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LIMITING CREDITOR RECOURSE

Asset protection techniques work best as a "Team," i.e., when multiple techniques are used together.

The June 2005 edition of Strasburger's Business & Law Newsletter began a two-part review of the topic of Asset Protection Planning for individuals, initiating that series with an examination of Risk Management issues. This month's article will complete this review by focusing on the related objective of Limiting Creditor Recourse.

Once an individual's risks have been identified, managed and sought to be limited, the next objective is to limit the amount of that individual's assets which ultimately may be seized by creditors because of liability which later arises from those risks. For purposes of this overview, several key planning concepts are reviewed below.

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.***

Compartmentalize

- **Separate Assets from Risks.** One of the most important asset protection planning objectives is to separate assets from the risk of liability. If there are no separate entities involved, the first level of defense is to limit the extent that assets of an individual are mortgaged or pledged to secured creditors. This prevents a "supercreditor" from having contractual rights to seize any property remaining unencumbered in payment of an overdue debt. Instead, the creditor must take specific, additional legal actions in order to pursue those additional assets for any deficiency owed to it.

When separate entities or estates are involved, this principle becomes more powerful. For example, without a separate security agreement or cross collateralization, a secured creditor of Corporation A has no right to proceed against the assets of Corporation B. Why should Corporation B's assets serve as security for the risk or liabilities of corporation A? Why should all of the assets of Corporation A serve as security for a single debt of Corporation A? Each of these questions reenforces the importance of initiating a negotiation at the time that the debt is sought.

The same principle applies to guarantees. A savvy investor will seek to avoid guarantying any of the debt of a third person, including the debt of a corporation or other entity which is wholly-owned by the individual. Failing that objective, the individual will seek to limit the dollar amount of his/her guaranty in an attempt to separate the assets of the individual to the full extent possible from the liability risk of the corporation or other third party.

Prenuptial contracts and post-marriage partition agreements can protect one spouse's assets from the other spouse's creditors.

Another level of compartmentalization is achieved when the assets of only one spouse are subject to the guaranty or the risk of another person. In the above example, if Spouse 1 is required to guaranty the business debts of his corporation or other entity, a significant compartmentalization benefit occurs when Spouse 1 negotiates the guaranty with the lender such that none of Spouse 2's assets are liable or, failing that, that the separate property assets of Spouse 2 are not subject to the guaranty.

Another important planning tool exists in the case of high risk individuals such as professionals whose personal malpractice liability risk cannot be limited by an entity and which may not be subject to being fully insured, either because the needed limits of insurance are not available or the cost of the liability premiums is exorbitant. A number of asset protection techniques might be utilized for this individual, but one of the most basic may involve having a prenuptial agreement or a post-marriage partition agreement such that the assets of the non-responsible spouse are not subject to the uninsured liability of the responsible spouse. As will be subsequently reviewed, the protection provided by this technique may be enhanced by the use of additional asset protection techniques discussed below.

Asset protection techniques work best as a "Team" i.e., when multiple techniques are used together.

- **Limit Creditor Recourse to the Smallest Asset Group Possible.** In every case, the objective of protecting assets from creditor liability is also enhanced by the principle of delegating risk and liability exposure to the smallest asset group possible. Multiple asset groups may be created by the use of multiple entities and the separation of the assets of one spouse from the assets of the other. In each case the objective is to limit the recourse of a creditor to those assets which are directly related to the business or investment operation which utilized the funds borrowed.

The benefit of these asset protection principles is cumulative and perhaps best illustrated by a common factual situation involving multiple business and investment operations. Consider, for example, a two career couple where Spouse 1 works as an executive for a large corporation and Spouse 2 owns a small business which has an outstanding loan used for inventory and working capital. Spouse 1 one has inherited a significant amount of money which is in her private brokerage account. Both spouses have been successful and they have invested part of their community property earnings in several rent houses each of which is subject to a mortgage used to purchase that property.

Under the facts of this example, attempts should be made to protect the assets of these two spouses using the following risk management and compartmentalization techniques:

1. The small business should be owned by a separate entity;
2. Attempts should be made to limit the security for the business inventory/working capital loan to those specific assets, or at least to the assets of that separate business entity;
3. If an individual guaranty must be provided for that business loan, the guaranty should be limited to a specific maximum dollar amount, and that amount should reduce as the debt is reduced;

It is essential to utilize the Texas laws that exempt property from creditors.

