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## **ASSET PROTECTION PLANNING**

Peter S. Gordon  
Thomas Mammarella  
**Gordon, Fournaris & Mammarella, P.A.**  
1925 Lovering Avenue  
Wilmington, DE 19806  
Tel: (302) 652-2900  
Fax: (302) 652-1142  
pgordon@gfmlaw.com  
tmammarella@gfmlaw.com

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Peter S. Gordon

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## ASSET PROTECTION PLANNING

### INTRODUCTION

We live in a litigious society. The newspapers are filled with stories of large jury awards. Stories from the McDonald's scalding coffee spill to Philadelphia jury awards against pediatricians in excess of 100 million dollars create uncertainty in the judicial process and the threat of substantial loss of assets creating tremendous anxiety among those with assets to lose.

- A. Most recently, a local lawsuit against a noted Delaware physician resulted in a jury award of \$7.1 million for alleged negligence. Without getting into the merits of the award, the question must be asked: How can a person economically survive a damage award of that magnitude?
- B. It is important to draw distinction between jury awards for negligence, malpractice and the like, and contract liability. Most economically responsible individuals are perfectly willing to suffer the consequences of their own bad business judgments. Houses are purchased subject to a mortgage that the mortgagor fully expects to pay. Lines of credit are extended by banks to individuals who start businesses. Securities investors often margin their stocks. In each of the foregoing situations, the liability is quantifiable. It is the great uncertainty of the unlimited jury award that stifles American businesses and economically responsible American citizens.
- C. Efforts have been underway to cap jury awards for some years. Malpractice award limitations have been proposed (but not passed) in Delaware. Proposals to change the American rule, which allows contingent fee awards and requires each party to pay its own legal fees, to the British system where the loser pays, have also failed. With the foregoing in mind, the question must be asked: What prudent steps may be taken to protect assets from runaway jury awards?
- D. As you will see, asset protection takes many forms. There is no one answer for all individuals. Decisions must be made on a case by case basis depending upon the assets owned by the individual and the individual's lifestyle and economic goals.
- E. The goal is to manage and preserve wealth in a manner that will protect it from the threats of a lawsuit. The case study and legal analysis that follow will illustrate this point. The primary focus of this paper is on preserving assets during lifetime through proper asset protection planning.

## **CASE STUDY**

### **THE LAWSUIT**

Dr. Mike is a fifty-eight year old pediatrician, married for the second time. He had plans to retire in two years at the age of sixty. He is well respected in the community. He has had an exemplary career during which he accumulated substantial wealth.

On the Wednesday before Thanksgiving, a day on which Dr. Mike promised to let his staff leave early, Dr. Mike made a final check of his telephone messages. He discovered, much to his dismay, a message from Peter Wolf.

Peter Wolf has one child, Peter, Jr., and makes a practice of calling the office repeatedly every time his son has any minor problem. Peter Wolf is always certain his son is deathly ill and always insists on bringing his son to the office immediately.

When Dr. Mike calls Peter Wolf he is informed that Peter, Jr. has a fever, is lethargic and has a rash. Peter tells Dr. Mike that his son does not look well and that Peter thinks his son's condition is "very serious".

Dr. Mike has seen at least twelve other children that day with similar symptoms due to a minor virus running through the community. He tells Peter Wolf that his office is closing, the situation is not very serious and that he has seen many other children that day with similar symptoms. Dr. Mike tells Peter Wolf to make sure little Peter gets plenty of fluids and rest. If Peter, Jr. does not perk up, Dr. Mike will be happy to see him on Friday. With that, Dr. Mike went home for the Thanksgiving holiday.

Dr. Mike is having a wonderful Thanksgiving when, late in the evening, his pager sounds. He learns that little Peter has been admitted to the DuPont Children's Hospital in serious condition. He has bacterial meningitis. After a harrowing hospitalization, little Peter returns home. He is permanently deaf and shows signs of significant cognitive impairment.

Peter Wolf is distraught. He goes to Delaware's famous malpractice attorney, Ken Fortress, who immediately files suit.

