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ASSET PROTECTION - THE TEXAS PLAN Protections for Companies and Individuals

OVERVIEW:

Texas has an established history of protecting debtors and may be the best state in the U.S. for formulating and executing an asset protection strategy. This is a summary of the how the Texas Property Code and the Texas Business Organizations Code make it possible for individuals and business to shield assets (particularly equity in real property).

The essential choice between the two strategies is whether or not a person wants to form a Texas LLC (limited liability company) or not; if not, one would instead opt for taking the necessary steps to claim the unique and extensive protections afforded individuals by the Texas Property Code.

Company protections are achieved by creating a Texas limited liability company; use of a land trust; use of “DBA’s;” and use of an attorney as a trustee who has the power to invoke the attorney-client privilege. The goal should be to achieve maximum anonymity (ideally, the investor’s personal name, address, or social security number should not appear anywhere on the transactional paperwork) combined with a solid liability barrier, all of which provide legal and practical obstacles to a potential plaintiff which may deter him and his attorney from filing suit and also make it difficult to collect on a judgment.

ASSET PROTECTION IN THE REAL WORLD:

Bulletproof asset protection is not achievable in the real world, in spite of claims by internet and seminar “gurus” (who have never spent time in a real court of law in front of a real judge). Regardless of how hidden or well-placed your assets are, U.S. courts always have a contempt remedy if you do not reveal or produce them. That could be mean fines or even jail. Technical arguments about trusts and corporations set up in exotic island nations will not prevent an American judge from holding you in contempt.

Therefore, asset protection is really about deterrence, especially considering the number of frivolous and contingency-fee lawsuits that are filed in the U.S. If an investor can make it unacceptably expensive and time-consuming for a plaintiff and his attorney to discover and reach assets, then the investor’s asset protection plan has done its job. Every dollar of cost that an investor imposes on a potential plaintiff or his percentage attorney makes the investor’s assets incrementally more secure and makes it less likely that he will have to endure the living nightmare of a lawsuit.

PREVENTIVE MEASURES:

It is vital that an asset protection plan be implemented *before* trouble arises. Otherwise its usefulness is limited, if not entirely defeated, by rules against “fraudulent transfers” that reach back up to 2 years (these rules apply in many foreign jurisdictions as well). Fraudulent transfers are generally indicated by the so-called “badges of fraud,” such as transfers to a family member; whether or not suit was threatened before it was filed; whether the transfer was of substantially all of the person’s assets; whether assets have been removed, undisclosed, or concealed; whether there was equivalent consideration for the transfer; and whether or not, after the transfer, the transferor became insolvent as a result (eg., made his cash disappear). Asset protection strategies do not help you in the case of such fraudulent transfers. Therefore, the investor should be proactive and not reactive in asset protection planning. Consider asset protection a form of insurance that one takes out *prior* to a catastrophic event.

THE ROLE OF INSURANCE:

It is often asked if obtaining liability insurance is not sufficient. The answer is a resounding “No.” All legal experts recommend a sensible mix of insurance and asset protection. The principal reason is that insurance companies are in the business of collecting premiums and denying claims – thus every effort will be made by the company to exclude coverage in your case (particularly if the plaintiff alleges fraud, which is never covered). Also, even if the company concedes coverage, extravagant claims made in lawsuits nowadays may (and often do) exceed available coverage. Moreover, the existence of a sizable policy and umbrella may in and of itself encourage a lawsuit because it will be perceived by the plaintiff’s attorney as a tempting target!

ELEMENTS OF BASIC ASSET PROTECTION USING AN LLC:

- Liability barrier (creation of an LLC to hold title to properties)
- Anonymity (creation of trust and/or DBA)
- Creation of separate management company
- Attorney-client privilege (use of attorney as registered agent or trustee)

CREATION OF AN LLC:

Texas has excellent LLC laws and is recommended for simplicity of operation. Other popular options include Nevada and Delaware, but forming one of these companies requires designation of a registered agent in that state (who serves for a fee) and expensive filing fees to register in Texas.

