Schlossberg & Associates, LLC

Report From Counsel

Insights and Developments in the Law **Spring 2009**

Staying One Step Ahead of Your Creditor Predator

By J. Keith Phifer, Esq.

Now more than ever before, our clients are expressing concern over their vulnerability to lawsuits and creditors. The question they ask us to help them answer is how can one shield assets from potential creditors? Medicaid planning and offshore asset shifting are the two things people most often think about when they hear the term "Asset Protection." However, these two topics are often not applicable to our clients, and, therefore, are not the subject of this article. On the one hand, some clients think of protecting assets from the cost of Medicaid. This is an important matter. But typically, Medicaid is a program for the impoverished, and therefore, really applies only to the impoverished. There are different rules that apply to Medicaid. Others think of sophisticated (and expensive) strategies involving Swiss bank accounts and trusts set up in the Cook Islands, among other places, for the ultra-wealthy. Important as well, admittedly, but the costs are often prohibitive to the typical small to mid size business owner.

Many of us, therefore, just don't think about taking steps to protect assets in our own lives, even though there are some relatively simple, time tested, and absolutely legitimate strategies that can effectively protect personal as well as business assets from the grasp of creditors, no matter how small or great a person's net worth might be. Clearly, in the increasingly litigious society in which we live, the use of asset protection planning to maximize the protection of an individual's estate is more important than ever. We are all exposed to divorce, civil lawsuits, environmental hazards, malpractice claims, simple contract issues, and taxes. Therefore, it is crucial to conduct a review of your own assets and, if you haven't already done so, implement a personalized asset protection strategy.

The following is a brief discussion of some basic concepts and strategies.

1. Incorporating

Whether it is a corporation, a limited liability company, or a limited partnership, the fundamental reason to incorporate is that it provides a legal structure for protecting one's personal assets from those of a business enterprise. The law in every state reflects the public policy that an individual pursuing a commercial endeavor may protect his or her personal assets from the creditors of the business by incorporating. This protection, however, contains exceptions for incorporated entities that do not follow appropriate corporate formalities. Merely having incorporated isn't enough. A corporation, for instance, must have bylaws, annual corporate minutes, stock ownership records, etc.,

Continued on page two.

Massachusetts Data Security Law Seminar Postponed

As many of you know, the implementation date for the new Massachusetts Data Security Laws has been pushed back to January 1, 2010. Therefore, the Firm's seminar (for the benefit of Firm clients) on the same topic has also been postponed. We have set a tentative date of October 1, 2009 at 8:30 am for the seminar. We will provide more details and sign-up information as the date gets closer. Seating capacity will be limited, however, those clients that signed up to the previously scheduled seminar will be given priority for attendance.

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Protecting Assets

Continued from page one.

and must not commingle funds or use business assets for personal expenses. Other incorporated entities, such as limited liability companies, and family limited partnerships have different requirements, but the substance is the same, they must follow the formalities required for that type of entity. Courts will deny the asset protection an incorporated entity is intended to provide, on the basis that in substance, if not in form, it was not operated as a separate incorporated entity. *To the extent a business has incorporated, but does not maintain the necessary documentation, the business is no more protected than it would be were it to operate as a sole proprietorship.*

2. Separating Assets

Once incorporated, a business owner should consider segregating business assets into separate entities, thereby protecting claims against one portion of the business from others. This can be accomplished by separating different business functions. For instance, a business that manufactures and ships widgets, may consider incorporating a widget manufacturing company that is separate from the widget shipping company. To the extent that a delivery truck, for example, has an accident that creates a claim, the assets of the shipping company may be exposed, but the assets of the manufacturing company may be preserved. The same widget manufacturer may own his own manufacturing plant. Typically, the business real estate is owned by a separate entity, and a formal lease (with fair market value rent) is executed between the real estate entity and the business entity, even though the same person or group ultimately owns both entities. Other more sophisticated strategies for separating assets from claims of the business involve selling a valuable asset (an expensive widget making machine, for example) to a separate entity, and having the business lease it back from the separate entity (Care must be given, however, to avoid unintentionally triggering Massachusetts sales taxes, among other traps for the unwary). The business can thereby protect the capital it has in the machine against other claims against the business. Or in the alternative, the company can make a loan to its shareholders, secured by the equipment, inventory, and receivables, for example, of the business, thereby stripping equity from the business. Of course, one other very simple way to accomplish such 'equity stripping' is to keep business cash accounts as low as possible by distributing cash out to the shareholders whenever possible.