### **THE JUDGMENT**

Dr. Mike attended many national asset protection programs during his career. He heard the horror stories of doctors losing everything as the result of "frivolous lawsuits." Throughout his career, Dr. Mike maintained \$3,000,000 of insurance coverage through the Funko Insurance Company. During the lawsuit he is informed that Funko is in receivership (primarily due to the large jury awards obtained by Ken Fortress) and that the State Insurance Commissioner's Office has a fund that will provide no more than \$300,000 worth of coverage. The lawsuit is emotionally draining and Dr. Mike begins arguing with his wife. She divorces him.

At trial, the jury takes one look at little Peter in his wheelchair and very quickly returns a verdict against Dr. Mike for \$8,500,000. The Delaware Supreme Court upholds the verdict.

Dr. Mike's life is in shambles.

**DR. MIKE'S ASSETS**

Dr. Mike was very careful not to put assets into joint names with his wife after his first divorce. His holdings immediately prior to the lawsuit are as follows:

<b><u>Asset</u></b>	<b><u>Dr. Mike</u></b>	<b><u>Mrs. Mike</u></b>	<b><u>Joint</u></b>
Greenville Home			\$600,000
Lewes Beach Home	\$1,900,000		
Newark Office, L.P.	980,000		
DE Bank Accounts	30,000	10,000	80,000
Mutual Funds	20,000		
Tangibles	30,000	10,000	150,000
Cars	70,000	50,000	
Universal Life Insurance Cash Value (Death Benefit \$2,000,000)	120,000		
Profit Sharing Plan	500,000		
MP Pension Plan	2,500,000		
IRA	350,000		
Commercial Annuity	50,000		
Offshore Trust (1990) – Cook Islands	1,000,000		
Delaware Asset Protection Trust (1997)	1,200,000		
Section 529 Plans	300,000		
Dr. Mike, M.D., P.A.	<u>100,000</u>	<u>                    </u>	<u>                    </u>
 Total	 <u>\$9,150,000</u>	 <u>\$70,000</u>	 <u>\$830,000</u>

The beach house is titled solely in Dr. Mike's name. His office is owned by a family limited partnership created for estate tax purposes. Dr. Mike owns a 1% interest as general partner and a 97% interest as limited partner. His brother is a 1% general partner and a trust for the benefit of his three children is a 1% general partner. Dr. Mike serves as sole trustee.

Dr. Mike created the Cook Islands Offshore Trust in 1990 after he attended an asset protection seminar for doctors sponsored by Hiding Your Assets, Inc. Dr. Mike created the Delaware Asset Protection Trust immediately after Delaware adopted the Qualified Dispositions In Trusts Statute with the help of his local estate-planning attorney.

Can Dr. Mike save his assets from the judgment creditor?

[Discussion]

### **AVOIDANCE AND INSURANCE**

- A. Obviously the greatest way to avoid loss of assets is to avoid the liability in the first place. Professionals adopt practices and procedures over the years that prevent injury and protect them from lawsuits.
- B. Malpractice coverage is also important in preventing loss of assets. An aggressive trial lawyer with a good liability case is not likely to walk away without something for the effort. Quite often the practice is for the plaintiff's counsel to accept insurance coverage (the quick and certain cash) and release the defendant from loss of personal assets.
- C. General liability coverage is also an important part of insurance protection. Individuals are encouraged to purchase more than the minimum coverage required for automobile liability and to purchase umbrella coverage of anywhere between \$1,000,000 to \$3,000,000 as part of the homeowner's and automobile liability insurance coverage. Umbrella coverage tends to cost about \$300 per \$1,000,000.

