this happens.
- Restrict distributions to a beneficiary if the trust protector has reason to believe that a distribution from the trust to that beneficiary is at risk of being seized.
- Move your trust to a different legal jurisdiction in order to take advantage of any legal differences in that jurisdiction that would work to the advantage of the trust and its assets. For example, it would be appropriate to move the trust if one of your creditors files a lawsuit against you in the jurisdiction where the trust is located.

• An offshore trust will provide you with a significant amount of financial privacy.

While an offshore trust presents you with many complex choices, its value lies in its separation from the American legal system, which can be very attractive if you believe that the legal system in this country is out of control and fear that you could lose much of your wealth as a result of a lawsuit. While the veracity of this concern is subject to debate, an offshore trust *does* provide you with a means of opting out of the American legal system to some degree. In any event, an offshore trust provides an additional obstacle to your creditors, making it all the more likely that if one of them sues you, the creditor will settle for less.

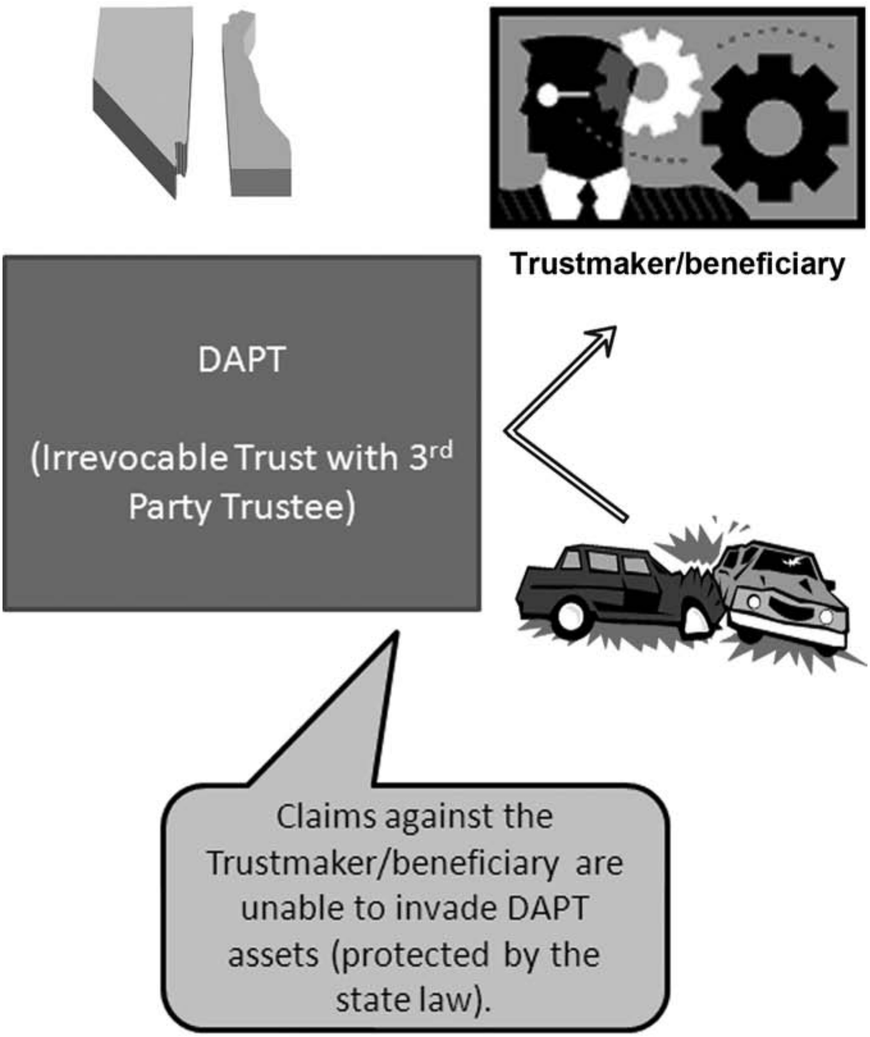
Tip: The key to any successful asset protection plan is to reduce any settlement to the amount of liability insurance available.

*Please see **Analysis 3.2** for a diagram on how **Offshore Trusts** work.*

Analysis 3.1

DAPT
Domestic Asset Protection Trust

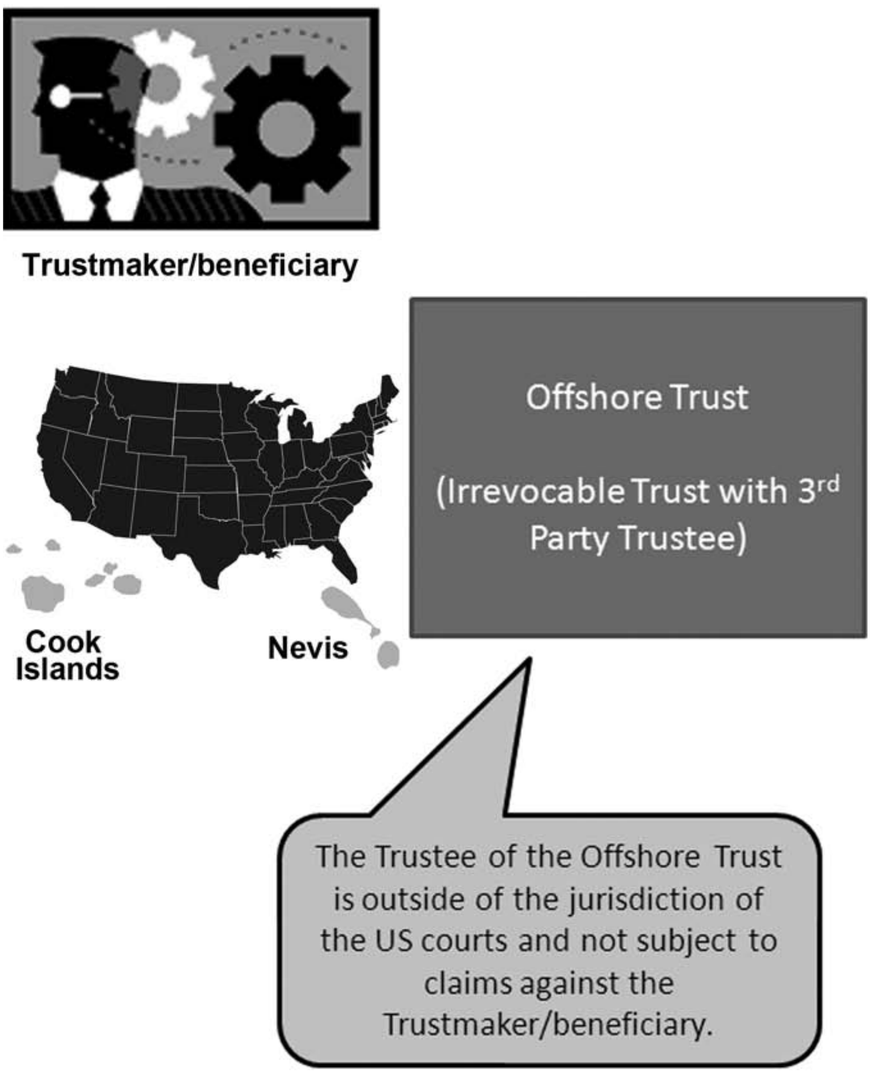
A DAPT uses the law of a state that allows creditor protection for self settled trusts



Analysis 3.2

Offshore Trusts

An **Offshore Trust** relies on the trustee being outside of the jurisdiction of US courts.



NOTES

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CHAPTER 4.

PROTECTING YOUR ASSETS:

BUSINESS OWNERS, PHYSICIANS, AND OTHER PROFESSIONALS

You face special asset protection risks if you own a business, real estate or are a physician or other professional. This chapter begins by highlighting those risks. It then describes how the right legal structure for your business or practice can help minimize those risks and protect your personal assets from any judgments and claims against your business. It also explains which structures will help protect your business from the loss of its own assets because of a judgment against you or against one of your co-owners.