An LLC provides a true liability barrier (so long as the company is maintained by minimal record-keeping plus payment of taxes) along with limited anonymity. Anonymity is

limited because information on the initial members and the incorporator of an LLC can be obtained from the secretary of state's office. Tenants and creditors should be instructed that they are doing business with the LLC and making payments to the LLC. **NO REAL ESTATE INVESTOR SHOULD BE WITHOUT A LIMITED LIABILITY COMPANY.** If you cannot afford one, you should wait until you can before entering the real estate investment business. Fees (subject to change) are \$650 plus costs (\$325 filing fee, \$80 for the corporate book, \$10 shipping), which include extensive documentation and follow-up legal advice.

An additional option is to create a Cayman Island, Belize, or other offshore entity which will own the U.S. LLC. This structure is entirely legal and provides superior asset protection. Note: use of an offshore entity for asset protection purposes is *not* designed to achieve tax reduction or avoidance, which is illegal. All U.S. citizens must pay income tax on earned income.

ROLE OF A LAND TRUST:

Once the LLC is established, it can choose to transfer its properties to a land trust which indicates nothing of record about real underlying ownership.

Land trusts also provide the capability of closing into a subprime buyer without lender approval and (for brokers) the opportunity to earn a commission. This is possible because beneficial interests in a trust are personal and not real property, and therefore the transaction is not subject to Sec. 5.069 of the Texas Property Code, which now makes conventional lease-options generally unworkable unless written for a term of less than 6 months or the property is paid for.

Note that land trusts do not defeat "due on sale" clauses although they may make a lender's exercise of such a clause less likely.

Note that a trust should always be used in conjunction with an LLC. This is necessary because a trust alone is *not* a liability barrier and therefore provides *no* asset protection. The belief that *intervivos* trusts protect assets is widespread but unfortunately false.

MANAGEMENT COMPANIES:

The investor should consider setting up an unaffiliated management company to serve as the front line of defense against tenants, creditors, and their attorneys. Tenants should do all their business with the management company and should never even be made aware of true underlying ownership. This entity should also be an LLC that is basically a shell or a pass-through for funds. It should own no real property, just its office furniture and equipment. So, in addition to its management duties, its role is to serve as a target that is deliberately put out there to draw fire away from the owners. If anyone obtains a judgment against the management company, it will likely be uncollectible.

ATTORNEY-CLIENT PRIVILEGE:

Use of an attorney as registered agent for the LLC or as trustee of a land trust adds yet additional layers of protection – first, anonymity, and second, the attorney-client privilege. In the case of a trust, the attorney serves is named as trustee but then appoints the Investor’s LLC as managing agent and attorney-in-fact to conduct day-to-day operations. A drawback to this technique are the fees and costs that must be paid annually to the attorney to compensate him for the risk involved in acting as the investor’s lightning rod.

FAMILY LIMITED PARTNERSHIPS:

What about family limited partnerships (FLP’s)? As for anonymity, Texas limited partnerships (like LLC’s) must be filed with the state and pertinent ownership information is revealed. An in-state registered agent must be designated to receive service of process if the partnership is sued. Liability protection is best achieved if the limited partner is a corporation or LLC. Nonetheless, an FLP is not the best ownership vehicle for so-called “risky assets” such as investment real estate. They are more suitable for cash, stocks, and bonds. Also, the FLP concept of a “friendly lien” on the homestead is not workable in Texas. FLP’s are not a panacea, at least in Texas, but have some utility as part of an overall asset protection plan. FLP’s are not included among the more basic options for purposes of this article.

LIMITED PARTNERSHIPS WITH AN LLC GENERAL PARTNER:

These vehicles are more complex and expensive, usually used in large commercial transactions, and are beyond the scope of these comments.

