MAXIMUM ASSET PROTECTION
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ASSET PROTECTION: THE BASICS

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A. What is Asset Protection?

For the past several years asset protection has been one of the fastest growing areas of law. It is also one of the most controversial – the goal of asset protection is to shield assets from the reach of creditors.

Asset protection should simply be about structuring the ownership of one's assets to safeguard them from potential future risks. Most asset protection structures are commonly used business and estate planning tools, such as limited liability companies, family limited partnerships, trusts and the like. Properly implemented asset protection planning should be legal and ethical. It should not be based on hiding assets or on secrecy. It is not a means or an excuse to avoid or evade U. S. taxes.

There is no one "magic bullet" in asset protection. The term "asset protection" encompasses a number of planning and structuring mechanisms that may be implemented by a practitioner to minimize a client's exposure to risk. For each client the asset protection solution will be different, depending on (i) the identity of the debtor; (ii) the nature of the claim; (iii) the identity of the creditor; and (iv) the nature of the assets. These are four threshold factors that are either expressly or implicitly analyzed in each asset protection case. The analysis of these four factors determines what planning would be possible and effective for a specific client.

B. Identity of the Debtor

In analyzing the identity of the debtor, practitioner should consider the following initial issues:

1. Is the debtor an individual or an entity?

   a. If the debtor is an individual:

      i. Does he or she have a spouse, and is the spouse also liable? For example, the spouse may be liable as a co-signor of a personal guarantee or as a co-owner of community property assets.

         A. If the spouse of the debtor is not liable, is it possible to enter into a transmutation agreement transmuting the assets from community property to the respective separate property of each of the spouses?[1]

      ii. Are the spouses engaged in activities that are equally likely to result in lawsuits, or is one spouse more likely to be sued than the other?

   b. If the debtor is an entity:

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[1] See California Family Code ("CFC") Section 850 for rules governing transmutation agreements and the discussion below (Section IV, Planning in the Context of Marriage).

i. Did an individual guarantee the entity's debt?

ii. How likely is it that the creditor will be able to pierce the corporate veil, or otherwise get at the assets of the individual owners?

iii. Is there a statute that renders the individual personally liable for the obligations of the entity? For example, Section 6672 of the Internal Revenue Code of 1986, as amended (the "Code") renders those persons who are "responsible persons" liable for federal withholding taxes that were withheld but unpaid to the IRS.

Often, clients assume that if assets are placed within a limited liability entity, such assets are shielded from lawsuits. Another common assumption is that a lawsuit against such an entity cannot reach the owners of the entity. These assumptions are frequently erroneous (see Section VIII, Choice of Entity).

C. The Nature of the Claim

It is not sufficient to know the identity of the debtor. The practitioner will also need to know what type of a claim will be brought against the client. Here are some variables:

1. Are there any specific claims against the client, or is asset protection being undertaken as a result of a general fear of lawsuits and the desire to insulate the client from lawsuits?

2. Has the claim been reduced to a judgment? If the claim has been reduced to a judgment, what assets does the judgment encumber? For example, a lien will cover only those assets that are titled in the name of the defendant. If there is any variance, the judgment lien will not attach. Similarly, a notice for a debtor's examination will impose an automatic lien only on those assets which are titled in the name of the debtor.[2]

3. Has the claim matured to the extent that any transfer of assets will constitute a fraudulent transfer?

4. Is the claim brought against the debtor a tort claim? Tort claims are generally covered by liability insurance. To the extent that asset protection is desired, it is because the plaintiff will deem that the insurance coverage is not sufficient, and will seek to get the defendant to contribute to a settlement with the defendant's own funds.

5. Certain debts are subject to pre-judgment attachment, if: (i) they arose in the context of the debtor's business, and (ii) the amount owed is readily ascertainable. In this case the plaintiff does not need to wait until he obtains a judgment in order to encumber the asset.

[2] See, California Code of Civil Procedure ("CCP") Section 697.910(a).

