CHAPTER 80

Asset Protection Utilizing Asset Protection Trusts and Limited Liability Companies

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INTRODUCTION AND OVERVIEW

Corporate Shield of Liability

For centuries, business structures have been utilized for asset protection planning. A corporation is normally a very effective way to shield one's personal assets from liability resulting from the operation of a business. Normally, the shareholders of the corporation are only liable to the extent of their investment in the corporation. However, officers, directors, and employees can be personally liable for their conduct relative to the operation of the business and, therefore, may want to consider other alternative means of asset protection with respect to their personal assets. Over the last few decades, expanding theories of liability and the proliferation of litigation has given increased emphasis to asset protection planning above and beyond the corporate shield of protection. Potential liability is a major concern to doctors, dentists, other professionals, and persons of high net worth engaged in business or real estate activities.

Inside and Outside Debts

1. Inside creditors are those creditors whose claims are directed against the business operation or real estate which is operated and owned inside of a business entity.
2. Outside creditors are those creditors whose claims arise outside the purview of the business entity and are generally asserted against the professional, business, or real estate owner personally.
3. Corporations protect against inside debts against the business, as do limited liability companies (LLCs). LLCs are state chartered entities that provide a shield of protection similar to the corporate shield, but are treated for tax purposes as either a sole proprietorship or partnership. LLCs are extensively used to hold real estate assets because they combine the protection aspects of a corporation with the tax benefits of a partnership or proprietorship. Because of the tremendous liability potential of real estate activities, serous consideration has to be given to holding real estate (especially income-producing real estate) in LLCs.
4. Although corporations and LLCs protect against inside debts, we have already

indicated that many professionals, business, and real estate owners are concerned about outside debts or personal debts such as malpractice claims, negligence claims for accidents, and other kinds of personal liability claims engendered by aggressive plaintiffs' lawyers. The question then becomes, how do we protect against the outside claims (personal liability claims)? This is where the combination of an LLC with an asset protection trust can be a very beneficial strategy.

The LLC and the Charging Order

The basic remedy of a creditor of a member or owner of an LLC is to obtain a charging order against that member. The charging order prevents the creditor from reaching the LLC assets. The creditor is limited to a court order charging the interest of the member/debtor so that if any distributions are made from the LLC to the member, they have to be distributed to the creditor. Normally, the creditor gets only the economic rights to the distributions, not the voting rights or other non-economic rights of the LLC member. The application of the charging order in any particular case will depend on the state's statutory provisions and case law treating the charging order subject. The benefit of the charging order remedy to the owner of the LLC is that the assets within the LLC are protected from outright seizure by the creditor who is limited only to distributions that may not be made pursuant to the discretionary right of the manager to withhold such distributions. In other words, assets that would otherwise be attractive to a judgment creditor become much less attractive if they are held within a LLC where a charging order is the exclusive remedy.

Domestic Asset Protection Trusts

1. The general rule in most states is that creditors can reach the interest of the trustor (the maker of the trust) of domestic self-settled trusts. However, several states have recently adopted legislation somewhat similar to various offshore jurisdictions that provide, by statute, various degrees of asset protection for a trustor's interest as a beneficiary of a self-settled trust. Alaska, Delaware, South Dakota and Nevada seem to have the best laws in this regard.

2. If properly set up and maintained, the domestic asset protection trust is a significant barrier to creditors and will afford significant leverage to the debtor with respect to his or her negotiations with the creditor. This is especially true if the assets of the trust needing protection are domiciled in a state which is a domiciliary of the asset protection trust.

3. The problem is that the courts of the non-domiciliary states may not give effect to the asset protection features of the trust. However, there is no question that a significant degree of protection is afforded by using the domestic asset protection trust, especially when it comes to negotiating for a settlement with the creditor.

Foreign Asset Protection Trusts

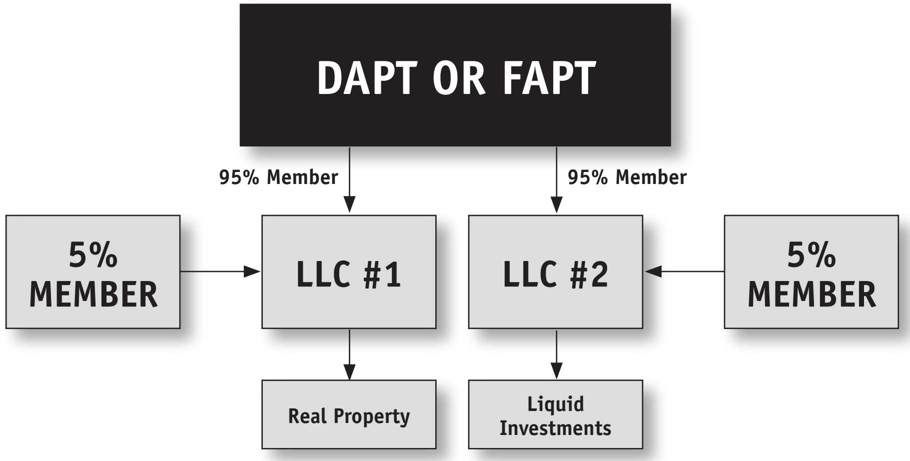
1. A foreign asset protection trust is a trust that is set up in an offshore jurisdiction which has enabling trust legislation providing for substantial protection against