TEXAS HOMESTEAD PROTECTIONS FOR INDIVIDUALS:

Texas Homestead protections for individuals are contained in Art. XVI, Sec. 50 of the Texas Constitution and in Chapters 41 and 42 of the Texas Property Code.

The Texas Constitution provides the homestead of a family or single adult is protected from forced sale for purposes of paying debts and judgments except in cases of purchase money, *ad valorem* taxes, owelty of partition (divorce), home improvement loans, home equity loans, and reverse mortgages. Further, even a permitted lien must be in writing and signed by both spouses. This protection, combined with the prohibition against garnishment of wages contained in Sec. 28, has long made Texas a haven for debtors.

The Texas Property Code goes into more detail, specifically listing the amount and types of exempt property. It further provides in Sec. 41.001(5)(c) that “The homestead claimant’s proceeds of a sale of a homestead are not subject to seizure for a creditor’s claim for six months after the date of sale.” This expressly permits homestead protections to be rolled over from one homestead to the next, notwithstanding the preference on the part of title companies to collect judgments upon sale of the homestead. *Taylor v. Mosty Bros. Nursery, Inc.*, 777 S.W.2d 568, 570 (Tex.App. - San Antonio 1989, no writ).

Texas homestead laws are liberally construed by the courts. “Indeed, a court must uphold and enforce the Texas homestead laws even though in so doing the court might unwittingly assist a dishonest debtor in wrongfully defeating his creditor.” *Painewebber, Inc. V. Murray*, 260 B.R. 815, 822 (E.D.Tex.2001).

The Constitution and the Property Code provide an excellent opportunity for individuals (not corporations, LLC’s, or partnerships) to engage in asset protection.

Although there is a conceptual overlap, the homestead protection laws should not be confused with the homestead tax exemption as reflected on the rolls of an appraisal district, which is designed to lower *ad valorem* taxes on homeowner-occupied property.

DEFINITION OF HOMESTEAD:

Property Code Sec. 41.002 supplies the following definition:

(a) If used for the purposes of an urban home or as both an urban home and a place to exercise a calling or business, the homestead of a family or a single adult person not otherwise entitled to a homestead shall consist of not more than 10 acres of land which may be in one or more continuous lots, together with any improvements thereon.

(b) If used for the purposes of a rural home the homestead shall consist of:

(1) for a family, not more than 200 acres, which may be in one or more parcels, with the improvements thereon; or

(2) for a single, adult person, not otherwise entitled to a homestead, not more than 100 acres, which may be in one or more parcels, with the improvements thereon.

Note that this definition applies to realty and fixtures, not movable personal property (boats, travel trailers, and the like), although such personal property may be exempt under Chapter 42 (see below).

A person may claim an urban homestead or a rural homestead but not both. What constitutes “urban” versus “rural” has been the subject of much litigation. It is a fact issue that may differ from case to case. Once established, however, the initial characterization of the property as urban or rural continues even if the nature of the surrounding area changes. *U.S. v. Blakeman*, 997 F. 2d 1084.

A family may have only one homestead. Individual family members may not also claim

separate homesteads.

DESIGNATION OF HOMESTEAD:

It may be useful, both for *ad valorem* tax purposes and for protection from creditors, to file an affidavit designating the homestead in the real property records of the county in which the property is located (Prop. Code Sec. 41.005). However, for creditor protection, this is not strictly necessary. If a person receives a homestead tax exemption then this designation is automatic. Case law further provides that “when a homestead claimant is in actual occupancy of his homestead, it will be deemed that a lender or encumbrancer acted with knowledge of the occupant’s right to invoke the rule of homestead.” *Sanchez v. Telles*, 960 S.W.2d 762, 770 (Tex. App. - El Paso 1997, pet. Denied).