The chapter also introduces you to two concepts you should understand when you are choosing a structure for your business. The *Veil of Limited Liability* is one of those concepts; there is more detail later in this chapter about what the veil of limited liability is and when it can be lifted. The other concept, which is also discussed below, is the difference between *Inside and Outside Asset Protection*.

*Please see **Analysis 4.2, Analysis 4.3, and Analysis 4.4** for diagrams on how **Inside and Outside Liability** works.*

Having the right kinds and amounts of insurance is another key component of an effective asset protection plan when you are a business owner, physician or other professional. Therefore, the last part of this chapter reviews the various types of insurance you need.

Unique Asset Protection Risks of Business Owners, Physicians, and Other Professionals

Owning a business or a professional practice is a risky proposition for many reasons, including the fact that these businesses are especially vulnerable to lawsuits. For example, there are a wide variety of potential types of plaintiffs that might decide to sue your business or practice for one reason or another. Those potential plaintiffs include your patients, customers, clients, employees, and suppliers, as well as other businesses. Examples of reasons why your business might be sued include:

- Your business defaults on a debt that it owes, or violates the terms of a contract it entered into.

- A water spill in one of your stores is not cleaned up and a customer is badly injured after slipping on the spill and falling.

- The son of one of your customers is injured by a product that was improperly installed at the customer's home.

- Some people become violently ill after eating at your restaurant.

- One of your employees alleges that her manager sexually harassed her and that although she reported the problem to her manager's supervisor, the harassment was allowed to continue.

- Someone you did not hire for a job claims that he did not get the job because you discriminated against him.

Not only is it possible that your business could be found liable for such problems, but you could also be held personally liable as a business owner for any judgments unless you have structured your business (and your personal assets) to limit your liability. (This is true even if you are only a partial owner of a business.) Furthermore, even if you have insurance, it may not protect you in some instances. For example, if one of your employees injures someone while working for your business and the injured person is able to prove to the court that the injury happened because you were *negligent in your hiring* or *supervision of the employee*, you could be held personally liable for the harm that the employee caused.

You could be found negligent in your hiring if the plaintiff in the lawsuit proves that you failed to exercise the appropriate amount of care that a *reasonably careful person* would use when you hired the employee who caused the injury. Here is how that could happen: while delivering flowers for your floral business, one of your delivery people slams into the back of the car in front of him, totaling that car and sending the other driver and her passenger to the hospital with serious injuries. If you had checked the employee's driving record before you hired him to deliver flowers, you would have learned that a couple of years ago, he had been previously responsible for causing two serious auto accidents and even had his license suspended after receiving too many speeding tickets.

You will be found negligent in your supervision if the plaintiff can prove that you did not exercise the care that a *reasonably careful person* would use in overseeing an employee's work. By way of illustration, let's imagine that you own a plumbing company and send an apprentice plumber to install a water heater at a customer's home. The customer later suffers third degree burns on his body when the water heater explodes. During your trial, the plaintiff's attorney argues that you were negligent because you did not send an experienced plumber to accompany the apprentice to ensure that the water heater was installed properly.

Given that you can be found personally liable for such problems regardless of how your business is structured, it's essential that you protect yourself by:

- Running credit and criminal background checks on any job applicant you are considering hiring.

- Drug testing potential employees who will be operating equipment or driving vehicles for your business. Periodic drug testing once such employees are hired is advisable, too.

- Checking references.

- Providing new employees with adequate training and supervision and furnishing other employees with regular training to help them keep their knowledge and skills up-to-date.

- Implementing a mechanism for controlling/checking the quality of work your employees do for your customers or clients.

- Conducting regular employee performance reviews.

- Following up promptly on any complaints/issues that may arise related to an employee and addressing them as necessary.

- *Documenting everything*.

If you are a medical doctor, you may also be held personally liable for any malpractice committed by a medical professional in your employ, such as another doctor, a nurse or a lab technician. For example, a young doctor who is working for your pediatric practice calls in the wrong prescription for a sick child he is treating and the child suffers two seizures as a result. Or, a new surgeon in your orthopedic practice makes an error during an operation on a teenager which causes him to have limited mobility for the rest of his life and lose a sport's scholarship for college. A good malpractice insurance policy will help protect you from such risks. Malpractice insurance is discussed later in this chapter.

> **Warning!** If you *personally* create the problem, your business entity *will not* shield you from personal liability; so it is important to always have your non-business assets protected too.

> **Warning!** *Accounts receivables* often represent a significant portion of a medical practice's value, and are *not exempt* from seizure under Texas law. Special planning must be utilized to ensure that these are properly shielded.

Business Structures That Do Not Limit Your Personal Liability

Organizing your business as a sole proprietorship or a general partnership provides absolutely no protection for your personal assets. Zippo! Steer clear of both organizational structures. In other words, your personal responsibility for any judgments against your business will be unlimited if it is structured as a sole proprietorship or a general partnership. In the worst case scenario, your business' problems could cause you to lose your personal assets and even force you to file for personal bankruptcy.

Sole Proprietorship

A sole proprietorship is a one-person business. It is easy and inexpensive to begin and to operate. All you need to do to run your business as a sole proprietorship is to start acting like you are in business, and register the name of the business with the counties in which it will operate.

There is a steep tradeoff for such simplicity, however, and the trade-off is that you are 100% *personally* liable for every single aspect of your business – its debts, contracts, the decisions and actions of your employees, and so on. Why? Because when you operate your business as a sole proprietorship, there is no legal distinction between you and the business – you are one and the same. Therefore, it is you, not your business, who enters into contracts, takes on debt, hires and fires employees. This means that if someone sues your business, it will be you that they actually sue because in the eyes of the law your business will not exist. And, if the court awards a judgment against you in a lawsuit, the judgment creditor will try to satisfy the judgment by going after your business and personal assets.

General Partnership

A general partnership is a business with at least two owners, both of whom are referred to as *general partners*. Like a sole proprietorship, there are no state-required legal formalities for organizing a business as a general partnership. In other words, if you and your two best friends begin operating a restaurant together and share in its profits and losses, the three of you are in a general partnership, unless you have structured the business some other way.

When your business is a general partnership, you and your partners are each 100% personally responsible for all of its liabilities and you are each 100% personally liable for one another's business-related actions and decisions. This is known as *joint and several liability*. For example, if one of your partners goes on a wild spending spree with your company's American Express card and incurs more debt that the partnership can afford to repay, and assuming the partner is unwilling (or unable) to pay the bill himself, American Express is legally entitled to look to you and your partners to pay the full amount of the debt. As general partners, you are each equally liable for all of that debt.

> **Warning!** As a general partner, you are legally responsible for the full amount of any liability your partnership incurs, not just for the amount that you have invested in the business. This is not the case with business structures that limit your personal liability such as Limited Partnerships, Limited Liability Companies and Corporations.

> **Warning!** All partnerships are general partnerships unless they are properly created limited partnerships.

Organizational Structures That Limit Your Personal Liability

This part of the chapter describes organizational structures for your business that will limit your personal liability for claims against it. Those structures include:

- A limited partnership
- A corporation
- A limited liability company

> **Warning!** The term *limited* does not mean that your business has limited liability for its own legal problems, because, in fact, its liability for its debts and other obligations is unlimited. Instead, this refers to the fact that as a business owner, you have limited your personal liability for any claims against the business.

Limited Partnership

Limited partnerships must be established according to the terms of the Texas Business Organization Code. Among other things, in Texas the law requires that you file a *certificate of formation* with the Texas Secretary of State's Office and pay a filing fee. It also says that your limited partnership must have at least one general partner and one limited partner. The limited partner can be an individual, a corporation, a trust, a general partnership, or another limited partnership. A *Family Limited Partnership (FLP)* is a limited partnership whose partners are all members of the same family.

> **Warning!** Two people (or entities) are required to form a limited partnership. A single individual cannot serve as the sole general partner and the sole limited partner.

The general partners in a limited partnership are responsible for managing its day-to-day operations and for making decisions on behalf of the business. They are also personally liable for all of the partnership's debts and any claims against it.

