COVERING YOUR ASSETS: A PRIMER ON ASSET PROTECTION

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This article will ask you to imagine that the unthinkable has just happened to you. For the last two years, you have been a defendant in a lawsuit along with the other shareholders in your business, Acme Manufacturing, Inc. Your working capital lender required all of Acme's major shareholders to sign personal guarantees of the corporate debt. Business was good for a while, but the fallout following the financial crisis of 2008 was too much for the business to survive and in 2012, Acme defaulted on the loan. The lender foreclosed and obtained judgments against all of you.

That was bad enough. Over the last few months however, you have come to realize that the lender has chosen to proceed only against you rather than any of the co-guarantors. Your attorney has explained to you that the liability from the guarantee is joint and several so the lender has the right to collect its debt from any one or more of you. In an effort to cheer you up, your attorney says that you have rights of contribution against your fellow co-guarantors so that after you pay the entire debt to the lender, you may recover a pro rata share from all of them.

That makes you feel a little better until you ask your attorney why the lender chose to proceed only against you. "Oh that's easy," he says. "All of the other co-guarantors took steps to make collection of a debt against them difficult. You didn't do anything to protect yourself. It's nothing personal, the lender just made a rational decision on who would be easiest (and least expensive) to pursue."

It dawns on you that you will have a difficult time pursuing a contribution remedy against the co-guarantors. The same techniques that they used to discourage the lender from going after them will be just as effective against you. Let's take a look at those techniques that the co-guarantors have used to make debt collection against them difficult.

TENANTS BY THE ENTIRETY

Co-Guarantor No. 1, Alan, lives in one of the states that recognize a form of joint ownership between a husband and wife, called "tenants by the entirety" ("TBE"). Alan titled his residence and his mutual fund account (most states that recognize TBE allow both real and personal property ownership in the form TBE) with his spouse Zoe. Zoe was not a shareholder, a co-guarantor or in any way involved with Acme. Creditors of an individual spouse may not attach the interest of that spouse in assets held in TBE. Therefore, unless a creditor has both spouses obligated under a loan or credit arrangement, the property owned as TBE is protected from such creditors. Certain states with TBE also have enacted statutes that expressly allow TBE property to be transferred to a Joint Revocable Trust and still retain this very desirable form of creditor protection of TBE property. This allows couples in those states to utilize the favorable estate planning aspects of a

Revocable Trust as part of their estate plan, while retaining the effective creditor protection aspects of TBE.

401(K) PLANS/IRAS

Co-Guarantor No. 2, Brent, has a large 401(k) account. Unlike some of the other co-guarantors, he did not borrow against his account when Acme started to fail. Brent knew that his 401(k) account would be an exempt asset in the event any creditor came after him, so he maxed out contributions to the 401(k) account and never took any distributions or loans from it. Overall, Qualified Retirement Accounts (401(k) Plans, Pensions and IRAs) have very good creditor protection attributes, including exemptions in bankruptcy. However, such security was jolted in a 2014 Supreme Court ruling in which the Court ruled that inherited IRAs (where one is a beneficiary of an IRA rather than the owner) were not "retirement funds" and therefore lack the creditor protection afforded under Federal law.

HOMESTEAD

Co-Guarantor #3, Caroline, resides in one of six states – Florida, Iowa, Kansas, Oklahoma, South Dakota and Texas – that recognizes a very generous homestead exemption. That is, if Caroline lives in an urban area, her residence, including up to one acre of land (less in Florida and Iowa), is exempt from creditors, regardless of its value. Similarly, if Caroline lives in an unincorporated area, her residence, including up to 160 acres of land (less in Florida and Iowa), is exempt from creditors, regardless of its value.

Your attorney points out that, even in the six states with very generous homestead exemptions, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 restricts homestead exemptions in bankruptcy: individuals who have acquired their homes less than 40 months prior to filing for bankruptcy are capped at an exemption amount of $155,675. Because Caroline has resided in her home for five years, her potential filing for bankruptcy won't cause her to lose her most valuable asset.

CASH VALUE LIFE INSURANCE

Co-Guarantor No. 4, Delia, lives in one of the 14 states that exempt substantial amounts of cash value in a life insurance policy from attachment in a civil suit or in a bankruptcy proceeding. In Delia's state, 100 percent of cash value that has accumulated at least 12 months prior to the recording of a judgment or the filing of bankruptcy is exempt from creditors. Your attorney points out that in some states, the cash value is exempt only if the amount expended on life insurance premiums was not made with the intent to avoid, hinder or delay creditors. In other states, there is a limit on the dollar value of cash value that may be protected from creditors. Unfortunately for you, Delia lives in one of the states that allow for a 100 percent cash value exemption even if the life insurance was acquired with the intent to avoid, hinder, or delay creditors.

You tell your attorney to examine Delia's policy closely to see how much of the cash value accumulated within the previous 12 months.

DOMESTIC ASSET PROTECTION TRUST

Co-Guarantor No. 5, Ethan, lives in one of the 14 states (a very different group than the states referred to in the Cash Value Life Insurance section) that have enacted statutes allowing the creation of Domestic Asset Protection Trusts ("DAPTs"). Essentially, DAPTs allow an individual to establish a trust, contribute property to it and retain a beneficial interest in that trust. In other words, a DAPT allows one to do what was until recently impossible to accomplish: Create a trust for one's own protection. Your attorney points out that there are numerous state-specific rules that Ethan must follow in order for his DAPT to "work." Those rules generally encompass such items as (1) the identity of the trustee; (2) the timing of contributions to the DAPT; the contributions must have been made a certain number of years prior to the creditor's filing of a judgment or the debtor's filing of bankruptcy in order for the DAPT protections to be effective; (3) the nature of the debtor's beneficial interest; the trustee of the DAPT must have a discretionary right rather than a mandatory obligation to distribute trust assets to Ethan in order to be able to decline demands to make distributions to Ethan's creditors.

You tell your attorney to examine Ethan's DAPT and the contributions that he has made to it closely to determine if all or any of his contributions to the DAPT are protected.

CONCLUSION

So what conclusions can we draw from this unfortunate experience?

First, don't assume that if your liability is joint and several (general partnership, tenants in common arrangement or a co-guarantor), that your liability is limited to your pro rata portion of the total debt.

Second, if your liability is joint and several, be proactive about protecting yourself. Ask to see the net worth statements that your co-guarantors provide to the lender. If those statements contain the type of assets or ownership arrangements described in this article, understand what impact that may have on you. You may wind up shouldering much more than your pro rata share of the liability.

Third, be aware of certain clues that will tell you whether your co-guarantors are using or are planning to use asset protection techniques. Some are obvious. If any of the co-guarantors live in a state with a very generous homestead exemption, find out when they purchased their homes and what their mortgage balances are. If they are paying down their mortgage balances faster than usual, understand why they might be doing that. Some techniques are less obvious. You would have no idea that a fellow co-guarantor had a life insurance policy with a large cash value accumulation unless you asked about it specifically or saw it on a net worth statement.

Fourth, learn what asset protection options are available to you and decide if you are comfortable using any of them. Keep in mind the old adage: "If you are playing poker and you don't know who the mark is, it's probably you."

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