4. If possible, Spouse 1 should not execute the guaranty, such that the earnings from Spouse 1's employment (his/her "sole management community property") should not be subject to creditor liability under the guaranty as long as the marriage continues and Spouse 1 controls those community funds;

5. If possible, the guaranty should expressly exclude the separate property of Spouse 1;

6. Each rental property should be in a separate entity and each separate entity should have sufficient initial capital so that no guaranty is required in addition to the mortgage on the rental property;

7. Each liability of the business and the liability of each rental property should be carefully insured;

8. Spouse 1 and Spouse 2 should have sufficient home, auto and liability insurance and a comprehensive liability policy;

9. The inherited investments of Spouse 1 should be maintained in a specially identified separate property account which is kept separate from any community property securities and there should be no co-mingling of those accounts or assets;

10. Spouse 1 should review the existence of a corporate indemnity and of director and officer insurance before becoming an officer or director of her employer; and

11. Separate family limited partnerships should be considered for the rental properties and for the community investment securities.

A review of the various multiple asset protection techniques suggested above illustrates the cumulative benefit which is obtained by identifying/minimizing risks, then separating the assets from risk and then delegating risk to the smallest asset group possible. Using these techniques together multiplies the asset protection benefit.

Understand and Utilize Exempt Property Rights

- **Texas Homestead Rights.** The equity in a home is commonly one of the most significant elements of a family's wealth. Although now subject to certain new rules under the recent changes to the U.S. bankruptcy laws (see May 2005 edition of Strasburger's Business & Law Newsletter), the homestead rights provided in the Texas Constitution and statutes continue to be one of the most powerful creditor protection rights of individuals in the State of Texas.

Remember that the equity in a qualifying Texas homestead may be reached by the following creditors only:

1. Internal Revenue Service;
2. Purchase Money Mortgage Holder;
3. Jurisdiction Imposing Property Taxes;

4. Lienholder for Labor and Material used in improvements;
5. Lender in Qualifying Home Equity Lines of Credit (“HELOC”).

Additionally, the monies received upon the sale of a homestead property are not subject to seizure by a creditor for six months from the date of sale—thereby allowing for the investment of those proceeds in a subsequent homestead.

O.J. Simpson playing golf today in Florida illustrates the power of the exemption of qualified retirement plans from creditors.

Because of the new bankruptcy laws, analysis of the extent of Texas homestead protection now needs to be given to newer homesteads and to home buyers moving into the state of Texas. Nevertheless, the Texas homestead rights represent one of the most fundamental concepts of asset protection available to Texas residents.

- **Qualified Retirement Plans and IRAs.** Both the Texas Property Code and Federal law provide important exemptions from creditor seizure for the accounts of participants in **employer-sponsored** qualified retirement plans (e.g., 401(k)’s, pension and profit sharing plans, and 403(b)’s of tax-exempt organizations) and exclude these amounts from a debtor’s bankruptcy estate.

The creditor exemption rules for IRA’s have been more complicated. Texas law provides a blanket creditor exemption for IRAs while Federal law has clearly exempted only (a) those IRAs which are used in connection with an ERISA benefit plan (e.g., an employer-sponsored SEP or SIMPLE 401(k), but not individual contributory IRAs such as Roth IRAs), and (b) a limited amount necessary to support the debtor in retirement where the debtor in bankruptcy elects the Federal (not Texas state law) exemptions. The bankruptcy law changes effective October 17, 2005 broaden the Federal protection for both employer-sponsored qualified retirement plans and IRAs used in connection with an ERISA benefit plan and rollover IRAs. The new law also plans a $1 million dollar creditor exemption cap on non rollover IRA or Roth IRA funds.

The significance of the retirement plan exemption is obvious, given that one of the major assets in an individual’s estate is commonly the retirement plan benefits of the individual or his spouse. Difficult technical issues arise, however, as to each spouse’s rights to qualified retirement plan benefits in the case of divorce including the respective rights of each spouse based upon his or her status as the participant spouse or non-participant spouse. Accordingly, special attention needs to be given to the drafting and documentation of the division of retirement plan benefits in divorce.

The power of the exemption of qualified retirement plans from creditors may best be illustrated by the fact that O.J. Simpson is today playing golf in Florida and paying his green fees with the proceeds from his NFL retirement plan.

- **Insurance and Annuity Benefits in Texas.** Insurance and annuity benefits also represent a significant element of the wealth of a typical Texas resident. Section 1108.051 of the Texas Insurance Code exempts from creditor seizure:

> “… any benefits, including the cash value and proceeds of an insurance policy, to be provided to an insured or beneficiary under:

CONTINUED – PAGE 4 OF 6

(1) an insurance policy or annuity contract issued by a life, health, or accident insurance company, including a mutual company or fraternal benefit society; or

(2) an annuity or benefit plan used by an employer or individual."