Limited partners, on the other hand, have virtually no right to manage the business or make decisions on its behalf, although they are entitled to review the partnership's financial records and to receive income, capital gains, and tax benefits from the business. Also, their personal liability for any claims against the partnership is limited to what they have invested in it.

> **Tip:** The individuals who would naturally serve as the general partners of a limited partnership can protect their personal assets by setting up a corporation, irrevocable trust or a limited liability company (LLC) and making it the general partner rather than themselves. Alternatively, Texas law allows general partners to limit their personal liability for claims against their business by registering their partnership with the Secretary of State's office as *Limited Liability Limited Partnership*s (LLLP).

> **Warning!** If you are a limited partner, you will lose your limited liability status if one of the partnership's claimants or judgment creditors proves to a court that you have been acting like a general partner; for example, you have been making business decisions for the partnership, which is something a general partner would do.

As you learned in the previous chapter, if there is a claim against you personally and you are a partner in a limited partnership, the creditor cannot try to collect the money it is entitled to by going after the assets owned by the partnership. It must instead get a charging order from the court against your interest in the business. Turn back to Chapter 3 to learn how charging orders work.

Corporation

Like LLCs and limited partnerships, a corporation is a legal identity that is totally separate from the identities of its owner/s. In other words, if you incorporate, the corporation, not you, enters into contracts, hires and fires employees, and is legally responsible, with some exceptions, for paying its debts, any judgments against the business, and so on. Therefore, a corporation provides its owners (the shareholders) with limited personal liability for its obligations. For an explanation of when that limited liability does not apply, read *When Your Corporation's Creditors Can Go After Your Personal Assets* later in this chapter.

You must follow the process that is set forth in the Texas Business Organization Code if you want to incorporate your business. That law requires you to file a *certificate of formation* with the Secretary of State's Office, pay the office a filing fee, establish a board of directors for the corporation, issue shares of stock and adopt written corporate bylaws. The law also details specific rules that your corporation must comply with to remain a corporation once it has been set up, including holding regular board meetings and maintaining written minutes of those meetings.

The rules that apply to corporations make it a more expensive and complex type of business to establish and run especially when compared to sole proprietorships and general partnerships (or even LLCs). Like LLCs and Limited Partnerships when there is a judgment or claim against a corporation, your personal assets are shielded in most instances because creditors, with a few exceptions, must go after the corporation's assets, not yours, to collect what they are owed. That is not the case when your business is organized as a sole proprietorship or a general partnership.

For income tax purposes only, there are two types of corporations: a *C corporation* (the traditional type of corporation) and a S*ubchapter S or S corporation*. For state law purposes there is no difference between an S-Corporation or C-Corporation. Here are brief descriptions of some of the key differences between these types of corporations:

- A *C corporation* files its own tax returns and pays taxes on income it earns. Its owners also report any income they may receive from the business on their own tax returns and pay taxes on that income, too, whether it is salary or dividends. The fact that both the corporation and its owners are taxed on the same income is referred to as *double taxation* and is often seen as a drawback associated with C corporations.

- An *S corporation* files its own tax returns but does not pay taxes itself. Instead, its owners report their share of the corporation's income (or loss) on their personal returns. An advantage of an S corporation is that it avoids the problem of double taxation, but it has its own limitations.

Tip: LLCs have four options for tax elections: a disregarded entity (taxed just like a sole proprietorship), a partnership, an "S" entity or a "C" entity. Limited Partnerships are generally taxed as partnerships, but may be taxed as other forms of business.

When Your Corporation's Creditors Can Go After Your Personal Assets

Under certain circumstances if you are a corporate shareholder, you can be held personally liable for claims against the business. Those circumstances include:

- One of the corporation's creditors *pierces its corporate veil,* generally referred to as the *veil of limited liability*. (See page 94).

- The corporation defaults on a debt that you personally guaranteed.

- The corporation does not live up to the terms of a promissory note or lease that you personally guaranteed.

- The corporation does not pay the IRS the payroll tax dollars that were deducted from the paychecks of its employees. Any "responsible" party can be held personally liable for those unpaid taxes. Responsible parties include a corporation's shareholders, corporate directors and officers.

- You *personally* created the problem from which the lawsuit arose.

- All of these issues can also apply to LLCs and limited partnerships.

> **Warning!** If there is an outstanding claim against you at the time that you incorporate your business, the claimant can try to collect the money it is entitled to by going after your ownership interest in the corporation (your shares of the corporate stock). If that should that happen, and depending on the size of the claim, the creditor could end up controlling your business, assuming that you are the majority stockholder.

Piercing the Veil of Limited Liability

If your business is organized as a corporation, a limited liability company (LLC), or limited partnership, your personal assets are shielded from the company's creditors by the *veil of limited liability*, which is sometimes referred to as the *corporate veil.* Under certain circumstances, however, a tort creditor may be able to penetrate that veil and if it does, your personal assets will be at risk. However, compared to most other states, it is very difficult for a tort creditor to pierce the veil of limited liability in Texas. Generally, the only way the creditor can do that is by proving to the court that:

- You have failed to sufficiently separate your business' financial affairs from your personal financial affairs. In other words, you and the business are essentially one and the same. For example, you deposit company funds in your personal bank account or vice versa; you pay your personal expenses with a business check or corporate credit card; or you use your business vehicle to run personal errands. In such instances, your business may be viewed as your *alter ego*.

Limited liability for your company will be forfeited if it does not file a franchise tax return with the Texas Comptroller each year. If the return is not filed, your company's right to do business will be suspended and eventually the state will revoke the charter of the corporation/LLC/Limited Partnership, putting your personal assets 100% at risk for any claims against it.

Inside Protection versus Outside Protection: What's the Difference?

Some business forms provide *inside* asset protection; others provide *outside* asset protection; and still others provide both types of protection. Sole proprietorships and general partnerships provide *neither*.

A business structure that provides inside asset protection shields your personal assets from claims *against* your business. Both corporations and LLCs do that. Limited partnerships do, too, assuming that you are a limited partner and not an individual general partner in the business.

A business structure that protects your business assets from claims against you personally is described as providing outside protection. Only LLCs and limited partnerships do this. The fact that both provide both inside and outside asset protection helps explain the popularity of these business structures.

Please see ***Analysis 4.2, Analysis 4.3 and Analysis 4.4*** *for diagrams on how* ***Inside and Outside Liability for LLCs and LPs*** *works.*

Here is a diagram on the **Inside and Outside Liability** features of different entities.

	INSIDE PROTECTION	OUTSIDE PROTECTION
Sole Proprietorship	No	No
General Proprietorship	No	No
Corporation	Yes	No
Limited Partnership	Yes (For Limited Partners)	Yes
Limited Liability Company	Yes	Yes

Limited Liability Company vs. Corporation

Organizing a business as a LLC is generally considered to be the best way to shield your personal assets from your business' liabilities, especially if the business owns a dangerous or risky asset, i.e. one that is more prone to lawsuits; like a restaurant, nightclub, retail business, ranch or rental property (as opposed to cash, securities, and the like), which are "non-risky" assets since these cannot cause a lawsuit. To establish a LLC you must file a *Certificate of Formation* with the State of Texas, name Managers or Managing Members, pay a filing fee and adopt a company agreement, which is much like corporate bylaws.

> **Tip:** If you own more than one risky asset, it is a good idea to set up a separate LLC for each one. Also, never mix risky with non-risky assets in the same LLC.

Chapter 3 of this book explained that the owners of a LLC are called *members* and that all members can help manage an LLC without jeopardizing their limited liability. Members of a LLC can be either individuals, a limited partnership, a corporation or a trust, and a LLC can have just one member in Texas.

A LLC has all of the strengths of a corporation without the drawbacks. For example:

- A LLC has its own legal identity, just like a corporation does.

- It is easier and less expensive to set up and operate.

- There are far fewer operating requirements and formalities associated with running a LLC compared to a corporation.

- Your *stock* in your corporation can be *seized* if you are held personally liable in a lawsuit; if your business is a LLC (or Limited Partnership) the Plaintiff will *not* get your ownership, but will only be able to obtain a charging order. Charging Orders were discussed in Chapter 3.