However, the amount of the debt must be evident from the face of the instrument sued upon, such as a promissory note or a liquidated damage provision.[3]

6. An always relevant question is the dischargeability of the claim in bankruptcy. If the claim is dischargeable in bankruptcy, and the debtor's debts are exempt or otherwise unreachable, then asset protection planning may not be warranted - a bankruptcy discharging the claim will be sufficient.

a. The fact that a claim is dischargeable provides leverage when negotiating with creditors.

b. Asset protection planning and bankruptcy planning usually go hand-in-hand. Often the goal of asset protection planning is to structure the debtor's assets so that upon the filing of a bankruptcy the debtor's claims are discharged and assets are retained.

c. Certain debts, such as debts occasioned by fraud or breach of fiduciary duty, are not dischargeable in a Chapter 7 bankruptcy.[4] However, if the debtor qualifies under Chapter 13, even fraud claims may be effectively eliminated.

d. Federal income taxes are generally dischargeable in bankruptcy, provided that:[5]

i. The tax is assessable;
ii. The tax has been assessed or has been assessable for more than 240 days; and
iii. More than three years have elapsed from the due date of a timely filed return, or more than two years from the date of a late filed return, whichever is later.[6]

e. California income taxes are dischargeable four years from the due date of the return. However, if the California tax arises out of a federal income tax liability, the California tax is not dischargeable until four years from the date of filing of the amended return reporting the tax that arose from the federal liability.

f. Federal and state employment tax liabilities are generally not dischargeable.

g. It is unclear whether sales tax liabilities are dischargeable.

7. What is the statute of limitations for bringing the claim?

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[3] See, CCP Section 484.010(c) NOTE: Courts construe this statute strictly. The creditor must show that the debt arose out of the exact business that the debtor was engaged in. See, Nakasone v. Randall (1982) 129 Cal. App. 3d 757, 181 Cal. Rptr. 324.
[4] See, 11 U.S.C. Section 523.
[5] NOTE: This results only in the IRS losing its preference in bankruptcy. If the debtor has sufficient assets such that any unsecured creditor could recover in bankruptcy, the IRS will recover as well.
[6] See 11 U.S.C. Section 507.

a. The IRS may not assess any income tax after 3 years from the filing of the return.[7]

i. Exceptions: Fraud or unfiled return: no statute of limitations.[8]
ii. Where gross receipts (not income tax) is underreported by more than 25% of the amount required to be stated on the return: six year statute.[9]

b. The IRS has 10 years to collect any assessed tax. If the IRS cannot collect the tax within 10 years of assessment, the tax lien is removed and the tax debt extinguished.[10] This is also true of assessments resulting from unpaid employment taxes.

c. There is a 20-year statute of limitations with respect to the collection of assessed California income or employment taxes.[11]

8. What is the size of the potential claim? Creditors become more aggressive if the liability is greater. In addition, certain asset protection strategies are more expensive than others.

D. Identity of the Creditor

The third factor to be considered before implementing an asset protection strategy is the identity of the creditor. Here we are referring to certain creditor traits:

1. How aggressive/lazy is the creditor? How smart/knowledgeable is the creditor and the creditor's counsel? Accurately answering these questions will help us determine the scope of collection activities that the creditor is likely to engage in. This tells us how much protection the debtor requires.

2. Is the creditor a government agency? Taxing authority? Some government agencies possess powers of seizure that other government agencies do not. For example, the Federal Trade Commission has the power to seize assets that it deems are used to defraud creditors.

a. The IRS is now prevented from levying upon any asset without first giving the taxpayer the right to a Collection Due Process hearing to determine whether the proposed seizure is proper and is not an abuse of discretion.[12]

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[7] Code Section 6501(a).
[8] Code Sections 6501(c)(1) and (3).
[9] Code Section 6501(e)(1).
[10] See Code Section 6502(a)(1).
[11] Cal. Rev. Tax. Code Section 19255.
[12] See Code Section 6330.

b. There is no such prohibition on the ability of the California Franchise Tax Board to seize assets, but as a matter of policy the FTB will not seize a taxpayer's residence to pay a tax debt.

