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**COVER STORY**

# Protect your assets *before* you're sued

The malpractice crisis makes guarding your wealth more important than ever. You can improve your estate planning in the process.

By Robert Lowes, Senior Editor

The latest malpractice crisis is producing a bumper crop of clients for lawyers who specialize in the art of asset protection. "Doctors worry that they're one lawsuit away from financial disaster," says St. Louis tax and wealth management attorney Richard Petrofsky.

They've got a point. The traditional bulwark of malpractice insurance is crumbling before their eyes. Some insurers have folded or stopped writing new policies, while others have jacked up rates to unaffordable levels. In Florida, the land of $100,000-plus premiums for several high-risk specialties, doctors ponder going bare or reducing coverage.

So doctors try to defend their assets in other ways: family limited partnerships, irrevocable life insurance trusts, offshore trusts. If nothing else, these vehicles are valuable for their deterrent power.

"Once a would-be plaintiff knows your assets are tied up, he may be less inclined to sue you," says New York asset protection attorney David Mandell, co-author of *Wealth Protection: Build and Preserve your Financial Fortress* (John Wiley & Sons, 2003). "Or if he sues and wins, he may be more willing to settle for the amount that insurance will cover. You get these advantages even with asset protection plans that creditors can theoretically unravel—it takes them more time and money than they're willing to spend."

Flimsy or nonexistent malpractice coverage isn't the only reason to shield hard-earned wealth from creditors. You and your assets are fair game in all kinds of suits—sexual harassment, slip-and-fall, breach of contract—and a judgment may exceed your coverage for those risks as well.

As crucial as asset protection is, though, it's important not to panic and spend money on unnecessary measures. Some assets enjoy more built-in protection than you imagine, and a doctor rarely loses his home to a creditor, says Mandell.

It's also important to remember that the overwhelming majority of malpractice suits are settled for amounts within insurance limits, even when awards exceed the stated boundaries. It's unusual for a physician to pay even part of an award or settlement out of his own pocket, although nobody wants to risk being the exception to the rule.

That said, if you're going to build walls around your wealth, do it *now*. An asset protection strategy implemented after a lawsuit is filed—or even anticipated—generally will get struck down in court as a "fraudulent conveyance." You've got to put assets out of a creditor's reach *before* the need arises.

Here's another incentive: The money you spend to frustrate would-be creditors may produce even bigger estate-tax savings down the road, and hence, more assets for your heirs. Besides, asset protection done with estate planning in mind, experts say, has a better chance of holding up in court, because it won't look as if you're only trying to stiff creditors.

## How effective is the spouse defense?

Married doctors sometimes put all their worldly goods in their spouse's name for safekeeping. That tactic may work, depending on where you live. State laws vary widely on what assets creditors may seize, so consult an experienced estate planner. You can find such a professional at the Web sites of the American College of Trust and Estate Counsel ( www.actec.org ) and the National Association of Estate Planners & Councils ( www.naepc.org ).

In many states, signing property over to a spouse is better than owning it together, because a creditor can force a couple to liquidate jointly held assets to collect the debtor's share. Of course, letting a spouse own everything puts you in a vulnerable position if you later get a divorce. "Use this tactic only in a solid marriage," advises Stewart Welch III, a financial planner in Birmingham, AL, and co-author of *J.K. Lasser's New Rules for Estate and Tax Planning* (John Wiley & Sons, 2002).

The spousal defense isn't shatterproof, however. "If your spouse is merely holding assets that you still control—by writing checks on a bank account, for example—a creditor has a good shot at them," says estate-planning attorney Stephan Leimberg in Bryn Mawr, PA. "To qualify for protection, the transferred assets must truly become the spouse's property."

Shifting assets to a spouse may be in vain in states that have community-property laws, such as California and Texas. There, a married couple jointly owns all property acquired during the marriage, even if it's titled in only one spouse's name, although exceptions are made for gifts, bequests, and the like. Generally, a creditor of one spouse can pursue the entire value of community property to satisfy a judgment. A couple can beat these laws, however, by signing a "transmutation agreement" that converts jointly held property into separately held property.

In Florida, Ohio, Pennsylvania, and a number of other states, you needn't sign over assets to a spouse to safeguard them. You can choose a formidable version of joint ownership called "tenancy by the entirety." In most states that offer this option, a creditor can't grab your property unless he has a judgment against your spouse, too. This protection disappears if you get a divorce, though, or if your spouse dies before you do, notes estate-planning attorney Gideon Rothschild of New York City.