Filing an affidavit designating homestead may meet the homestead claimant’s initial burden of showing that property is homestead in character. Then, “Once property has been dedicated as homestead, it can only lose such designation by abandonment, alienation, or death. After the party has established the homestead character of the property, the burden shifts to the creditor . . . to disprove the continued existence of the homestead. In other words, a homestead is presumed to exist until its termination is proved.” *Wilcox v. Marriott*, 103 S.W.3d 469, 472 (Tex App. - San Antonio 2003, pet. denied). Once obtained, homestead rights are not easily removed. A homestead claimant may even temporarily rent the property so long as another homestead is not acquired (Prop. Code Sec. 41.003).

Note that it is not necessary that a homestead claimant actually reside on the property at the time homestead is claimed. “A homestead exemption may be established upon unoccupied land if the owner presently intends to occupy and use the premises in a reasonable and definite time in the future, and has made such preparations toward actual occupancy and use that are of such character and have proceeded to such an extent as to manifest beyond doubt the intention to complete the improvements and reside upon the place as a home.” *Farrington v. First Nat’l Bank*, 753 S.W.2d 248, 250-251 (Tex.App. - Houston [1st Dist.] 1988, write denied). Therefore, the key issues are *intent* and *preparation*. By these criteria, even a vacant lot can be homestead. So can a life estate or an executory interest (eg., a purchaser’s equitable title under a contract for deed). Generally, however, to in order to make a valid homestead claim, a person must have a present and exclusive possessory interest in the property.

A person may also execute an affidavit disclaiming particular property as homestead (and, optionally, designating other property as homestead), and a lender is entitled to rely on such an affidavit in making a loan that will be secured by non-homestead property. This is typically referred to as a “non-homestead affidavit.”

JUDGMENTS:

Texas courts have ruled that although a judgment lien may be unenforceable against a

homestead, it may nonetheless constitute a cloud on title, even if it is invalid. *Tarrant Bank v. Mark B. Miller, et al.*, 833 S.W.2d 666 (Tex.App. - Eastland 1992). This generally results in title companies refusing to issue title insurance unless a seller/debtor's judgments are paid, notwithstanding the six-month rollover protection contained in Property Code Sec. 41.001(5)(c). The remedy is found in Property Code Sec. 52.0012 (new in 2007), which provides a statutory method for securing a release of a judgment lien against homestead property.

PERSONAL PROPERTY PROTECTIONS:

Certain personal property receives protection under Chapter 42 of the Texas Property Code. Specifically, personal property valued at \$60,000 for a family or \$30,000 for a single adult (exclusive of liens) is exempt from garnishment, attachment, execution or other seizure so long as it is on the following list:

- (1) home furnishings, including family heirlooms;**
- (2) provisions for consumption;**
- (3) farming or ranching vehicles and implements;**
- (4) tools, equipment, books, and apparatus, including boats and motor vehicles used in a trade or profession;**
- (5) wearing apparel;**
- (6) jewelry not to exceed 25 percent of the aggregate limitations prescribed by Section 42.001(a);**
- (7) two firearms;**
- (8) athletic and sporting equipment, including bicycles;**
- (9) a two-wheeled, three-wheeled, or four-wheeled, motor vehicle for each member of a family or single adult who holds a driver's license or who does not hold a driver's license but who relies on another person to operate the vehicle for the benefit of the nonlicensed person;**
- (10) the following animals and forage on hand for their consumption:**
 - (A) Two horses, mules, or donkeys and a saddle, blanket, and bridle for each;**
 - (B) 12 head of cattle;**
 - (C) 60 head of other types of livestock; and**
 - (D) 120 fowl; and**
- (11) household pets.**

Retirement plans are exempted under Sec. 42.021.

Finally, Sec. 42.004 states that an exemption is lost if non-exempt assets are used to buy or pay down indebtedness on exempt assets “with the intent to defraud, delay, or hinder” a creditor. However, proving such intent can be difficult, particularly since the debtor is expressly permitted to raise an “ordinary course of business” defense.

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