3. Is the potential creditor a spouse in a divorce that has not yet been filed? When a dissolution proceeding is commenced in California, an automatic freeze goes into effect, *i.e.* once the petition is filed, neither party to the proceeding has the right to transfer assets other than in the normal course of the marriage.

E. The Nature of the Assets

The final factor that needs to be analyzed is the nature of the assets we are seeking to protect. This factor, to a much greater extent than anything else, will determine what may be done and what needs to be done to protect the debtor:

1. To what extent are the assets exempt from the claims of creditors?

a. The California Homestead Exemption ($75,000, $100,000 or $175,000 depending on the circumstances).[13]

b. Assets in a qualified plan, *i.e*. assets in a plan under the Employee Retirement Income Security Act of 1974 ("ERISA") are generally exempt from the claims of creditors.[14]

i. A statutory exception exists for divisions of property incident to a divorce. A spouse may obtain a Qualified Domestic Relations Order ("QDRO") which has the effect of requiring the trustee of the plan to disgorge assets to the other spouse pursuant to the order. The spouse may also reach the assets of the qualified plan to satisfy an alimony obligation or child support.

ii. Assets in a qualified plan that are maintained solely for "employee-owners," *i.e*. plans whose only participants are owners, do not qualify for the exemption.

iii. The Internal Revenue Service may generally reach the assets of a qualified retirement plan. In U. S. v. Sawaf, 74 F. 3d 119 (1996), the court held that the Service can enforce its judgment by garnishment against the taxpayer's ERISA-qualified plan.

c. Assets in a non-qualified plan (called "private retirement plans" under California law) are exempt from the claims of creditors; and assets in an IRA or

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[13] See CCP Sections 704.720 and 704.730 and discussion below.

[14] See, Patterson v. Shumate, 112 S. Ct. 2242 (1992).

any other self-employed retirement plan are exempt to the extent the assets are necessary for the retirement needs of the debtor and the debtor's dependents.[15]

d. Face amount of life insurance and annuity policies is protected without a limitation, but loan values are protected only up to $9,700.[16]

e. Certain small exemptions are listed in the Code of Civil Procedure. This includes household furnishings, appliances and clothing (exempt without a limitation but to the extent ordinarily and reasonably necessary to the debtor),[17] jewelry, heirlooms and art (up to $6,075),[18] and tools of the trade (up to $6,075).[19]

2. How are the assets titled? If assets constitute community property, it is usually irrelevant that the assets are titled in the name of one spouse. The creditor can attach all of the community property, even if only one spouse is the debtor. This may hold true even if the debt arose prior to the marriage.[20]

3. The ability of a creditor to foreclose upon the assets of a trust of which the debtor is a beneficiary is governed by the Probate Code. As a general rule, a creditor has no right to attach the assets of a trust that is a spendthrift trust (but see discussion below).[21]

a. Also, as a general rule, if a beneficiary has no right to receive assets from a trust (*i.e*. where the trustee has the discretion to withhold distributions or where the trustee has a limited power of appointment to choose among different beneficiaries) the beneficiary's creditors will have no greater rights to the trust's assets than the beneficiary does.

b. A settlor in California cannot avoid his or her own creditors by placing the assets in a self-settled trust.[22] This rule does not obtain in many foreign jurisdictions that seek to attract trust assets, and has been repealed in Alaska, Delaware, Nevada and Rhode Island.

Each of the issues presented above should be carefully considered by a practitioner before structuring and implementing an asset protection plan. The following discussion will address some specific issues present in asset protection in greater detail.