3. The Charging Order

In the event that a slip and fall at the business results in a claimant suing the business and further, that the claimant makes a successful argument against the business owner, individually, as well (perhaps due to not having operated the entity with the appropriate level of corporate formality as discussed above), then in certain instances, the claimant can only obtain a charging order against the interest owned by the business owner in certain entities. A charging order is merely a right to receive the income earned by the owner of an interest in an incorporated entity, if, and only if, the entity makes such a distribution. In many ways, a charging order is a frustrating award to the recipient creditor because the creditor cannot compel the entity to make distributions of cash or assets to pay off the claim. The creditor merely owns a non-controlling, non marketable interest. This makes the collection much more difficult for the creditor, especially if the managing principals of the incorporated entity do not want that creditor to obtain the money. And in the closely held business context, they often do not. There is some disagreement in the legal community over the effectiveness of the charging order in the context of entities which are owned 100% by one individual, but these issues can typically be resolved with proper planning.

4. The Estate Plan

When considering drafting an estate plan designed to distribute assets to children, avoid probate, and save in estate taxes, a parent often overlooks what may be the biggest asset protection strategy available, the kind of asset protection otherwise only available to the ultra wealthy as discussed above. By providing children their inheritance *in trust* (to be used for their benefit) for their entire lifetime, a parent can protect that inheritance from the claims of creditors (including ex-spouses). Typically, the law provides that a person can not protect against claims against that person, individually, by making transfers of his or her own assets to a trust of which he or she benefits. (In simple terms, a person who is getting a divorce can not transfer his or her brokerage account to a trust, established for his or her benefit, that will prevent it from being considered in divorce proceedings). But, the law also recognizes a person's right to restrict a gift of assets to another. In essence, an inheritance is merely a gift to one's children, and therefore such a gift can have restrictions placed on it. So although the child can not keep his or her own assets from consideration in divorce proceedings, a parent's estate plan can contain provisions that allow the child to be the beneficiary of a trust during the child's lifetime (and even allow the grandchildren to get the assets upon the child's death) while preventing exposure of the assets to the child's ex-spouse, or other creditors. Since the parent has restricted the use of the inheritance (while still providing for the use of the money for the children's benefit) the ex-spouse's rights to the assets are limited.

5. Insurance

Of course, the first topic in any asset protection discussion involves insurance. Life, property, casualty, and umbrella are all considerably effective methods for ensuring that in the event of a loss, whether due to creditors, acts

Continued on page four.

Estate Planning: A Gift of Debt

If you inherit property, of course you should be grateful and count your blessings. Still, consider the possibility that the gift may come with a big string attached—a debt linked to the property, such as is particularly common with real estate or a car. In that event, the question arises as to whether the debt must be satisfied from the particular asset or from the decedent's estate more generally. How this question is answered can cause a big swing in the respective gift amounts for beneficiaries of an estate.

Historically, the law presumed that the debt was *not* to be paid from the property that was connected to it. The reasoning was that a true gift should not come laden with such a burden. Over time, as taking on debt became commonplace, this thinking changed and statutes flipped the conventional assumption. Increasingly, these laws start from the premise that the property left to someone includes the debt on the property, unless the decedent in his or her will clearly indicated a different intent. That is where careful estate planning, with professional guidance, comes in.

It is best to leave no doubt for the ordinary lay reader of a will. A general directive in the will to pay all debts of the testator is too nebulous. Instead, if the intent is not to keep the asset joined to the debt, language something like this should be used in a will: "If [the specific asset] is subject to a mortgage, security interest, or other lien, I direct that my executor pay the debt from other property of my estate which is not given to a specific person or entity."

This scenario was played out recently in a case in which a farmer left to his (favored?) son three different farms, each of which was encumbered by debt. To his other son he left the residue of the estate. When the father died, the executor used part of the estate proceeds to pay off the loans to the farms, so that the first son would receive them debt-free. Not surprisingly, the second son, whose inheritance was thereby diminished, brought the matter to court.

The second son prevailed, forcing payment of the debts for the farms to come from the farms themselves. The father's will directed in a general way that debts were to be paid from the estate. However, under the relevant state statute, that was not a sufficiently explicit indication of intent to satisfy the debts on the farms from the residuary estate. In other words, the will had not clearly shown an intent that the first son was to receive the farms debt-free. As a result, the first son got the three farms, but he, not the second son, also got the responsibility for paying off the attached encumbrances, which totaled almost a quarter of a million dollars.

Real Estate Roundup

No-Show Mover Must Make Mortgage Payments

A family hired a moving company to pack up their belongings in their home and move them to a new house in another state. The mover packed up everything, but failed to come back for the loading and moving. This was more than merely inconvenient, because the family's sale of their old house was contingent upon delivery of a vacant house. When the purchasers arrived to find a house full of packed boxes, the sale fell through.