### **ASSET PROTECTION TECHNIQUES**

- A. Notwithstanding that great efforts may be made to avoid liability and to insure against it, there is always the possibility of a large jury award. When this happens, the loss of the defendant's assets will depend upon the type of assets owned and how those assets are titled.
- B. The following considerations should be taken into account:
  - (1) Tenancy by the Entirety - Tenancy by the entirety is a form of joint ownership that may only be accomplished when a husband and wife, or partners in a civil union, take title to an asset as tenants by the entirety and not as joint tenants with right of survivorship or as tenants in common. Typically, a husband and wife will own the marital residence as tenants by the entirety. However, it is also possible to own investment accounts, e.g. brokerage accounts and bank accounts, as tenants by the entirety. Most institutions are not familiar with this rule and you must press to have the account properly titled.
    - (a) A judgment against one spouse who is an owner of tenancy by the entirety property does not allow the judgment creditor to levy on the property. Caution: The lien of a judgment against real property is good for ten (10) years and may be renewed for another ten (10) years in Delaware. A judgment creditor of one spouse may docket the judgment and wait in the hope that the innocent spouse will die first (so that title is owned solely by the spouse against whom the judgment is docketed) or the couple may divorce.

- (b) Placing title to property in a tenancy by the entirety is often not the best planning in second and third marriage situations where the property was owned by one spouse before the marriage and is not “marital property” subject to equitable division in the event of a divorce.
- (2) Qualified Retirement Plans and IRAs - These assets are protected by specific statutes in Delaware. Title 10 of the Delaware Code § 4915 exempts IRAs and retirement plans from the lien of a judgment creditor. In addition, federal law specifically protects all qualified retirement plans, in full, and IRAs to a certain extent through the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (“Bankruptcy Act”).
  - (a) There is no doubt that assets in a qualified retirement plan, such as a 401k plan, pension plan and the like, are protected. The protection is unlimited and, in Delaware, is mandated by statute.
  - (b) IRAs present a different issue. They are fully protected to the extent of a rollover from a qualified retirement plan. In addition, non-rollover IRAs are fully protected under state law and protected to the extent of \$1 million indexed for inflation under federal law.
- (3) Life Insurance and Annuities - There are new laws in Delaware that protect life insurance and annuities, but under old statutory provisions there were extreme limitations. These limitations have now been removed.
  - (a) Under old law, the cash value of life insurance was not exempt from the owner’s creditor, but the death benefit payable to a third party while the judgment is in place is exempt. 18 Del. C. § 2725.
  - (b) Under old law, annuity contracts were protected, but only to the extent necessary to provide a monthly benefit of \$350 to the owner. 18 Del. C. § 2728.
  - (c) The Delaware state legislature adopted a new law, which became effective in Delaware on August 1, 2011. The new law completely exempts life insurance (the cash surrender value and the death benefit) and annuities from attachment.
- (4) Qualified State Tuition Programs - Nearly every state sponsors a qualified state tuition plan. These plans, often referred to as Section 529 Plans, allow after tax dollars to be contributed to a plan where the funds grow tax free to provide for higher education. To the extent the funds are used for higher education, there is no income tax on the fund. The Delaware plan is managed by Fidelity Investments.

- (a) The owner of the account is the person making contributions. The owner may always withdraw the funds at any time subject to the requirement that tax on the earnings must be paid, together with a penalty tax equal to 10% of the earnings.
  - (b) The maximum contribution limit to a plan is \$320,000 per beneficiary. Contributions are exempt up to the gift tax limit of \$13,000 per year, but a “quick start” contribution of \$65,000 may be made for a beneficiary and amortized over five (5) years.
  - (c) Assets contributed to a qualified state tuition plan more than 365 days before a judgment against the owner are exempt from creditors’ claims. 10 Del. C. § 4916. Assets contributed within the one-year period are exempt, but only in an amount that is the greater of \$5,000 or the average annual contribution made by the debtor-owner to the plan account for the two calendar years preceding the date of the filing of execution on the judgment.
  - (d) Qualified state tuition plans are an excellent way to provide for a child’s education and also protect assets from creditors.
- (5) Automobile Ownership - Delaware, like most states, has special laws dealing with liability of an adult for a minor driving an automobile. Delaware provides that an owner of a motor vehicle who knowingly permits a minor to drive the vehicle shall be jointly and severally liable with the minor for any damages caused by the negligence of the minor. 21 Del. C. § 6105. It should be apparent that a husband and wife who are protecting assets by having them titled as tenants by the entirety should not co-own a vehicle that is principally driven by a person under the age of eighteen.
- (a) Delaware law also makes a parent, guardian or employer of a minor liable for the negligence of the minor where the person signs the license application on behalf of the minor. 21 Del. C. § 6104.
- (6) Limited Liability Companies and Limited Partnerships - Limited liability companies and limited partnerships are forms of business ownership that carry with them specific characteristics for both federal income tax and state law purposes. When two or more individuals contribute assets to a limited partnership or a limited liability company that is properly formed, those individuals no longer own a direct interest in the asset. Instead, they own an interest in the entity that owns the asset.
- (a) Under Delaware law, a judgment creditor of a partner in a limited partnership or a member of a limited liability company may not reach the defendant’s proportionate ownership interest in the assets of the entity.