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[15] See CCP Section 704.115. "...exempt only to the extent necessary to provide for the support of the judgment debtor when the judgment debtor retires and for the support of the spouse and dependents of the judgment debtor, taking into account all resources that are likely to be available for the support of the judgment debtor when the judgment debtor retires."
[16] CCP Section 704.100.
[17] CCP Section 704.020(a).
[18] CCP Section 704.040.
[19] CCP Section 704.060(a).
[20] See CCP Sections 695.020, 703.020 and 703.110.
[21] California Probate Code ("Probate Code") Section 15300. "Except as provided in Sections 15304 to 15307, inclusive, if the trust instrument provides that a beneficiary's interest in trust income is not subject to voluntary or involuntary transfer, the beneficiary's interest in income under the trust may not be transferred and is not subject to enforcement of a money judgment until paid to the beneficiary."
[22] Probate Code 15304(a).

II. Collecting on Judgments

A. California Statutory Collection Laws

Asset protection planning is premised on the creditor's ability to collect. After all, if the creditor has no right or power to collect on a judgment, there is no need for protective planning. This section will assume that a creditor has obtained a judgment against the debtor. What now? What can the creditor do to enforce that judgment, to collect on that judgment?

California collection statutes – those statutes that set forth a creditor's collection rights and powers, and explain the collection process, are set forth in Title 9 of the CCP, entitled "Enforcement of Judgments."

CCP Section 695.010(a) provides that all property owned by the debtor, subject to certain exceptions, is subject to enforcement of a judgment. Community property owned by a debtor's spouse is included within the "all property owned by the debtor."[23]

Additional costs and interest may be added to the judgment. As money comes in from the debtor to the creditor, it is first applied to satisfy any additional costs and interest, and only then, the principal balance of the judgment.[24] Interest accrues only on the original amount of the judgment unless judgments are periodically re-recorded, in which case interest compounds.

Judgments continue to exist for 10 years from the date of the entry of the judgment.[25] Judgments may be renewed for additional terms of 10 years.[26]

Judgments are usually collected through the lien mechanism. The creditor will place a lien on the debtor's real and personal property (by recording the judgment with the county recorder's office or entering it with the Secretary of State), and the lien will be satisfied when the property is sold by the debtor or foreclosed upon by the creditor. Once the underlying judgment is satisfied, the lien must be released.[27]

A judgment lien on real property is created when the judgment is recorded in the county where the debtor owns real property.[28] The judgment must be recorded in each county where the creditor wishes to create a lien against the debtor. The judgment lien continues to exist for 10 years from the date of the judgment, unless it is renewed.[29]

A judgment lien on personal property is created when notice is filed with the California Secretary of State and continues for 5 years.[30]

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[23] CCP Section 695.020(b).
[24] CCP Sections 695.210 and 695.221.
[25] CCP Section 683.020.
[26] CCP Sections 683.110(a) and 683.120(b).
[27] CCP Section 697.050.
[28] CCP Section 697.310(a).
[29] CCP Section 697.310(b).
[30] CCP Section 697.510.

In addition to collecting through the lien process, a creditor can collect through the writ of execution.[31] A writ of execution is issued by the clerk of the court where the creditor obtained its judgment.[32] The writ of execution directs the county sheriff to secure the debtor's property in that county. Thus, the writ of execution is a levy. A separate writ of execution must be issued for each county where the creditor intends to levy on debtor's property. The writ of execution is effective for 180 days.

All property owned by the debtor that is subject to a judgment may be levied upon through the writ of execution process.[33] This includes real property, but the levy must first be recorded in the county where the real property is located.[34] There are several exceptions, which include the interest of a partner in a partnership or a member in a limited liability company, the loan value of a life insurance contract, and the interest of a beneficiary in a trust.[35]

Once the levied property is collected by the sheriff, whether real or personal, the property is sold at a foreclosure sale to the highest bidder, for cash or cashier's check.[36] For tax liens, the property cannot be sold until the bid amount exceeds the state tax lien on the property and the exemption amount for the claimed property. Once the property is sold at the foreclosure sale, the lien on such property is extinguished.

Following the foreclosure sale the sheriff remits the amount collected, less certain costs, to the creditor, unless the property was subject to other liens with a priority higher than the judgment creditor. In that case the creditors are paid off in the order of their priority, and any amount left over is remitted to the debtor.[37] It is important to note that foreclosures of mortgages are subject to special rules.[38]

In some circumstances, the creditor may attempt to obtain a turnover order – a court order directing the debtor to turn its assets (usually a specific asset) over to the creditor. The turnover order is an exception to the writ of execution and is not easy to obtain.