The Texas exemptions for homestead, qualified retirement plans, and insurance and annuity benefits represent the "Triple Crown" of asset protection.

This Texas statutory exemption from creditors represents one of the most powerful and least-limited asset protection benefits for Texas residents.

The significant power of the Texas insurance and annuity benefit exemption may be illustrated by two very common insurance applications to individuals. First, under Texas law, the death benefit proceeds from a life insurance policy which are received by an individual are not subject to creditors—either initially, or later. So, unlike an inheritance to be received by a bequest in a will, a child with significant creditor problems may not need to disclaim the right to receive insurance proceeds on the death of his or her parent.

A second example of the power of this exemption relates to the fact that the exemption from creditor seizure protects both the insurance or annuity benefits to be paid to a designated beneficiary and the investment assets held by an insurance company in connection with the policy in question. As a result, it is common in asset protection planning for an individual to transfer his or her investment securities from a brokerage account to an insurance company to hold and invest in connection with an annuity policy of insurance. In this way, the individual has the benefit of the very same investment portfolio until the annuity insurance contract is "annuitized." By making this securities transfer, the individual is effectively moving his or her non-exempt investment securities into an insurance contract where those same securities are exempt from creditor seizure. Among the planning considerations are the fees charged and the possible triggering of gain and taxes which may result if the securities in question must be transferred between institutions.

- **Other Texas Statutory Exemptions.** The Texas Property Code provides for other Texas exemptions, including specific personal property in amounts up to $30,000 for a single adult/$60,000 for a family and for certain college savings plans such as prepaid tuition contracts and Section 529 tuition programs. These exemptions, and certain elections; which are considered in the context of a bankruptcy proceeding, are beyond the scope of this review.

NOTE: The Texas exemptions for homestead, qualified retirement plans, and insurance and annuity benefits represent the "Triple Crown" of asset protection in Texas.

Minimize Non-Exempt Assets Available to Future Creditors

- **Making Gifts to Others.** As always, provided first that there are no actions being taken in fraud of existing creditors, making gifts and thereby transferring assets from ones ownership is a commonly-used asset protection concept. Significant gifts are the subject of estate and trust planning and wealth transfer of concepts utilized in estate planning. An ancillary benefit to these gifts, however, is that property gifted to children, grandchildren, or to trust for third parties are no longer subject to the creditors of the donor or settlor of the trust. As a result, actions which may be taken to reduce or eliminate estate tax or to

transfer wealth to family or to charities, may also achieve asset protection objectives.

- **Making Property Pursuit Unattractive.** Even though an individual utilizes exempt property to the full extent allowed in Texas and makes gifts to family or charity, such that his/her non-exempt assets are reduced, he/she may still own significant property which is not exempt from seizure by creditors and which still remains subject to creditor pursuit. Assuming that the individual has utilized separate entities and compartmentalized risks, then the next level of additional asset protection involves making these non-exempt assets unattractive to creditors, so that the creditors are less likely to pursue those assets or, having seized them, are more likely to negotiate terms which are more attractive to the individual debtor.

Individuals should be wary of promoters of non-U.S. trusts.

For example, a creditor which seizes a limited partnership interest of an individual does not become a limited partner, but only the "assignee" of the rights of that limited partner. Given that the limited partner has no right to vote and no right to receive any distribution, this type debtor property becomes much less attractive to a seizing creditor than the assets that may be held by the limited partnership. The interests seized become even less attractive to a creditor if they do not represent control of the entity, or if that control ends when the interests are seized by the creditor.

A common technique of making property pursuit unattractive to creditors involves a "family limited partnership" having properly-drafted provisions. This was the subject of the July 2004 edition of Strasburger's Business & Law Newsletter.

- **Using Special Trusts.** Utilizing trusts governed by the laws of Texas, other states, or foreign countries, represents another, very specialized alternative for placing assets into a separate, recognized legal entity. These trusts are utilized most often in connection with sophisticated estate planning and family wealth transfer planning. As such, the field of trust planning has developed into a recognized, particular legal specialty. Recent changes to the trust laws of several states, including Delaware, and the Bankruptcy Reform Act have refined the rules for use of both domestic and offshore asset protection trusts. Accordingly, individuals should consult with qualified specialists for these trust planning inquiries and should be wary of promoters of non-U.S. trusts, especially where secrecy, avoidance of U.S. taxes, or creditor protection are specified objectives. ■

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