## Digging a moat around the family castle

How do you keep creditors away from the family home? If you live in a state where you can own real estate under tenancy by the entirety, you're covered. Otherwise, look to state homestead laws, which put varying amounts of home equity out of a creditor's reach. In some states you must file for homestead status; in others, it's bestowed automatically. Florida, Iowa, Kansas, South Dakota, and Texas exempt the entire value of a debtor's home, although exceptions may apply, such as acreage limits. Most states, however, exempt only $10,000 to $50,000 worth of equity, says David Mandell. That's not much protection.

For greater peace of mind, consider putting the house in your spouse's name, if that move makes sense in your state. Other defenses include assigning the deed to a family limited partnership or similar entity (not ideal, since you risk losing valuable tax breaks), making your house unattractive to creditors by mortgaging it to the hilt, or creating a qualified personal residence trust. With a "QPRT," you give the house to the trust but continue to live there for a given number of years. A creditor theoretically could claim the right to either live in or rent out a QPRT house during that period, but probably would find this unattractive. At the end of the term, you either turn over the keys to the beneficiaries—presumably your children—or lease the house from them.

"Besides reducing the size of your estate and the estate-tax bill, a QPRT uses up less of your $1 million gift-tax exemption because the house's value is discounted," says Stewart Welch. "A $450,000 house isn't worth $450,000 to your kids if they can't live in it right away. For gift-tax purposes, it may be worth only $95,000."

Other real estate warrants special ownership methods, too. If you own a medical office building in your name, for instance, a victorious plaintiff can claim it. To forestall such a maneuver, have an entity such as a limited liability company hold title. Likewise, set up separate ownership vehicles for rental property, one for each building, says Richard Petrofsky. "That way, if a tenant sues the company that owns his building, he can't go after the other buildings to satisfy a judgment."
Will creditors crack your nest egg?

A doctor with an employer-sponsored retirement plan—401(k), defined-benefit, defined-contribution, profit-sharing, or Keogh—generally can breathe easy about those. As long as they comply with the federal Employee Retirement Income Security Act, such plans are off limits to creditors.

The trick is making sure you comply with ERISA. Say you've incorporated your practice and you and your spouse—technically employees of the corporation—are the only participants in a retirement plan. The plan isn't qualified under ERISA, because it discriminates against other employees; therefore it isn't protected. "That's a good reason to add another employee to the plan," says Welch.

Unlike qualified retirement plans, individual retirement accounts don't enjoy federal armor against creditors. An increasing number of states, however, are coming to the rescue. Forty-five exempt traditional IRAs from creditors, and 35 do the same for Roth IRAs, according to 1999 survey data from the Investment Company Institute, a Washington, DC-based association that represents investment firms. Some state exemptions are incomplete, however. Maine, for example, limits debtor protection to what's considered reasonably necessary to support a retired person and his dependents. A judge could decide you only need to hang onto half of your IRA's value.

If you live in a state where your IRA is at risk, you have one last resort: rolling it over into a qualified retirement plan like a 401(k). That switch became possible as a result of tax legislation passed in 2001. "A 401(k) might not give you the kind of investment options or performance possible with an IRA, but that's the price you pay for asset protection," says Welch.

Given the vulnerability of IRAs, you should carefully weigh your options when leaving a job that provides a qualified retirement plan. Instead of rolling the assets over into an IRA, you may want to keep them in the old plan, assuming your former employer will let you. Or, if your new job has a qualified plan, roll them over into the new plan directly.

**Heavy-duty defenses**

Several wealth-management tools combine asset protection and estate planning, and many of them work for single as well as married doctors. (See "How a single physician can fend off creditors".)

**A family limited partnership** is a popular way to hold real estate, mutual funds, bank accounts, and other possessions. You could be the general partner with a 1 percent interest and managerial rights, while you and your spouse would own the remainder as limited partners. Or your spouse could be the general partner, and you and your children the limited partners.

An FLP lets you reduce your estate by gradually transferring assets to your heirs in the role of limited partners. However, you or your spouse retains control of the assets. And when you die, your partnership interest can be discounted for tax purposes. For one thing, it's not marketable. So $500,000 in FLP assets might be taxed, say, as only $300,000. The same principle also applies to gifts made to limited partners to avoid or reduce gift taxes.

Meanwhile, a creditor faces a thorny problem. Generally, to reach your partnership assets he must obtain a "charging order" from the court. This order entitles him to any income that's generated by FLP assets and paid to you. However, the general partner—again, you or your spouse—isn't obligated to distribute this income to partners and won't be in any rush to do so. So the creditor must sit on his heels and wait. Plus, he may be stuck with the tax bill for your FLP income! "The hassle factor gives you leverage with a creditor to settle for a smaller amount," says Gideon Rothschild.

**Limited liability companies** closely mirror FLPs in form and function. Instead of general partners and limited partners, LLCs have managing and nonmanaging members. But LLCs also force creditors to obtain charging orders.