- It is relatively easy to coordinate a LLC with other asset protection strategies. For example, they work well with domestic asset protection trusts, which were also discussed in Chapter 3.

- Although you can be held personally liable for a claim against your LLC if one of its creditors *pierces* its *veil of limited liability*, piercing the veil of an LLC would be extremely difficult to do.

Please see ***Analysis 4.4*** *for a diagram on* ***Outside Liability and Corporations***

Tip: A MUCH BETTER option to owning stock in a corporation is to do a tax free conversion to an "S" LLC if you are an S Corporation or create a limited partnership (or LLC) to own the stock of your "C" Corporation. By doing this, none of your ownership interest will be directly seizable in a lawsuit against you. Unlike a corporation, if there is a claim against a LLC member, the creditor cannot try to satisfy the claim by going after the business' assets. Instead, the creditor must get a charging order against the member's interest in the LLC and charging orders are not easy to enforce as Chapter 3 explained. With a corporation, *all of your stock could be seized which means the creditor would then own your company!*

Warning! If your LLC is not organized according to the requirements of Texas law, it could end up being treated like a sole proprietorship or general partnership, which would mean that your personal assets would be at risk for your business' liabilities. This is a problem that can be created with a "do-it-yourself" LLC.

Warning! Beware of software or "forms" purchased over the internet. Those can cause many problems that are not discovered until it is too late.

Warning! Professional Associations (PA) and Professional Corporations (PC) are treated as corporations for asset protection purposes although the stockholders must possess a certain professional license.

BEST SOLUTION: If you are currently operating your business or practice as a corporation, because all of your stock can be seized if you are held personally liable in any legal matter, convert your "S" corporation to a LLC or transfer your "C" corporation stock owned by a LLC or Limited Partnership right away.

*Please see **Analysis 4.5** for a diagram on **Segregating Multiple Assets***

*Please see **Analysis 4.6** for a diagram on **Multiple Assets in LLCs and Limited Partnerships***

*Please see **Analysis 4.1** for a **Summary of Business Structures and Asset Protection***

The Right Insurance

If you are a business owner, your company or ownership share may very well be your most valuable asset, so it is important that you protect it with the appropriate kinds of insurance. Insurance will not only help you protect your business from judgments and other claims against it, but it may also help protect your other assets from being seized in order to satisfy claims that your business does not pay. This part of the chapter reviews the various types of insurance your business may need, beginning with liability insurance.

> **Warning!** Besides having the right types of insurance, it is critical that your business have enough coverage. Most claimants would rather settle their claims against your business for what its insurance company will pay (assuming that the coverage is available and adequate) than go to the trouble of trying to collect a judgment against your business for the harm or damage it caused.

Liability Insurance

Business liability insurance is essential. This kind of insurance protects your business should you or someone working on behalf of your company (an employee, independent contractor, or student intern, for example) injure someone or cause damage to someone else's property. For example, a customer shopping at one of your retail stores falls and breaks his leg because one of your employees did not clean up a water spill.

Your business should also have property insurance. A property insurance policy will protect it from losses caused by fire, wind, hail, flooding, vandalism, and the like.

The insurance agent for your business may also recommend that it purchase:

- **Multiple Overlapping Liability Policies.** If one of your business' policies does not cover a particular problem, one or more of the other policies may.

- **An Umbrella Policy.** This type of policy will provide your business with liability coverage over and above what its basic liability policy provides.

- **Auto Insurance.** Your business should have auto insurance if you, the other owners of your business, its employees, or anyone else working on behalf of your business drives a vehicle owned by your business.

- **Directors and Officers Insurance (D & O insurance)**. This kind of insurance protects the personal assets of the officers and members of the board of directors of a business or charity from their actions as officers and directors. D & O policies are discussed at the end of this chapter.

Depending on your profession, your business insurance agent may also advise you to purchase malpractice insurance, which is a special type of liability insurance. Malpractice insurance is also known as *errors and omissions insurance* and *professional liability insurance*.

Malpractice Insurance

You need malpractice insurance if you are a physician or some other kind of health care professional, like a dentist, nurse or pharmacist. You need similar insurance if you are an attorney, architect, financial advisor, engineer, accountant, realtor, or some other type of service professional. The insurance for these other types of professionals is generally referred to as *professional liability insurance*.

Malpractice insurance helps protect your personal assets from judgments against you personally because of your professional negligence, errors, or oversights. It should also protect you from being liable for any judgments against your employees or any independent contractors acting on your behalf that are the result of their own professional negligence, errors, or oversights.

> **Warning!** Even if your business is organized as a corporation, LLC, or limited partnership you can be held personally liable for your own malpractice or negligence.

In other words, the personal liability protections that these types of business structures would normally afford you do not apply when you are the person committing the act of malpractice. However, these entities may protect you from being held personally liable for any malpractice that may be committed by one of your co-owners or employees.

> **Tip:** Texas has very strong laws limiting "damages" against medical professionals.

Directors and Officers Insurance

If you are a director or officer of a business or on the board of a non-profit, you assume responsibility – a *duty of care* – for that business. Therefore, unless the business has purchased Directors & Officers (D & O) insurance to protect the members of its board of directors, your personal assets could be at risk if the board is sued for *breach of duty*. (A similar kind of policy is available to the member-managers of LLCs and to the board members of nonprofit organizations.) The lawsuit might be filed by one or more corporate shareholders or by someone else. By way of illustration, the board of directors of a corporation could be sued for mismanaging the business' assets or for not taking appropriate action to resolve a problem related to the business (for example, the board was aware that there had been complaints about a manager sexually harassing the women in his department, but it ignored the complaints or failed to address them in a timely manner). Lawsuits against a corporate board could also arise because the board did not exercise its fiduciary duty to the business – the duty to protect its assets – because of a wrongful termination, for discrimination, for not providing appropriate services, not protecting the rights of minority shareholders and so on. The board of a charity may be held liable for failing to properly supervise an employee who commits embezzlement or misappropriates funds.


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Analysis 4.1. Summary of Business Structures and Asset Protection

TYPE OF BUSINESS	DESCRIPTION	DEGREE OF PERSONALLIABILITY BY OWNER'S FOR
Sole Proprietorship	1 owner; No State requirements to set up or operate	100%
General Partnership	2 or more owners; No State requirements to set up or operate	100%
Corporation	1 or more owners (shareholders); formally created under State law; law also establishes operating requirements for corporations	All owners have limited liability; shares of stock can be reached by creditors if shareholder is personally liable
Limited Partnership (including a FLP)	At least one general and one limited partner; Must register with State	Individual General Partners are 100% liable. (Use LLC as General Partner to limit liability) Limited partners can only lose the amount of their investment
Limited Liability Limited Partnership	At least one general and one limited partner; Must register partnership with the State as a LLLP	All partners have limited liability
LLC	1 or more owners; State requirements for setting up and running are simpler and less expensive than those that apply to corporations	All owners have limited liability; creditors can only obtain charging orders

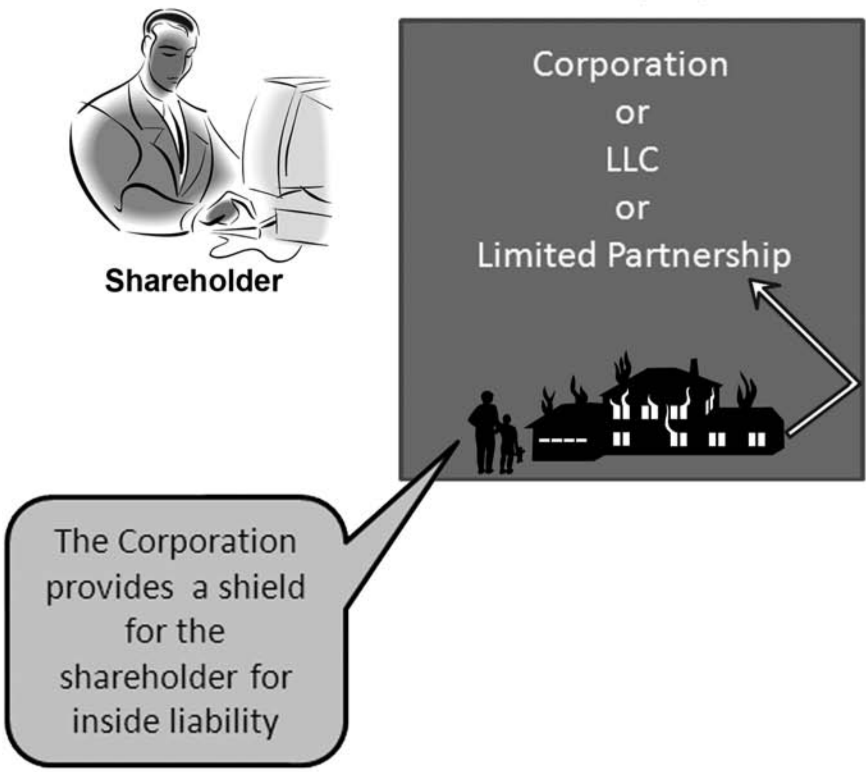
Analysis 4.2

Inside Liability

Inside Liability is a claim that arises from the course and scope of business.