The family sued the moving company for breach of contract and negligence. Their attorney wrote to the mover demanding reimbursement for lost profits when the family had to regroup and find a new buyer, and for the additional mortgage payments, utilities, and taxes they had to pay during that time. The letter stated that it was not possible to give an exact dollar amount on the damages until the home was actually sold to a new buyer.

Under a federal law known as the Carmack Amendment and accompanying regulations, a carrier must issue a receipt or bill of lading, under which it may be liable for loss or injury to property if the claimant makes a timely claim for the payment of a specified or "determinable" amount of money. The Amendment preempts any state law claims such as the family had alleged in their lawsuit.

The mover argued without success that the family could not recover the mortgage payments and other forms of damages under the Carmack Amendment because the letter from the family's attorney, lacking a dollar amount for the claimed damages, had not sought a "determinable" sum of money. A federal court ruled that valid claims against a carrier are "determinable," not because they include some dollar amount, but because they provide enough information about the na-

Continued on page three.

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.

Real Estate Roundup

Continued from page three.

ture and extent of the carrier's liability to allow the carrier to understand its potential exposure to liability. The attorney's letter satisfied that requirement. Although a valid claim against a carrier will often include an estimate of the shipper's damages along with enough factual information to inform the carrier of the basis for the claim, a dollar amount is not an absolute requirement under the Carmack Amendment.

Economic Loss Rule Bars Misrepresentation Claim

Where parties have entered into a contractual relationship and damage occurs occasioning merely economic losses, the economic loss rule bars the complaining party from asserting tort remedies and limits that person to the contract remedies that were bargained for and agreed upon. Economic losses are distinguished from physical harm or damage to property other than the defective property itself. The rationale for the rule is that parties to a contract should resolve disputes emanating from that contractual relationship under the legal remedy that is most appropriate and most in keeping with their expectations when they signed the contract.

After a couple purchased a home, they discovered that the home had some leaks in its roof, despite what they said were assurances given both verbally and in disclosure forms that the sellers had never had a problem with the roof. When the new owners experienced water damage to interior ceilings, walls, and flooring due to the leaky roof, they sued the sellers for negligent misrepresentation. That theory ran aground on the economic loss rule, notwithstanding an argument against its application. The buyers argued to no avail that the rule should not apply because the claim was not for damage to the leaky roof itself, but to the resulting damage inside the home.

The court declined to split up the house, figuratively speaking, for purposes of the economic loss rule. As the court put it, the buyers purchased a finished home from the sellers, not a collection of component parts. Both the roof and the other damaged parts of the house were under the umbrella of the sales contract. Accordingly, any assurances that had been given by the sellers had to be examined and evaluated through the agreement, not on tort principles.

Protecting Assets

Continued from page two.

of nature, or otherwise, there is protection. All individuals, whether business owners or not, should take efforts to implement and regularly review their insurance protection, and their coverage exclusions.

6. Homestead

A simple way of protecting the value of the equity in a primary residence is by recording a homestead declaration. A homestead in Massachusetts is a statutory mechanism that provides for the protection of up to $500,000 worth of the equity in a primary residence from the subsequent claims of creditors. There is enhanced protection for individuals over the age of 62 and disabled individuals. Homesteads do not protect against claims of all creditors, however, including claims of child support, alimony, and, as recent case law indicates, bankruptcy.

7. Domestic Asset Protection Trusts (DAPT's)

Recently, Rhode Island has joined other states such as Delaware, Nevada, and Alaska, among others, in recognizing trusts that allow a person to transfer assets to avoid creditors claims in the same manner that foreign jurisdictions (like the said Cook Islands) purportedly provide. Although these types of trusts are certainly viable strategies (especially for clients who live or have assets in those jurisdictions), there is some uncertainty as to whether or not Massachusetts, for example, will recognize them with respect to a claim brought in Massachusetts. Therefore, due consideration should be given to whether the expense of setting up a DAPT is worth the potential benefit.

8. Foreign Entities

Costly though they may be, there are potential benefits to establishing offshore entities for clients who have high tolerances for risk. Examples do exist of wealthy individuals with major claims against them, who successfully shield assets from creditors by moving them offshore. Bernie Madoff, for example, has likely researched these kinds of strategies recently. The writing on the wall, however, seems to indicate such strategies are becoming less effective. The U.S. Government has recently had success against the likes of UBS, the Swiss banking giant, which led the Swiss government to overturn longstanding Swiss banking secrecy laws that historically enabled U.S. residents to shield their assets in Swiss banks.

The above examples are intended to convey generally methods of asset protection available. There are plenty of caveats and exceptions, and other matters to consider in the discussion of what kind of asset protection plan is right in each individual circumstance. But certainly, in every case, attention should be given to making sure assets are protected.