

Business & Law Newsletter

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ASSET PROTECTION? YOU MUST PLAN AHEAD!

The [May 2005 edition of Strasburger's Business & Law Newsletter](#) explained the recent changes to the U.S. bankruptcy laws which will affect both individuals and businesses in future years. Debtors and creditors alike may only fully understand the true effect of new bankruptcy laws after a future economic downturn has led to defaults, failed businesses, and increased debtor calls for bankruptcy protection.

Preserving wealth, especially during difficult times, is important to everyone. Liability exposure may have helped to create wealth, but it is a major threat to retaining it. This and upcoming future editions of the Newsletter are intended to provide a broad overview for nonlawyers of certain well-established family wealth preservation techniques — a process sometimes referred to as “asset protection” planning.

Reviewing these important planning concepts reveals that:

1. Asset protection planning should be viewed as a continuum which originates with the identification and management of future liability risks (“Risk Management”—the subject of this month’s Newsletter) and then continues through a variety of actions which may be legally and properly taken to limit the assets which may be successfully seized by creditors (“Limiting Creditor Recourse”—the subject of an upcoming Newsletter), and
2. The basic concepts utilized in asset protection should be in repeated and continuous use over time as new assets or business operations are acquired, or there are changes to liabilities or risks.

IMPORTANT NOTE: The law is clear that no action by a debtor will be legally effective if it has been undertaken in a manner which acts as a fraud upon existing creditors. To the contrary, any debtor-prohibited action of this type is very counterproductive as it may create civil or criminal liability in addition to preventing bankruptcy relief from creditors which might otherwise be available. Consequently, ***planning and implementing legitimate actions in advance of creditor liability is the critical key to successfully using asset protection techniques.***

RISK MANAGEMENT

For purposes of this overview, key risk management elements to consider include:

Identify Each Separate Risk

- **Where Do Your Risks Originate?** Risk is a very important element which accompanies income or wealth. It may be occupational, such as the malpractice, errors and omissions, or breach of contract claims that may be alleged in lawsuits against physicians, attorneys, accountants, insurance and

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real estate executives and builder/developers. It may arise from management activities, as in the case of accounting fraud, breach of fiduciary duty, negligence, securities fraud and other claims made against the officers, directors, partners and managers of corporations, partnerships, LLCs and other entities. It also may relate to investment activities because of margin loans, personal guaranties of debt or financial reverses.

- **What Risks Originate Within Your Family.** Significantly, many substantial risks originate within the family. Consider the adult son or daughter having judgment creditors that may later seize his or her inheritance. A common risk involves the guaranty by a parent of his child's real estate lease or business loan where the business may later fail. And each divorce creates competing demands for family assets. **Remember, in a divorce each spouse is a creditor.**

Additionally, divorce terminates the Texas community property regime. As a result, divorce often enables creditors of one spouse to pursue their claims against Texas community property assets which previously were not subject to seizure during the marriage because those assets had been managed by the other spouse, i.e., had been that spouse's "sole management community property."

Limit the Amount of the Risk

- **Is the Risk Insurable?** Each risk needs to be evaluated for insurability. Everyone is aware that auto, director and officer ("D&O"), employment practices ("EPLI"), errors and omissions ("E&O"), excess liability ("umbrella"), fidelity bonding, malpractice, and property insurance is available to assist in limiting specific types of risks. Yet, not everyone appreciates the fact that providing a defense together with the services of a defense lawyer is a very important benefit of those insurance policies. But, insurance may not be available for some risks such as auto insurance where DWI convictions exist or for criminal liability. Further, the costs of the premiums may affect whether insurance is purchased or the level of "self-insurance" that is retained. **In all cases, the amount of risk not fully insured represents a continuing contingent liability.**
- **Can the Risk Be Limited or Decreased Over Time?** Each and every contract is negotiable. This applies to common contracts of individuals just as it does to the large contracts of major corporations. The more important the contract, the more important it is that it should be negotiated in order to limit future liability and avoid later issues or unresolved questions.

To use an example, an individual's guaranty of a real estate lease or of a bank loan can be limited at the time of the initial negotiations, or at the time of later renegotiations. The value of the leasehold improvements made by a tenant may assist in convincing a landlord that the lease guaranty should be limited in dollar amount or "burn off" over a negotiated period of years. Where there are multiple guarantors, a landlord or lender may agree to limit the amount of each individual's guaranty. Lenders may also agree to limit a guaranty to the existing debt as opposed to requiring a blanket or "continuing guaranty" which continues to apply to both the existing debt and all future borrowings from the lender.

*Parents may protect
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by becoming secured
creditors*

Savvy guarantors seek to renegotiate guaranties and act to limit their personal liability at renewal time and especially when they terminate their interest in the debtor business. In every case where an investor-guarantor (or his/her child) ceases to be an owner, attempts must be made to negotiate the agreement of both the business entity **and** the continuing owners to hold the guarantor harmless against the guaranteed debt, any increased debt, and any additional new debt.