Corporations, LLCs and Limited Partnerships (excluding the General Partner) provide protection for inside liability claims.

The Plaintiff who obtains a judgment may be able to seize all of the assets owned by the entity but cannot “get out of the box” and seize the individual owners’ personal assets including their stock or partnership or membership interests in the company.

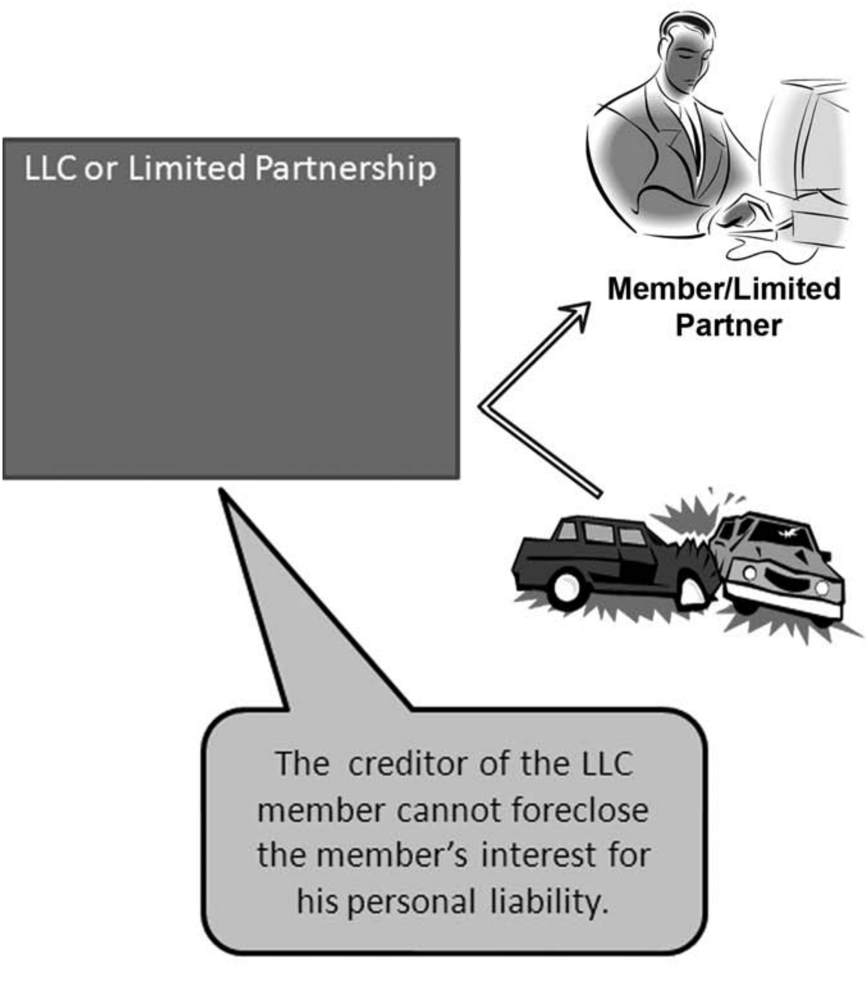


Analysis 4.3

Outside Liability - LLCs & LPs

LLCs and Limited Partnership provide the business owners with "charging order protection."

Charging order protection provides that the owner's interest in the company cannot be seized. The creditor may only receive a charging order or lien.

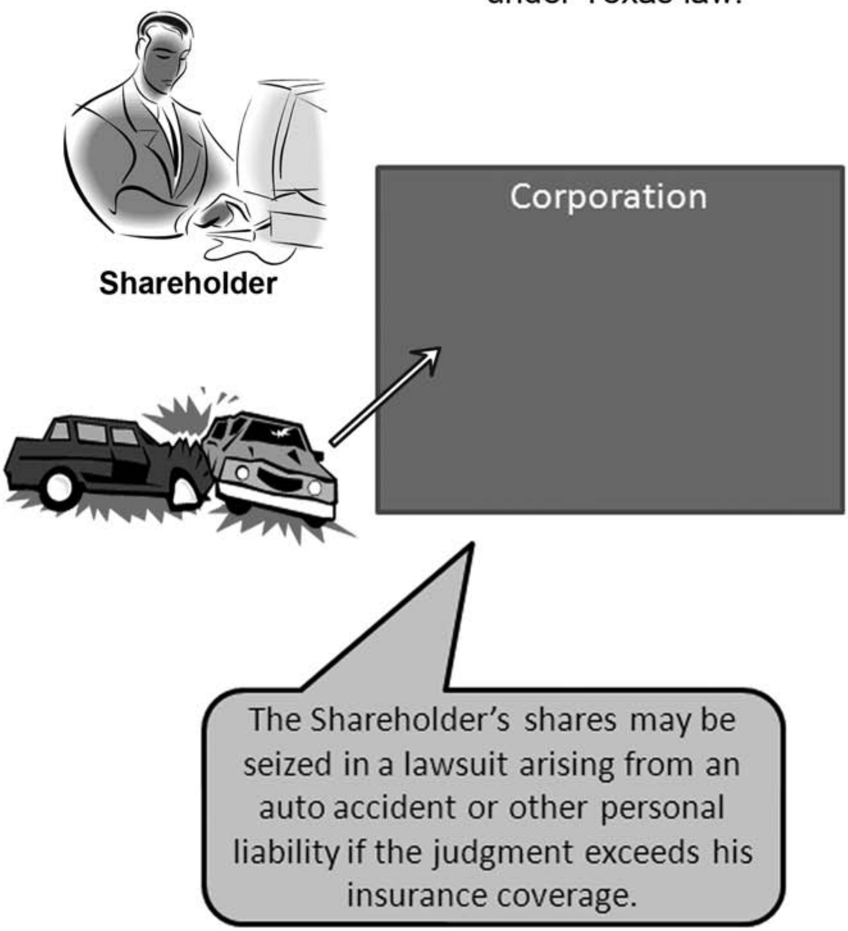


Analysis 4.4

Outside Liability - Corporations

Outside Liability is claim that arises against the business owner for their personal actions.