Instead, the judgment creditor receives only a charging order. 6 Del. C. § 17-703 and 6 Del. C. § 18-703.

- (b) A charging order allows the judgment creditor to receive any distributions that otherwise would have been made directly to the owner of the partnership or limited liability company. If no distributions are made, the judgment creditor receives no funds.
- (c) Notwithstanding that no distributions are made, it appears that a judgment creditor with a charging order is liable for income taxes on the proportionate part of the income held by the entity and not distributed. This puts the judgment creditor in the unenviable position of having a tax liability without the cash with which to pay the tax.
- (d) Often in situations where a charging order is obtained and no distributions are made, the judgment creditor will be quick to settle to avoid the tax liability.

### **THE DELAWARE ASSET PROTECTION TRUST**

- A. Delaware has always had a strong asset protection statute that protects the beneficiaries of a third party “spendthrift” trust. For example, when due to a parent’s death or lifetime creation of an irrevocable trust assets pass to a child in the form of a trust that is properly drafted, the judgment creditors of the child may not reach the assets of the trust to satisfy their lien. 12 Del. C. § 3536. A child may continue to receive lifetime benefits from the trust and may ignore the judgment creditors.
- B. Common law and strong public policy prohibited a person from creating a trust for himself (“self-settled trust”) to insulate his assets from creditors. It was, therefore, not possible for a person to transfer his or her own assets to a trust that provided lifetime benefits to the person and also protects the assets.
- C. All of the traditional thinking on self-settled trusts was changed in Delaware when Delaware adopted The Qualified Dispositions in Trust Act. 12 Del. C. § 3570. The Act was adopted on July 9, 1997. It is now possible for a person anywhere in the United States to establish a Delaware asset protection trust that provides lifetime benefits to that person and also insulates those assets from attachment by judgment creditors notwithstanding that the person continues to receive lifetime benefits from the trust.
- D. To create a Delaware asset protection trust the following must occur:
  - (1) A trust document must be executed.
  - (2) The trustee must be either a Delaware resident individual or a Delaware trust company.

- (3) A Delaware trustee must conduct some minimal level of business, i.e., maintain records, file tax returns, and hold title to the assets.
  - (4) The trust must be irrevocable.
  - (5) The trustor may retain the right to veto trust distributions, to receive income, to receive annuity or unitrust payments, to receive principal distributions and appoint the assets at death to the beneficiaries the trustor desires.
  - (6) A person other than the trustor may be appointed as a distribution advisor for distributions to be made from the trust and an investment direction advisor may also be appointed to direct how the trust assets will be invested.
- E. Assets transferred to a Delaware asset protection trust through a qualified disposition that meets the requirements of the statute are protected from claims of judgment creditors against the maker of the trust as follows:
- (1) The trust assets are exempt from all claims against the trustor that arise more than four years after the transfer of assets to the trust; and
  - (2) The trust assets are exempt from all claims that arose before the transfer to the trust one year after actual notice to the claimant of the transfer to the trust.

#### **FOLLOW UP**

It should be apparent that there are many techniques to protect assets from a judgment creditor. While common principles of asset protection apply, each situation is unique and requires individual planning.