

Report From Counsel

Limiting Personal Liability Exposure

By George W. Skogstrom, Jr., Esq.

One of the questions we are frequently asked in these interesting economic times, with sales off, debt mounting, and expenses high (despite cost cutting measures) is “How much exposure do I have.”

The simple answer is: if you own it and you are found liable, then it is exposed. Like every good rule, however, there are exceptions. Certain assets are exempt from attachment or execution (subsistence payroll income, for example). What we are concerned with for purposes of this article, are the assets that are likely to be two of your more valuable assets: your home and your retirement accounts.

Homestead

It is this simple, if you don't have one—get one. A homestead will protect up to \$500,000 in equity (that is, above the mortgages!) and, in certain cases, can be “stacked” (that is, two people can each have a homestead on the same home). A few of the basic rules are that the homestead must be in writing, it must be recorded at the registry of deeds and you can only have one (that is, you can only homestead your principal residence and not your summer house). Under Massachusetts law, the homestead is valid only against subsequently incurred debts, so it won't protect your home from previously incurred debts.

While lawyers can, and do, debate what is a “debt” and “when did it arise”, the best thing to do is file a homestead now and get that clock tick-

ing. The homestead is never valid against a mortgage granted on the property, but will hold up against any other debt. Furthermore, unlike the state law which exempts debts incurred prior to filing, under the current bankruptcy law in Massachusetts, you can file a homestead on your way to the bankruptcy court and still get the full benefit of the homestead. While no one wants to consider bankruptcy, it is good to know that if things get really bad you can still keep the house.

401(k), IRA and Retirement Plan Exposure

Many business people have either participated in or established IRA, 401(k) or other retirement plans. If your plan is covered by ERISA (most plans are as ERISA is very, very comprehensive in its scope and application to almost any employee benefit plan), then your 401(k), SEP IRA, or Simple IRA plan account is protected from your creditors' reach. The protections afforded by ERISA are not as extensive as the homestead as the IRS can levy on your 401(k) for unpaid taxes while they cannot do so against your homestead.

In addition to the “Two cows, twelve sheep, two swine and four tons of hay” and other sundry items of personal property protected from creditors by Massachusetts law (other than spouses or crime victims), Massachusetts protects:

“The right or interest of any person in an annuity, pension, profit sharing or other retirement plan subject to the federal Employee Retirement Income Security Act of 1974, in any plan maintained by one or more self-employed individuals as a Keogh Plan, so-called, in any plan maintained by a corporation or other business organization pursuant to *section 401(a) of the Internal Revenue Code* but not subject to the federal Employee Retirement Income Security Act of 1974, or in any Simplified Employee Plan, annuity plan to which the provisions of *section 403(b) of the Internal Revenue Code* apply or Individual Retirement Account or Annuity maintained by an individual, or in any annuity or similar contract distributed from or purchased with assets distributed from any of the foregoing . . .”,

A very important and potentially very large carve out applies to IRAs where the statute provides that:

“The exemption in this section for plans maintained by an individual, whether or not self-employed, shall not apply to sums deposited, determined without regard to deposits pursuant to a rollover or transfer except to the extent protection under this sec-

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Life Insurance Policy Rescinded

A business executive was answering questions for an application for a \$3 million life insurance policy that named as the beneficiary a company he had started with others. He answered in the negative when asked the common question as to whether he “[e]ngaged in auto, motorcycle or boat racing, parachuting, skin or scuba diving, skydiving, or hang gliding or other hazardous avocation or hobby.” In fact, on about 20 occasions, the executive had gone heli-skiing, which involves skiing down remote

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mountain trails after being dropped off by a helicopter.

Only three months after the policy was issued, the executive was killed in an avalanche while heli-skiing. The tragedy for his survivors and former business partners was compounded in the courtroom when a federal appeals court upheld the life insurer’s rescission of the life insurance policy on the ground of a misrepresentation on the application.

A reasonable person in the position of the life insurance policy applicant would have known that his heli-skiing avocation constituted a hazardous activity, as that term was used in the application. The applicant clearly was aware of the heightened avalanche risks associated with heli-skiing, as compared to resort skiing. He had routinely signed waivers to that effect whenever he engaged a company that made arrangements for such excursions. It was hardly necessary for the insurer to point out, in making this argument, that heli-skiing commonly involves rescue and survival

training and the use of specialized lights and breathing devices meant to increase one’s chances of surviving an avalanche.