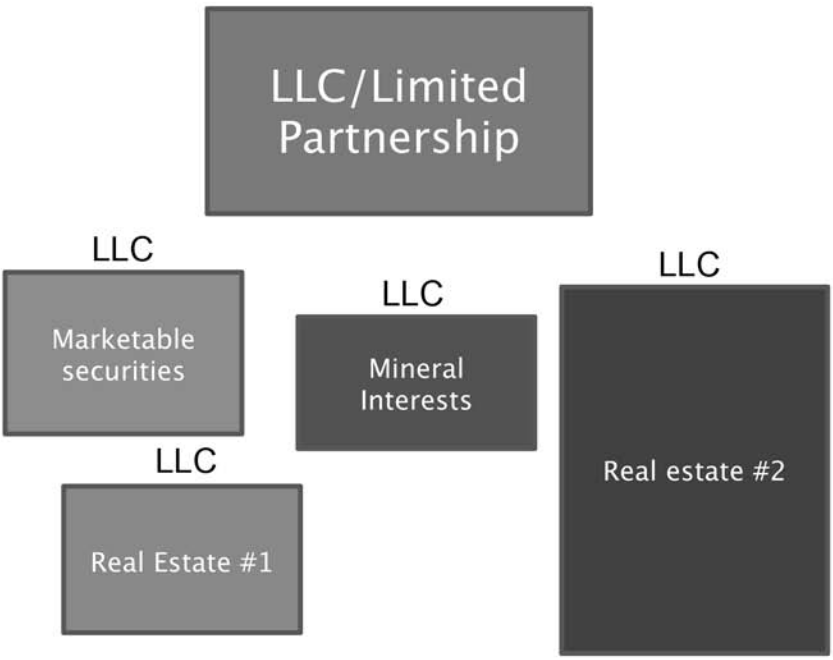
Corporations do not provide any protection for the owner's stock for an outside claim. Stock owned by an individual. Is not a protected asset under Texas law.



Analysis 4.5

Segregating Multiple Assets

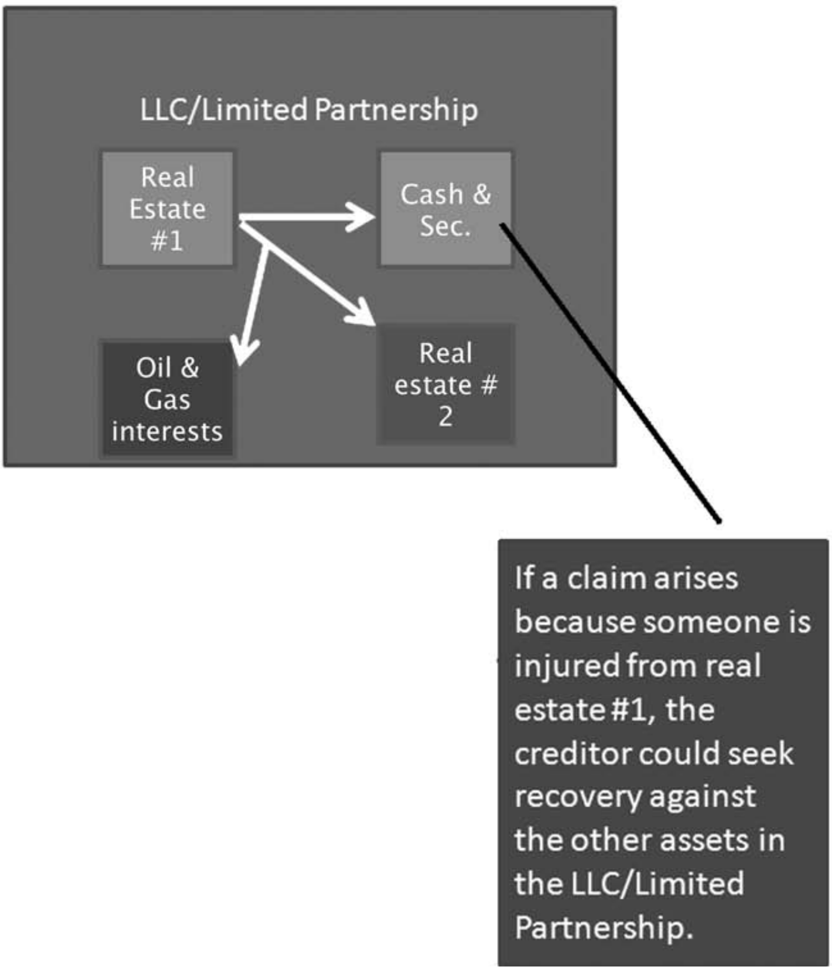
By segregating assets in separate subsidiary LLCs, a claim against any one asset is contained to that asset, and does not affect or “infect” the others.



Analysis 4.6

Multiple Assets in LLC/LP

If a claim arises from one asset in the LLC or Limited Partnership, the claim could spread or infect all the other assets in the LLC or Limited Partnership --none of the other assets in the LLC or Limited Partnership are otherwise protected.



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CHAPTER 5.

PROTECTING YOUR FAMILY FROM PREDATORS

The focus of the previous chapters in this book has been on how to protect your property from **creditors**. This chapter examines potential challenges to your estate by **predators**, particularly those that prey on surviving spouses and children. Such predators could represent the greatest threat that your estate ever faces.

Remarriage Protection

Remarriage after the loss of a spouse can be a very positive experience for many people because the new relationship combats loneliness and can help extend their lives (especially when the surviving spouse is a male). Unfortunately, however, it’s not unusual for a widow and widower to become involved with a predatory gigolo or bimbo, who takes advantage of them. Here is a case in point: a man became involved with a widow after the death of her husband. Her family was concerned because they felt this relationship was unhealthy. At first, the male friend started "fixing" things around her home, but then he moved in with her. Now he has begun using her money (and she has limited means) to buy expensive boy-toys, like boats, RVs, etc. The family is worried about the situation, especially because she is now afraid of the man and does not know how to get rid of him.

According to one commentator, while only one out of ten widows will remarry, a whopping nine out of ten widowers will do so. This statistic is concerning given that widowers tend to be much more vulnerable to predators than widows. The story of Anna Nicole Smith, the Playboy model who married an infirm 92-year-old multimillionaire, is a much-in-the-news example of what can happen when a lonely old man meets a female predator. While the story is sensational, estate planning attorneys hear similar ones quite frequently.

Using a Bypass Trust to Protect Your Estate from Predators

Protecting against the possible loss of an estate as the result of a predatory remarriage is not difficult and careful planning can mean the difference between disaster and your surviving spouse having sufficient assets to live on during the remaining years of his/her life as well as your children receiving a wonderful inheritance. Your planning should begin with the establishment of a bypass trust, which can be inserted into a married person's will or revocable living trust. On the death of the first spouse, the deceased's share of the estate is transferred to the bypass trust for the benefit of the surviving spouse. In other words, all the money is available for the surviving spouse's (and often the children's) health, education, maintenance and support. Only the trustee can sign the checks and only for the purposes outlined in the trust. The surviving spouse can be the trustee of the trust, but can be prohibited from transferring any of the trust assets to his or her new spouse. Using a bypass trust to protect an estate is not foolproof, however, because a creative "replacement spouse" could induce the survivor to secretly transfer assets from the trust to him or her despite the terms of the trust. This transfer may go undetected unless the family of the surviving spouse is very diligent. Often, a third party trustee is added for protection.

> **Tip:** Under tax law, when a bypass trust is created, it cannot hold more than the amount of the deceased spouse's estate tax exemption. If the deceased estate exceeds the exemption amount, an additional trust, called a Marital Deduction trust (sometimes called a "QTIP trust"), is established to bring remarriage and lawsuit protection to all of the deceased's share of the estate.

If you are worried about the possibility of an inappropriate transfer or distribution, inserting a bypass trust into your revocable living trust is a better option than using a will because assets held in the name of the trust cannot be held as Joint Tenancy with Right of Survivorship (JTWROS). When an asset is titled as JTWROS, it is held, with another person, and upon the death of the first owner, all of the money is transferred automatically to the other owner. Such accounts "trump" the terms of a will.

Here is a true story of what can happen when assets are held as JTWROS: Grandmother died and all of the family land was put in a bypass trust. The investment and bank accounts were kept in her grandfather's name. Later, her grandfather remarried but he refused to change his will. He did not want his new wife to get his property because he wanted everything to go to the children from his first marriage. However, his new wife was crafty – she asked to be "put on his accounts" so that she could write checks for his benefit when he could not do that himself. When the grandfather agreed, she set up *all* of those accounts as JTWROS. Later, when the grandfather died, his grandchildren only inherited some fairly worthless land while the new wife took all of his cash and securities!

> **Tip:** Assets in a bypass trust and QTIP trust are generally lawsuit protected for the surviving spouse.