B. Other Creditor Remedies

At any time while the creditor has a judgment outstanding against the debtor, the creditor may serve upon the debtor written interrogatories demanding information from the debtor which will assist the creditor in satisfying the judgment. Similarly, the creditor may demand documents and records from the debtor which will assist in satisfying the judgment.[39]

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[31] CCP Sections 699.010 through 699.090.
[32] CCP Section 699.510.
[33] CCP Section 699.710.
[34] CCP Section 700.015(a).
[35] CCP Section 699.720.
[36] CCP Section 701.510.
[37] CCP Section 701.810.
[38] See CCP Sections 725a-730.5.
[39] CCP Sections 708.020 and 708.030.

The creditor may also require the debtor to appear for a debtor exam before a court or a court appointed referee.[40] At a debtor exam, the debtor may be required to produce books and records, tax returns, financial information, witnesses and answer a battery of questions about past employment history, ownership and transfers of assets and any other information that would assist the creditor in locating debtor's assets.

If a creditor has a judgment against a partner in a partnership or a member of a limited liability company, the creditor can apply for a court order charging the interest of the partner/member in the entity.[41] (See discussion of charging orders, below.) Notice of the charging order must be given to all partners or all members of the entity.[42]

A creditor may also levy on the debtor's wages through the means of a wage garnishment.[43] The creditor cannot garnish the entire wage of the debtor. Pursuant to federal law, followed in California, the maximum the creditor can garnish is the lesser of: (i) 25% of the debtor's disposable earnings for the week, or (ii) the difference between (a) disposable earnings for the week, and (b) thirty times the federal minimum wage.[44] However, if the garnishment is to satisfy a support order, up to 50% of disposable earnings can be garnished.[45]

C. Exempt Property

Certain property of a debtor is exempt from collection by a creditor. The exemptions apply only to natural persons, not to entities.[46] If spouses co-own property that is covered by an exemption, the spouses are entitled to one exemption amount, they are not allowed to double the exemption amount, regardless of how they own the property.[47]

For certain properties an exemption must be claimed by the debtor, for other, the exemption applies automatically. To claim an exemption, the debtor must claim the exemption with the sheriff that is attempting to levy on the debtor's property.

The following property is exempt:

a. $2,300 of equity in automobiles;[48]

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[40] CCP Section 708.110.
[41] CCP Section 708.310.
[42] CCP Section 708.320.
[43] CCP Section 706.020-706.034.
[44] 15 U. S. C. 1673(a). The current federal minimum wage is $7.25 per hour. 29 U. S. C. 206(a)(1).
[45] 15 U. S. C. 1673(c).
[46] CCP Section 703.020. This should be considered before a personal residence is transferred to a limited liability company, a limited partnership or an irrevocable trust.
[47] CCP Section 703.110.
[48] CCP Section 704.010.

b. Household furnishings, appliances, provisions, clothing, and other personal effects if ordinarily and reasonably necessary to,[49] and personally used by the debtor and members of the debtor's family at their principal residence;[50]
c. $6,075 of jewelry, heirlooms, and works of art;[51]
d. $6,075 of tools of trade, including equipment, vehicles, books and other (amount is doubled if spouse is engaged in the same business);[52]
e. $9,700 of loan value of life insurance or annuity policy (face amount is exempt without having to make a claim);[53]
f. Private retirement plans without a limitation, but IRAs and self-employed plans to the extent amount necessary to provide for the support of the debtor (discussed in more detail at the end of the outline);[54] and
g. Certain claims for unemployment insurance, personal injury or workers insurance (without making a claim for exemption).