Of course, a well-advised investor insists on risk-limiting provisions being included in the documents **before** he or she individually signs a contract or guarantees any lease, debt, or other obligations of a third party. The protections are easier to negotiate in advance of the signing of the contracts in question. The same astute investor similarly insists on buy-sell contract provisions that clarify when, and on what terms, he may exit and “cash in” his investment. By doing so, the investor decreases his investment risk.

- **Can/Should a Proposed Equity Investment Be Elevated to Debt?** Other risk management strategies (many of which simply reflect good common-sense) should always be considered to attempt to limit the risk of future liability. Consider, for example, a parent who is asked by a child to contribute equity and to guaranty a mortgage on a new business venture or an investment rental house. In that situation, the parent’s money certainly will be fully at risk, he or she has added risk as a guarantor of debt owed to a third party, and the parent has no clear plan for investment return or “exit strategy” from the investment. Obviously, the parent is subject to a financial risk if there is a financial loss or business failure.

But, another option is for the parent (or a trust or entity controlled by the parent) to instead be a secured lender to the business or the real estate mortgage holder on the investment property. Hopefully, the parent can then avoid any further guaranty of debt or other obligations. In this way, the parent (who in this example was putting up money anyway) may elevate part (or all) of his risk position to include being a secured creditor—which is a much preferred position and which will allow the parent to limit the actual risk of his investment. The parent may be viewed as switching proposed investments in order to own a secured loan as opposed to fully investing in equity with his child for an uncertain, later return. The parent’s exit strategies now include the sale of the property serving as security as well as the possible later refinancing of the debt with a third party by his or her child. Finally, in the case of business or investment failure, the parent is entitled to foreclose on the property serving as security for his/her loan and thereby limit the amount of his or her financial loss.

Avoid the Risks of Others

- **Does Using A Separate Entity Make Sense?** It is naïve to believe that a separate entity is only required when an investment or asset is owned by more than one investor. Yet, many people do. Instead, in today’s world, a separate entity is desirable for each separate business, investment activity, or asset if it (1) involves significant potential uninsured risks; (2) has separate debt; (3) may later be the subject of a sale; or (4) may later involve additional investors. Upon deciding that a separate entity needs to be formed, a further examination of Federal and Texas tax and other issues is then required to determine the best type of entity to use in the particular factual situation.

Carefully negotiating contracts and obtaining guaranties and indemnification are tools available to individuals and small businesses.

Significantly, when a sole proprietor is sued, all of his or her assets are before the plaintiff and at risk—and it is then too late to engage in asset protection techniques such as are reviewed in this Newsletter. Contrast this to the situation where there has been asset protection planning and the lawsuit is against a business entity. There, the individual's assets are not at risk.

In the case of a wholly-owned entity, certain beneficial uses were addressed in the [December 2004 edition of Strasburger's Business & Law Newsletter](#). That article illustrated that an individual might use a single member LLC to own a real estate property that (1) might have environmental risks or (2) might quickly be exchanged for other real estate tax-free. In each case the new LLC entity provided state law liability protection to the individual owner while being disregarded for Federal income tax purposes such that there were no issues of double taxation and no Federal income tax return was required. Additional advantages in asset protection derived from the use of separate entities having a single owner will be subsequently reviewed below.

In the case of entities having multiple owners, any owners who are individuals (i.e., not entities) need to seek to avoid the joint and several liability of a general partner, because, as in the use of a proprietorship, being a general partner directly exposes the individual's assets to risk. If, on the other hand, the general partner is an entity, then the joint and several liability of a general partner only exposes the assets owned by the general partner to risk. Corporations, professional associations and corporations, limited liability partnerships ("LLP's") limited partnerships and limited liability companies ("LLC's") statutorily limit the individual's/owner's liability for this purpose. These liability-limiting entities are necessary to shield one owner from those liabilities which may arise from the acts of another owner. While it is a rule that professionals may not limit their own malpractice liability by using an entity, they can limit their liability for (1) the malpractice of other professionals and (2) for debts owed by the entity to general creditors.

- **Is a Third Party Indemnity or Guaranty Available?** In each case where risk or liability exists, or may arise later, the question should be asked "Who should also bear this risk?" It may be a fellow business owner, such as a professional partner, or it may be a family member. Effort should then be taken at the inception of each contract involving risk to negotiate and obtain enforceable contract rights against that other party(s) such that the risk or liability will be shared.

For example, an individual who loans money to a business venture should also seek a guaranty of that debt by each of the individual owners of the borrowing business entity. Similarly, when an entity sells its business operations it is customary that the purchaser will contractually agree to indemnify the seller (or, "hold it harmless") from any and all liabilities of the business which arise after the date of the sale.