> **Warning:** POD (Payable On Death) and TOD (Transfer On Death) accounts work like JTWROS because on the death of the owner the assets that are held in a POD or TOD account are transferred automatically to the person named on the account. In other words, neither type of account is controlled by the deceased's will or trust!

> **Warning!** Your estate is vulnerable to a predator even if your spouse says that he or she will never remarry, but would consider living (co-habitating) with someone after your death. This is because c*ommon law marriage* is valid in Texas and can be accomplished in a single night!

A good addition to a bypass trust is a requirement in the will or revocable living trust document that your surviving spouse execute a prenuptial agreement prior to a new marriage. If he or she does not sign the pre-nup, then the surviving spouse would be denied access to the deceased's share of the estate, and would no longer serve as trustee of the trust. This option can serve triple duty. First, it gives your surviving spouse an excuse to get a pre-nup drawn up, something that he or she might be reluctant to do otherwise. Second, if your children from your first marriage see the future new spouse as a threat to their inheritance, which often happens, having a pre-nup in place can help smooth over those waters. Finally, the pre-nup requirement may be just enough of a hurdle to make a would-be predator decide to move on to an easier victim.

A much more serious, but less popular way to protect an estate from a predator is to completely cut-off your surviving spouse from any access to your share of the estate after his or her remarriage either by appointing a third person as the trustee of the bypass and QTIP trust of that share on remarriage, or by removing your surviving spouse as a beneficiary of that part of the estate. The fact that your surviving spouse would have no access to your share of the estate would "keep the fox out of the hen house." However, your surviving spouse is apt to view such a provision as too great a loss of control given that during your marriage he or she contributed to the creation of the wealth you enjoyed as a couple.

Protecting Your Children from Predators (and from Themselves)

Thomas Jefferson once said that all men are created equal, but, unfortunately, we cannot say the same for our children. Some are better with money than others, and some are better at marriage than others.

Leaving your children their inheritance in cash, usually at a designated age, is shortsighted estate planning. Some of them may fritter away their inheritance while others could lose what you leave to them as a result of a divorce, lawsuit or a serious financial setback. In fact, millions of inherited dollars are lost annually to such misfortune – misfortune that cannot be predicted. Losing their inheritance because of their own mismanagement or because of a financial reversal or lawsuit can be catastrophic for your children, especially if they were counting on their inheritance from you to help them fund their own retirements.

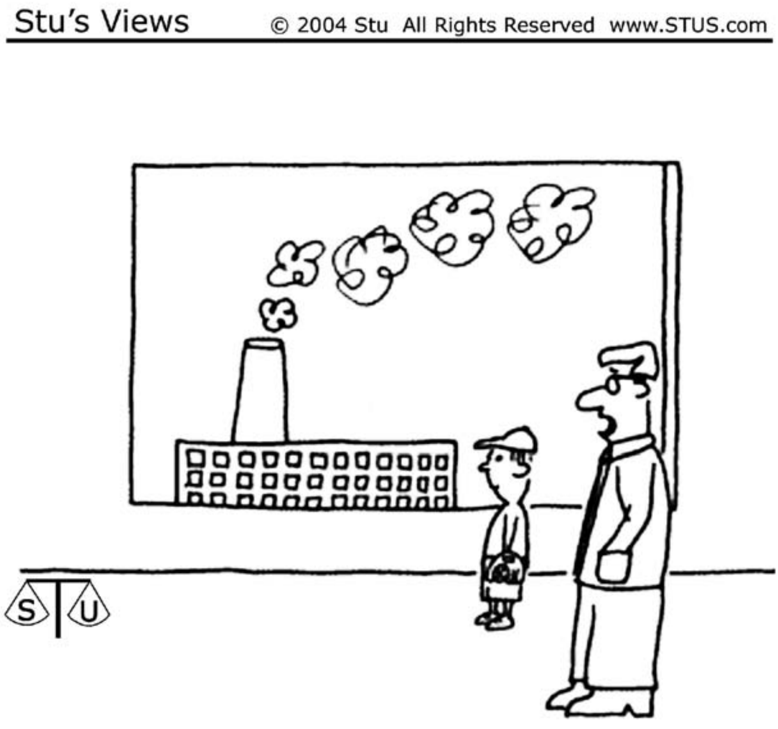
Rather than leaving your children cash, a smarter approach is to put their inheritance in a "spend-thrift" trust. A spend-thrift trust is a trust that is lawsuit protected, divorce protected and bankruptcy protected. It is sometimes called a "checkbook trust" because it works just like a checkbook. On the second death, a separate trust is created for each beneficiary. Properly structured, the assets in the trust generally can be invested anyway that the trustee believes is prudent. The trustee "writes the checks" and can distribute the assets to the trust beneficiary for his or her health, education, support and maintenance. ("Maintenance" is defined broadly enough to mean "maintaining the beneficiary's standard of living.")

In Texas, the beneficiary of a spend-thrift trust can also serve as the sole trustee of the trust, or the "signer of the checks." So, not only can your child have control over the trust assets, but also be protected from a bad marriage, serious financial troubles, or an overzealous plaintiff. However, if your child is not yet a legal adult at the time of your death, has problems with money, or has substance abuse or other addiction problems, a third party trustee can ensure that the trust assets are properly invested and distributed.

> **Warning!** Children with addictions or criminal problems need carefully drawn trusts to ensure that their inheritance does not indirectly cause their demise.

> **Warning!** A child with developmental disabilities needs a carefully drawn Special Needs Trust to avoid the loss of valuable government benefits.

Dynasty provisions are a popular addition to a checkbook/spend-thrift trust document. These provisions allow the assets that you transfer to the trust to stay in your family for decades, and require that the property passes to your grandchildren (not your daughter-in-law or son-in-law) protected from lawsuits, divorce and bankruptcy. Also, if the trust is properly structured, a substantial amount of the assets that pass to each succeeding generation of your family will not be subject to estate taxes. This is the way that many wealthy families keep their assets intact.



"Son, someday
this will all be yours,
unless we're sued."

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GLOSSARY OF TERMS

ANSWER
A written response to the citation you are served with when you are sued.

ASSET
Something of value that you or your business owns. An asset may be tangible or intangible. Examples of tangible assets include physical assets, like vehicles, real estate and office equipment. Intangible assets on the other hand do not have a physical presence, like stocks, bonds, mutual funds, cash, patents, trademarks, copyrights and good will.

ASSET PROTECTION
The process of protecting your assets from seizure by creditors and predators using legal means.

ATTACHMENT
Seizure of property to satisfy a court judgment.

BENEFICIARY
A person who is entitled to distribution from a trust or an estate.

CITATION
A legal document formally notifying an individual or a business that it has been sued.

COMMUNITY PROPERTY
Assets and income that belong to both spouses in a marriage. Generally in community property states, any assets acquired and income earned by either spouse during a couple's marriage is considered community property. Inheritances and gifts are not considered community property. Texas is one of nine community property states.

COMPLAINT – See PETITION.

CORPORATION
A form of business that has a legal identity separate and apart from its owners.

CREDITOR
Someone or something that is owed money by a debtor. The creditor or debtor may be an individual or an entity such as a business, a government agency or a nonprofit.

DEBTOR
Someone or something that owes money to a creditor.

DEFAULT JUDGMENT
A decision for the plaintiff in a lawsuit that is issued when the defendant in the lawsuit fails to appear in court.

DEFENDANT
An individual or entity (business, a government agency or a nonprofit) that has been sued.

DEMAND LETTER
A letter demanding that the recipient take a specific action in order to avoid legal action – pay a debt or live up to the terms of a contract, for example. Usually a demand letter is written by an attorney.

DEPOSITION
Testimony made under oath outside of court by a witness prior to the start of a trial. The testimony is recorded by a court reporter.

DIRECTORS AND OFFICERS (D & O) INSURANCE
Insurance that protects the personal assets of the officers and members of the board of directors of a business or charity.

DISCOVERY
The process of collecting the facts in a lawsuit before the trial begins. Discovery may be informal or formal. It can be a very expensive part of a lawsuit.

DOMESTIC ASSET PROTECTION TRUST (DAPT)
A Self-Settled Trust created in certain states that limits assets that can be seized. See Chapter 3 for more details.