About three weeks after the executive had completed the insurance application by telephone, an underwriter making calls for the insurer called him with some follow-up questions, including the same inquiry about “any hazardous activities.” This time, the executive mentioned in the conversation that he enjoyed skiing and golf, among other things, but still there was no mention of heli-skiing. Nor did the executive show any concerns or confu-

sion over what the term “hazardous activities” meant. The beneficiary under the rescinded policy unsuccessfully sought to use this exchange to argue that the life insurer was chargeable with knowledge of the insured’s concealment of his heli-skiing avocation, and thus was precluded from seeking rescission.

The court ruled that the insured’s “skiing” statement, when combined with the negative responses to the general question of whether he engaged in hazardous activities, would not have put

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\$200,000 for Identity Theft Victim

Nicole discovered that someone with a name very similar to hers had stolen her identity and opened fraudulent accounts in her name and under her Social Security number. This was only the beginning of a long and arduous saga in which she took all of the recommended steps to rectify the problem, but nonetheless was beset by financial and emotional stresses over several years before the matter was finally resolved. Ultimately, she secured some relief in the form of a substantial jury verdict against a credit reporting firm. The firm bore no responsibility for the identity theft itself, but it had repeatedly compounded the impact of the theft by mishandling information about Nicole. Nicole sued the firm under the federal Fair Credit Reporting Act (FCRA).

Although it did not do so intentionally, the credit reporting firm had caused Nicole’s ordeal to be more protracted, and to have more consequences for her finances and general well-being, by mistakenly putting her address and Social Security number on

credit files set up by the identity thief. What is worse, the firm did this a few times over several years, even after having been informed of the problem. Because of the erroneously adverse credit files, Nicole was sometimes denied credit, such as for a home mortgage. On other occasions, she was offered credit only on very disadvantageous terms because she was perceived as such a high risk. Nicole did have some previous credit problems of her own making, but the “infection” of her credit information by the files created by the identity thief made her look even worse to lenders.

A key issue in the firm’s unsuccessful appeal from the jury verdict was whether Nicole had shown enough to recover a large sum not just for out-of-pocket losses, but also for emotional distress. The federal appellate court left the verdict undisturbed. The jury had not indicated what portion of its total award was attributable to emotional injuries, but, in any case, the

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Charitable Remainder Trusts

As the name implies, a charitable remainder trust involves the transfer of assets to a trust with the income going to an individual or individuals (which can include the owner of the assets) and with a charity receiving the assets at the expiration of the trust period. Such a trust device benefits the individuals who are the objects of the property owner's generosity, it transfers assets to the property owner's preferred charities, and it yields tax savings for the property owner.

If the trust is created during the property owner's life, there is a charitable tax deduction equal to the present value of the charity's remainder interest, and the transferred property will escape federal estate tax. If the trust is established under a will, the charitable tax deduction will remove the property from the taxable estate.

There can be other, not so obvious, benefits. Where appreciated assets are transferred, especially where the assets have a low cost basis and there is a likelihood that the property owner would have sold the assets at some point had he not transferred them to the trust, the property owner avoids a capital gains tax that would be imposed upon an outright sale. If the trust sells the assets, it will have no capital gains tax liability because the trust is a tax-exempt entity.

If the property owner has established the trust in his lifetime, the fact that the trust can sell the property tax-free maximizes the income base for the income beneficiary, which can be the property owner himself. Moreover, if the trust is a charitable remainder unitrust (CRUT), under which the income is measured as a percentage (no less than 5% of the value of the trust property in a given year), the trust serves as a hedge against inflation for the in-

come beneficiary because as the trust property appreciates in value the income paid out increases. This is not true under the other type of charitable remainder trust, the charitable remainder annuity trust (CRAT), under which a fixed amount of income is paid out each year.

A CRUT can be used as a retirement plan. Although a CRUT usually pays a percentage of the trust's annual value, it can provide that income distributions may not exceed the amount of income actually earned by the CRUT in a given year. Any shortfall in income can then be made up when there is sufficient income. During the property owner's preretirement years, the CRUT can be

invested in growth stocks, thus producing little or no income. Upon retirement, those assets can be sold, with the proceeds invested in income-producing assets that will yield the agreed-upon income percentage, plus a "make-up" portion to compensate for the earlier shortfalls. Thus, income distributions from a CRUT can be minimized during the preretirement years and then maximized for the retirement years.

It is important to remember that a charitable remainder trust must meet a series of technical requirements and therefore should be drafted only by an experienced professional.

Identity Theft

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court was satisfied that the award was not excessive in light of the evidence offered at trial.

Nicole had been made to spend literally hundreds of hours, often while having to miss work, trying to undo the tangled mess created by the firm. The record showed that as she dealt with the credit reporting service and tried to cope with the rippling effects of its errors, Nicole often was uncharacteristically upset with friends, family members, and co-workers. She was beset by frequent headaches, sleeplessness, and even such symptoms as bad skin and hair loss. In short, Nicole became a wreck emotionally and even physically. For its role in causing it all, the credit reporting firm had to pay.