Reducing financial risk and future liability by carefully negotiating contracts and by obtaining guaranties and indemnification is not just for large corporations—these tools are available to individuals and small businesses.

- **Is One Spouse's Property Liable for the Other Spouse's Debts?** Although a full review is beyond the scope of this article, the Texas Constitution and Texas Family Code provide specific community property laws and rules of

*Why should your wealth
feed the creditors of
other family members?*

marital property liability. Knowledge of these laws and rules is important to successful asset protection planning for several reasons. First, the general community property rules may be varied by a prenuptial contract or by a contract of partition and exchange after marriage. In either case, the spouses may design their property rights by a negotiated and agreed contract, thereby planning for the extent to which certain property of each spouse (such as investment income and earnings) will or will not be subject to liabilities created by the other spouse. The contracts also determine whether, and to what extent, that the property owned by the spouses will be subject to division in the case of a later divorce.

For example, absent a contract changing the Texas community property rules, the earnings of each spouse are community property which is subject to the liabilities of the community. These community liabilities include the occupational, management, and investment-related risks of both spouses and specifically include the tort liabilities of each spouse. An illustration of the concept is the fact that the community property earnings of the business executive are liable for the malpractice/wrongful death/fraud judgments against his or her spouse.

Note, however, that the separate property of one spouse is not subject to those same community liability or tort liabilities incurred by the other spouse unless the spouse has guaranteed the debt or become otherwise liable. For this reason, a savvy guarantor negotiates to ensure that his business-related guaranty expressly excludes the property of his or her spouse, or, alternatively, excludes the separate property of his/her spouse.

These Texas marital property and liability principles lead to significant asset protection strategies (and related estate/wealth transfer planning) based upon the particular facts involved in each particular family situation.

- **Why Feed the Creditors of Other Family Members?** Asset protection strategies are first focused on each individual and his/her spouse. As just reviewed, the spouses may contract to change the way that normal Texas community property rules would apply in order to limit the extent to which their earnings, or the earnings from their separate property, may be available to the creditors of the other. The spouses may similarly exclude certain property from the reach of creditors by limiting the reach of creditor guaranties. In each way, the spouses, in effect, avoid agreeing to pay the creditors of the other.

But, the need exists in asset protection planning to focus on more than one generation of the family. Take, for example, the parents whose son has an outstanding judgment against him and other creditor problems. Careful planning would include gift and estate planning for the parents pursuant to which they would address wealth transfers to provide for the son and his family **without** subjecting their wealth to being seized by the son's creditors. For example, the parents might consider making gifts or bequests directly to their grandchildren or funding "spendthrift" trusts under which the son and/or his children were the beneficiaries. Creditors of the son would not be able to seize the property which his parents gifted or bequeathed to his children or any property that funded the carefully-drafted spendthrift trust. By using legitimate advance planning techniques such as these, the assets of a family can be preserved from generation to generation.

*Properly planned gifts,
bequests, and disclaimers
can preserve family wealth.*

**FOR MORE INFORMATION
ON THIS TOPIC,
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- **Should an Inheritance Be Disclaimed?** Another example of intergenerational family asset protection planning is illustrated by the fact that an individual who has creditor problems should consider disclaiming all (or a part) of an inheritance that he is designated to receive upon the death of a benefactor. This is because formal disclaimers meeting the statutory requirements of Section 37A of the Texas Probate Code result in property passing as if the disclaiming party predeceased the decedent in question. As a consequence, a disclaimer of an inheritance is not treated as a fraud upon creditors because the disclaiming party is treated as never having received the assets disclaimed and the creditors are not treated as having any interest in the disclaimed assets. In planning, every disclaimer decision will turn on both the amount of the debt owed to creditors and the person who will inherit instead of the disclaiming party. If that person is a child of the disclaiming party, for example, the net effect may be to accelerate the child's inheritance while bypassing the parent's creditors.

NOTE: Remember that certain "supercreditors" exist which have special rights. First, and most commonly encountered, secured creditors (those having perfected recourse rights to real estate under deeds of trust or to personal property under pledge and assignment agreements) have specific and preferential rights to the assets which secure the debts owed to them. Cities and other taxing jurisdictions also have special preferential statutory rights as to real property for which property taxes have not been paid. Additionally, the Federal tax laws provide certain special creditor rights to the IRS, such as its ability to seize otherwise-exempt Texas homestead property. As a consequence, in asset protection planning, special consideration must be given to paying off the liabilities owed to secured creditors, to tax authorities for property taxes and to the Internal Revenue Service for Federal tax liabilities.

Conversely, as previously illustrated, ***an important asset protection technique which is commonly used is for an investor (whether an individual or an entity) to seek to achieve and enjoy the preferred, less-risky status of a secured creditor.*** ■

This Newsletter has addressed Asset Protection from the standpoint of Risk Management. Our next Newsletter will continue this discussion of Asset Protection by focusing on the objective of Limiting Creditor Recourse.

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