DYNASTY TRUST
A trust designed to protect wealth from lawsuits, divorces and bankruptcy for multiple generations. These can also allow a large portion of the assets to pass estate tax free through those years. These are sometimes called Generation-Skipping Trusts. (See Chapter 5 for details)

EMPLOYEE RETIREMENT INCOME SECURITY ACT (ERISA)
The law that applies to employer-provided retirement, health and other benefits.

ERRORS AND OMISSIONS (E & O) OR PROFESSIONAL LIABILITY INSURANCE
Insurance that protects you or your company if a client or customer holds you liable for the fact that a service you provided (or failed to provide) was deficient in a manner that harmed someone. If you are a doctor, a dentist or some other professional, this kind of insurance is referred to as malpractice insurance.

EXEMPT PROPERTY
An asset that state or federal law says cannot be taken from you by one of your creditors.

401(K)
A tax-deferred employer-sponsored retirement plan that an employer may or may not contribute to. A 403(b) is like a 401(k) except it is only available to employees of non-profits.

FAMILY LIMITED PARTNERSHIP
A Limited Partnership in which all the individual partners are family members.

FOREIGN ASSET PROTECTION TRUST
Often called an "Offshore Trust". See Chapter 3 for more details.

FRAUDULENT TRANSFER
An illegal transfer of money or some other asset out of your name and into the name of someone else.

GENERATION-SKIPPING TRUST – See DYNASTY TRUST.

HOMESTEAD
Your primary residence in Texas. See Chapter 2 for the amount of acreage that can be protected.

INDIVIDUAL RETIREMENT ACCOUNT (IRA)
A tax-deferred retirement account that is set up by an individual and has nothing to do with their place of employment.

JUDGMENT
A court order in a civil lawsuit. It is what orders the defendant to pay money to the plaintiff if the plaintiff wins the lawsuit.

JUDGMENT CREDITOR
A person who is owed money by another person as a result of a judgment.

LIABILITY INSURANCE
Insurance purchased to pay for damages and attorney's fees as a result of an injury to another person.

LIMITED PARTNERSHIP
A legal ownership arrangement designed to limit the liability of each partner.

JUDGMENT PROOF
When an individual's assets are either too small to warrant suing them or are protected in ways that make the assets inaccessible to judgment creditors.

LLC (LIMITED LIABILITY COMPANY)
A legal ownership arrangement designed to limit the liability of each member.

MALPRACTICE
An error on the part of a professional (doctor, CPA, architect, attorney, engineer, etc.) that injures another person.

MEDIATION
A settlement method where a neutral third person helps facilitate an agreement between opposing parties.

OFFSHORE TRUST – **FOREIGN ASSET PROTECTION TRUST**.

PARTNERSHIP
A legal agreement between two or more people to share profits and losses.

PETITION
A legal document that formally begins a lawsuit (it is sometimes called a "**Complaint**"). It states the basic facts of the lawsuit from the perspective of the plaintiff (the initiator of the lawsuit), the legal justification for the lawsuit and the remedy that the plaintiff is requesting.

PLAINTIFF
The person who initiates a lawsuit.

PREJUDGMENT ATTACHMENT
A proceeding where a creditor seizes assets prior to winning a lawsuit.

PROFESSIONAL LIABILITY INSURANCE – See ERRORS and OMISSIONS.

RESPONSE – See ANSWER.

REVOCABLE LIVING TRUST
A trust that is changeable and revocable by the creator of the trust. It does not provide additional asset protection.

ROTH IRA
An IRA that allows tax free withdrawals. These are generally exempt assets in Texas.

SELF-SETTLED TRUST
A trust created by someone to protect their own assets from their own judgment creditors.

SUMMONS – See CITATION.

SUBPOENA
An order to appear in person or to deliver documents to a specific place at a specific time.

TRUST
A legal arrangement where one person (**Trustee**) controls, manages and distributes property for the benefit of another person (**Beneficiary**).

TRUSTEE
A person legally obligated to manage and distribute trust assets for the benefit of the trust beneficiary.

UMBRELLA INSURANCE
Liability insurance that is designed for providing coverage in the event of a large claim; it is typically sold in units of millions of dollars with a $1 million policy being the most common. It supplements your homeowners and auto insurance.

THE ATTORNEYS AT THE WIEWEL LAW FIRM

Brad Wiewel, Board Certified, Estate Planning and Probate Law*

Brad received a B.A. from the University of Illinois in 1974, and graduated from St. Mary's School of Law in San Antonio with distinction (Top 10%) in 1978. Brad teaches in the University of Texas CFP® training program, and has taught continuing education classes to CPAs at St. Edward's University. He also conducts education programs for financial service and insurance professionals. In addition, Brad has been a featured legal columnist for the Austin American Statesman. Brad is a graduate of the Advanced Studies in Wealth and Estate Strategies sponsored in conjunction with Michigan State University and is the creator of LifePlanning Legal Services™, which provides clients with a formal updating program for their estate plans. Brad and his wife, Cindy, have 3 sons all of whom are, like Brad, Eagle Scouts.

Doug Paul, Board Certified, Estate Planning and Probate Law*, Director of Advanced Planning

Doug's practice focuses on estate planning through the use of trusts, life insurance, retirement plans and family business entities. Doug received his undergraduate degree from the University of Texas at Austin and a Master of Business Administration from Louisiana State University. He began his legal education at Louisiana State and completed it at the University of North Carolina Law. Doug is also an instructor for the Estate Planning class for the CFP Certificate Program at the University of Texas at Austin. Doug and his wife, Marcia, make their home in Austin and have three children.

Candice H. Bocock, Board Certified, Estate Planning and Probate Law*, Director of Probate & Trust Administration

Candice's practice at The Wiewel Law Firm emphasizes probate and trust administration. She graduated with High Distinction from the University of Virginia with a degree in Government and Foreign Affairs, and was a member of Phi Beta Kappa. She also graduated with honors from the University Of Texas School Of Law, and was a member of the prestigious Order of the Coif. Candice has been practicing in the area of estate planning and probate since 1989. She and her husband, Rick, make their home in Austin and have four children and seven grandchildren.

Stephanie D. Allen, LL.M. - Tax, Director of Fundamental Planning

Stephanie's practice at The Wiewel Law Firm focuses on basic estate and disability planning for our Fundamental Foundations™ clients. She graduated from Southwestern Assemblies of God University with a Bachelor of Science and received her Doctor of Jurisprudence from Regent University. Stephanie and her husband, Mark, make their home in Austin.

Ann Lumley, Director of Fundamental Probate

Ann's practice at The Wiewel Law Firm focuses on basic probate and trust administration for our Fundamental Foundations™ clients. She received her undergraduate degree in history from Texas A&M University, where she was a member of The Order of Omega and Golden Key honor societies. She earned her law degree from California Western School of Law in San Diego, and is admitted to practice law in both

California and Texas. Ann and her husband, Michael, make their home in Round Rock with their three children.

* Less than one percent (1%) of all Texas lawyers are Board Certified in Estate Planning and Probate Law.

WHY WORK WITH THE WIEWEL LAW FIRM

We often get asked what sets The Wiewel Law Firm apart from other attorneys. Here are a few reasons:

- **Complimentary Initial Consultation**
- **Austin, San Antonio, Georgetown and the Highland Lakes Offices**
- **Prompt Preparation of Plans**
- **Fixed Planning Fees**
- **Advisor Supportive**
- **Education Focused Website: www.TexasTrustLaw.com**
- **Complete, Exclusive Estate Plans**
    - **Wills**
    - **Trusts**
    - **Probate**
    - **Asset Protection**
    - **Special Needs Planning**
    - **Powers of Attorney**
    - **Living Wills**
- **Optional LifePlanning™ Updates**
- **Small and Large Referrals Welcome**

Brad Wiewel, Doug Paul, and Candice Bocock are *Board Certified in Estate Planning and Probate* by the Texas Board of Legal Specialization. Less than 1% of Texas attorneys are Board Certified in Estate Planning and Probate Law.

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