Life Insurance

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a prudent underwriter on notice of the need to investigate further. Otherwise, any report by an applicant of a generally low-hazard recreational activity, such as wrestling, juggling, or fishing, would unreasonably require the insurer to investigate the myriad possible "extreme" variants of such activities.

Instead, to make an insurer legally chargeable with knowledge of an undisclosed fact, generally it must be shown that it had knowledge of evidence indicating that the applicant was not truthful in answering a particular application question. In this case, there was no such "red flag" that might have allowed the policy beneficiary to avoid the consequences of the executive's untruthfulness.

Actual resolution of legal issues depends upon many factors, including variations of facts and state laws. This newsletter is not intended to provide legal advice on specific subjects, but rather to provide insight into legal developments and issues. The reader should always consult with legal counsel before taking action on matters covered by this newsletter.

Bonus Plan May Trigger Overtime

The federal Fair Labor Standards Act (FLSA) provides that employers may not require their employees to work more than 40 hours per work-week unless those employees receive overtime compensation at a rate of not less than one and one-half times their regular pay. The FLSA contains certain exemptions from the overtime compensation requirement, one of which is for employees working in a “bona fide executive, administrative, or professional capacity.” In other words, if an employee works in such a capacity, the employer is exempt from the general requirement of paying overtime pay. Under the FLSA regulations, an employee’s position must satisfy three tests to qualify for this exemption: (1) a duties test, (2) a salary-level test, and (3) a salary-basis test.

The issue before a federal appeals court recently was whether the compensation plans used for management-level employees of a health club chain satisfied the salary-basis test.

Under its bonus plan, in particular, the employer could deduct bonus plan “overpayments” if an employee did not meet certain performance levels. The legal outcome for the employees was affected by the time frame in which the compensation plan was in effect. For the period after August 23, 2004, when a new Department of Labor regulation on the salary-basis test went into effect, employees were entitled to compensation for pay periods in which actual deductions from pay were made. The regulation provided that “[a]n actual practice of making improper deductions demonstrates that the employer did not intend to pay employees on a salary basis.”

Other employees also were entitled to overtime compensation for some pay periods before the regulation’s effective date, even when the employer made no actual deductions, but the employer had in place a policy that made such deductions significantly likely to occur. Under a then-controlling United

States Supreme Court ruling, an employee was not paid on a salary basis, and thus was eligible for overtime compensation, if (1) there was an actual practice of salary deductions, or if (2) an employee was compensated under a policy that clearly communicated a significant likelihood of deductions.

In the case before the court, the policy fit within the “significant likelihood of deductions” category. The employer’s compensation plan targeted specific members of management; its policy set out a particularized formula whereby their pay would be in jeopardy; the employer took affirmative steps to demonstrate that the pay-deduction plan would be enforced (including the creation of a “performance pay committee” that made the case-by-case decisions); and it took actual

deductions from employees’ salaries not long after the employees stopped meeting their performance goals.

Employers desirous of avoiding a similar outcome, in which overtime pay ultimately is owed to employees generally considered by the employer to have been “salaried employees,” should be cautious about making any alterations to the predetermined pay for such employees. An employee will be considered to be paid on a “salary basis” within the meaning of the regulations only if the employee regularly receives a predetermined amount constituting all or part of the employee’s compensation, and such amount is not subject to reduction because of variations in the quality or quantity of the work performed.

Limiting Exposure

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tion would be limited in the absence of a rollover or transfer, in said plans during the five year period preceding the individual’s declaration of bankruptcy or entry of judgment in excess of 7 per cent of the total income of such individual for such period.”

The statute limits the protection afforded to IRAs to 7 per cent of your total income over the five year period preceding the entry of judgment or filing of bankruptcy. This means if you have a big IRA balance that has accumulated over a long period of time, you could face the potential loss of some of your money under Massachusetts law. Again, the Feds come to the rescue! Even though ERISA does not apply to IRAs, federal law still provides protec-

tion for up to \$1,095,000 (in 2009) of your aggregate traditional and Roth IRA assets if you declare bankruptcy. In addition, if you rolled funds into your IRA from an ERISA plan, then those assets (and earnings on them) are not subject to the cap. Federal law fully protects SEP IRA and SIMPLE IRA plans without limitation. Again, federal law governs only bankruptcy claims, not claims made by creditors in the courts.

If you have concerns about your particular situation, do not wait to take action. Good asset protection planning occurs well before we enter “crisis mode”. While things can be done, even in “crisis mode”, early planning makes for better results. If you have any questions concerning asset protection, you should not hesitate to contact us as we know these rules can be complicated and we are here to help.