creditors of the trust. One of the greatest advantages of the foreign asset protection trust is the fact that by its very nature, any legal attack against its assets is transferred abroad to a different legal system. Normally, a foreign trustee is necessary for the efficacy of the foreign asset protection trust. The biggest advantage in utilizing the foreign asset protection trust is that assets can be placed offshore beyond the jurisdiction of U.S. courts. Some of the principal advantages of offshore trusts are as follows:

- Most foreign jurisdictions do not recognize U.S. court decisions as judgments. This may force a new trial on the merits in the foreign situs country.
- Some foreign situs jurisdictions require a much more difficult burden of proof for a creditor to challenge asset transfers to foreign asset protection trusts.
- Some jurisdictions have a statute of limitations for challenging asset transfers to a foreign asset protection trust that begins to run on the date of transfer.
- Fees and expenses in litigating in the foreign jurisdictions are going to be substantial, thereby serving as a strong deterrent to foreign litigation.

Modular Structuring

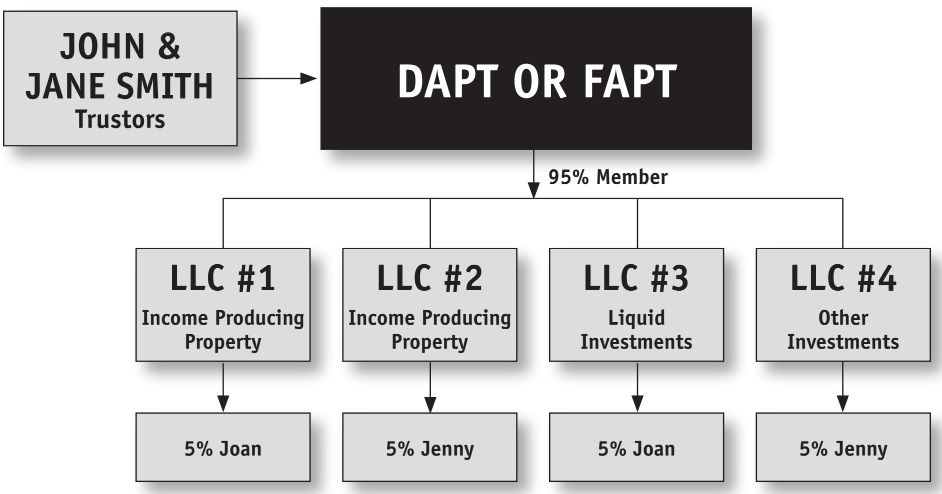
One of the best asset protection strategies is to combine the utilization of the domestic asset protection trust (DAPT) or foreign asset protection trust (FAPT) with an LLC. Basically, the member interest of the owner of the LLC is transferred to the DAPT or FAPT, which holds the interest more or less as a custodian. For example, a husband or wife can be a trustor or the maker of a DAPT or FAPT. An LLC can then be set up to hold real property and the member interest can be transferred to the DAPT or FAPT. Another LLC can be set up to hold liquid investments and, again, the member interest can be transferred to the DAPT or FAPT. It is recommended that a third party own at least 5% of the LLC because the efficacy of the charging order is greatly reduced and even eliminated when the LLC is a single member LLC. A diagram of the structure is set forth below:



Divided You Stand, United You Fall

If an individual owns everything in one company, or in his or her own name, one lawsuit can result in the individual losing everything he or she owns. However, if assets are spread around into different liability-protected entities, then only the entity involved in the suit may be at risk. What this means is that most valuable assets should be segregated into separate LLCs (i.e., real estate parcels in separate LLCs and business equipment and/or liquid investments in other LLCs).

> **EXAMPLE:** John Smith and his wife, Jane own two income-producing properties and several percentage investments in other real estate projects. John is a building contractor and developer, and is not only worried about liability for his real estate and business interests, but also has concerns about personal liability. He and Jane set up a DAPT and place their income-producing properties in separate LLCs, and some of their investments and liquidities in other LLCs. John's sister, Joan is given a small interest in some of the LLCs, and Jane's sister, Jenny is given a small interest in some of the other LLCs. If creditors try to assert personal liability against John and are successful in obtaining a judgment, they will have to try to enforce the judgment by going against the DAPT as well as the various LLCs, where they may be limited only to a charging order remedy. The example is diagrammed below:



Jeffrey R. Matsen, Wealth Strategies Counsel, has been designation by ***Worth Magazine*** *as one of the "Top One Hundred Attorneys" in the country. His firm provides estate, asset protection, and business planning.*