In addition to the above property, real property may be exempt to the extent the debtor has a homestead in the real property. Homestead real property is property which is the debtor's principal residence in which the debtor is residing at the time of the judgment and at the time of the collection. Homestead covers houses, condominiums, mobile homes, boats and other abodes of the debtor.[55]

The exempt amount of a homestead property is: (i) $75,000 unless clauses (ii) or (iii) apply; (ii) $100,000 if someone other than a debtor resides on the property and that other person does not have an ownership interest in the property, other than as a community property interest; or (iii) $175,000 for those debtors who are over 65 or physically disabled.[56] Spouses are not allowed to double their homestead exemption.[57]

A court order is required for the sale of the property in which a debtor has a homestead. Consequently, a debtor is not required to file a homestead declaration to benefit from the homestead exemption. However, a homestead declaration may be filed to designate a specific property as a homestead, when two or more properties can be treated as the debtor's primary residence.

D. Exemption Planning

[49] In determining whether an item is ordinarily and reasonably necessary, the court will take into account the extent to which the particular type of item is ordinarily found in a household, and whether the particular item has extraordinary value as compared to the value of items of the same type found in other households.
[50] CCP Section 704.020.
[51] CCP Section 704.040.
[52] CCP Section 704.060.
[53] CCP Section 704.100.
[54] CCP Section 704.115.
[55] CCP Section 704.710.
[56] CCP Section 704.730(a).
[57] CCP Section 704.730(b).

Exemption planning can be an important aspect of asset protection. Even if bankruptcy is contemplated, as discussed below, the debtor is allowed a choice of the exemptions provided by his or her state of residency and the bankruptcy code.[58] To be able to use a state's exemption statutes in the bankruptcy context, the debtor must have been domiciled in such state for at least 180 days. To be able to use an exemption for non-bankruptcy purposes, some states require residency, while others don't. This means that with respect to exemption planning debtors have an ability to shop for states with the best exemption scheme.

The two most significant exemptions are the homestead and life insurance exemptions.

Generally, a homestead exemption means that a creditor cannot force the sale of a property where the equity is protected by the homestead, and if the debtor sells the property, the sale proceeds are protected to the extent of the homestead.

In many states the homestead exemption greatly exceeds all other available exemptions. In California the homestead exemption can be $75,000, $100,000 or $175,000, with most debtors falling in the $100,000 range. While this exemption is generous compared to many other states, some states allow an even greater exemption.

For example, Arizona allows a flat $150,000 exemption, Massachusetts $125,000, while Minnesota allows a $390,000 exemption.[59] In Kansas, the exemption is unlimited for city lots not exceeding one acre (except for tax liabilities).[60]

The constitutions of Florida and Texas provide for unlimited homestead exemptions, although the size of the land is limited (Florida – 160 acres of rural land, and one-half acre of city land; Texas – 200 acres of rural land, and 10 acres of city land).[61]

It is important to remember that despite the amount of the homestead exemption, it does not exempt claims of all creditors. Certain creditors are not impacted by the homestead: the federal[62] and state governments for tax claims; alimony and child support claims; purchase money creditors who usually retain a security interest in the property; and debts for the improvement of the subject property.

In addition to the homestead exemption, many states grant a large exemption for life insurance. In California, there is no limitation on the face amount of insurance protected, but there is an $8,000 limitation on cash surrender value. In several states there is no limitation on protection afforded to cash surrender value. For example, in Florida cash surrender value is protected without a limit if the policy is owned by a state resident.[63]

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[58] Some states, including California, have opted out of this choice, which means that debtors in these states can only use the state's exemptions.
[59] Ariz. Rev. Statutes Section 33-1101(A) and (B); Mass. Gen. Laws ch. 188, Section 1; Minn. Stat. Section 510.02. All of these exemptions are periodically revised upward.
[60] Kan. Stat. Annotated Section 60-2301.
[61] Fla. Const. Article X, Section 4(a)(1); Tex. Const. Article XVI, Section 51.
[62] The Service is allowed to force the sale of property to satisfy tax claims under Code Sections 6321 and 6331.
[63] Fla. Stat. Annotated Section 222.14.