Whether you go with an FLP or LLC, count on spending $2,000 to $10,000 to create one, and $500 and $2,000 a year afterward to maintain it. And you must treat them as legitimate business entities, or their protective power won't kick in. You can't dip into a FLP bank account to pay for a vacation.

"If you don't maintain the integrity of an FLP or LLC, creditors can have them declared shams and cracked open," says Rothschild. "You may manage the assets, but you don't own them anymore."

Various kinds of **irrevocable trusts** do double duty in asset protection and estate planning. Many doctors already have revocable living trusts for the sake of avoiding probate, but these trusts offer no defense against creditors, because whoever puts assets into them can take them back out—if need be, to pay a judgment. With an irrevocable trust, you truly give up control of the assets, making them judgment-proof.

Generally, if you set up a trust that names you as a beneficiary, creditors can help themselves to it. However, several states have recently legalized what's called a **domestic asset protection trust**, which purports to thwart creditors while allowing you to be a beneficiary. Some estate-planning experts shy away from DAPTs because they haven't been seriously tested in the courts, although other experts say they're sound. The big question is whether a plaintiff who wins a judgment in New York, for example, can enforce it against a DAPT drafted in Alaska. After all, Article IV of the US Constitution says states should honor one another's decisions. DAPTs also cost $10,000 or so to set up, making them rather pricey.

Some countries don't honor US judgments, and that's why the super-rich rely on **offshore trusts**. These asset fortresses also allow you to name yourself as a beneficiary. Although given a bad name by scam artists, offshore trusts as well as offshore LLCs can work wonders. But you need to own enough vulnerable assets to justify spending the $20,000 or more it takes to create these legal structures. David Mandell recommends going offshore only if you have $500,000 or more in liquid assets—meaning stocks, bonds, and such, as opposed to real estate and retirement plans. "I don't think the average primary care doctor needs to look into offshore solutions," Mandell says.

**Use multiple safeguards, but don't get carried away**

No single line of defense will cover everything you own; you'll need a variety of tactics. Consider, for instance, the accounts receivable in your practice. You can keep creditors away from A/R by using it as collateral for a loan from your bank. "A creditor can't take an asset that's already encumbered," says Mandell. "You still collect the A/R and pay off the loan when you retire."

You may also want to set up an irrevocable life insurance trust. Although most states make proceeds from a life insurance policy unavailable to creditors, the cash surrender value doesn't enjoy as much widespread protection. Besides barring the door against creditors, such a trust exempts the proceeds from estate tax.

To safeguard savings for your children's college education in a state-sponsored 529 plan, set up the plan in a state that protects it from creditors. The Virginia Education Savings Trust, for example, is off-limits to creditors of both beneficiary and donor, although bankruptcy courts may not be bound by this provision in Virginia law.

Guarding your wealth is prudent, but don't try to lock down everything you own. If you transfer all your assets, your maneuvers will smack of fraud, and a court probably will give your creditors a free hand. "A pig that's too fat gets slaughtered," says Rothschild. "I think it's best to leave a little something on the table that creditors can take."

Likewise, don't try to hide assets in the hope that a creditor will never find them. "It's a myth that asset protection involves secrecy," says Mandell. "A creditor can go through the courts to make you reveal what you own, on threat of perjury.

"In fact, asset protection and candor go hand in hand. If you show a potential plaintiff what you own and that it can't be touched, he's more likely to walk away."

**How a single physician can fend off creditors**

Estate-planning experts say unmarried physicians can avail themselves of many of the asset-protection strategies that married couples exploit—domestic asset protection trusts, offshore trusts, even family limited partnerships.

"I've set up FLPs for single people, making them general partners with a 2 percent interest as well as limited partners with a 96 percent interest," says estate-planning attorney David Mandell of New York City. "A brother or sister would be another 2 percent limited partner."

An unmarried doctor can also shield assets inside a single-member limited liability company. "A doctor would be the managing member and own 100 percent of the LLC," says Mandell. Such a solo plan would benefit a doctor who has no family members to add to an FLP.

FLPs and LLCs allow single, widowed, or divorced doctors to pass wealth on to relatives and reduce gift and estate taxes in the process. Such doctors also should consider private annuities, says estate-planning attorney Stephan Leimberg in Bryn Mawr, PA. "You sell assets like real estate to your children in exchange for lifetime income, paid out in regular, fixed installments," says Leimberg. "This reduces your estate, and totally protects the assets from your creditors in all states, since you no longer own them." Creditors still have a shot at annuity payments, though in some states, they're protected.

Robert Lowes. Protect your assets before you're sued. *Medical Economics* Feb. 21, 2003;80:82.