Legal Considerations for Protecting the Physician's Assets

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Most states require that as a consideration of obtaining and maintaining a medical license, all applicants must demonstrate "financial responsibility." Usually this includes: (1) establishing an escrow account of cash and/or readily marketable securities; (2) an irrevocable, non-transferable letter of credit; or (3) in most cases, medical malpractice insurance coverage. In recent years, some states have passed legislation that provides that under certain circumstances, a physician may qualify to forego any of the financial requirements, commonly referred to as "going bare." In this regard, much of the impetus for the recently enacted Obama healthcare plan was the rising cost of healthcare in the United States arising from the extensive, and, to some, unnecessary and extraneous testing and retesting to confirm medical diagnosis and treatment–for the patient's benefit but, as importantly, to forestall a potential medical malpractice claim. As the political challenge to what is commonly referred to as "Obamacare" proceeds, and in the absence of any legislative support for "tort reform" and limitations on frivolous malpractice claims, it is abundantly clear that an integral part of any professional's "estate planning" should include and incorporate the asset protection and exempt property statutes available under the laws of the jurisdiction where the physician resides.

Key words: Medical malpractice; exempt property; asset protection; spendthrift trusts

Most states require that as a condition of licensing and maintaining a medical license, all applicants must demonstrate "financial responsibility" by either: (1) establishing an **escrow account** consisting of cash or other assets in an amount set forth under local statutes; (2) maintaining **medical malpractice insurance** coverage of certain minimums per incident and per annum in the aggregate; or (3) maintaining an irrevocable, non-assignable and nontransferable **letter of credit** in an amount not less than a statutorily set amount per claim. The burden of demonstrating financial responsibility is often reduced for physicians without hospital privileges.

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State law often exempts several types of physicians from meeting the above standards, including a physician that can comply with all of the following:

- The physician must have been licensed to practice medicine for a certain number of years;
- The physician has no more than a set number of patient contact hours per year;
- The physician has not paid substantial claims over the recent past few years;
- The physician has never been convicted of or pled nolo contendere to a felony;
- The physician has a clean Board of Medicine record during his or her career; and
- The physician prominently displays in the reception area a statement similar to the following required under Florida law:

Under Florida law, physicians are generally required to carry medical malpractice insurance or otherwise demonstrate financial responsibility to cover potential claims for medical malpractice. YOUR DOCTOR HAS DECIDED NOT TO CARRY MEDICAL MALPRACTICE INSURANCE. This is permitted under Florida law subject to certain conditions. Florida law imposes penalties against noninsured physicians who fail to satisfy adverse judgments arising from claims of medical malpractice. This notice is provided pursuant to Florida law. (Section 458.320(5)(f)7, Florida Statutes)

A physician who chooses to "go bare" by qualifying under the foregoing statutory requirements for eligibility to terminate medical malpractice coverage exposes his and his family's personal assets to claims brought against him for professional malpractice. Accordingly, an integral part of any professional's "estate planning" (which traditionally focused on one creditor exclusively, the Internal Revenue Service) should incorporate the asset protection and exempt property statutes available under the laws of the jurisdiction where the physician resides.

For example, Florida law provides, under both its constitution and legislative code, exemptions for certain types of property and property ownership from the claims of creditors of the property owner. Ostensibly, the purpose underlying such statutory exemptions is to allow citizens to retain some assets after financial hardship to avoid becoming wards of the state and the financial responsibility of its taxpayers. Of course, the legislature of each state has determined the appropriate balance between the need of the taxpayers from protecting the destitute with the public's interest in the regulation of the health services industry from misconduct and malpractice.

Consequently, the laws of each state may exempt any or all of the following property or interests in property from claims of creditors:

HOMESTEAD

Under Art. X, Sec. 4 of the Constitution of the State of Florida, a Florida resident's homestead is protected from any forced sale and liens resulting from judgments, decrees, or executions if:

1. The homestead is ***owned by a natural person*** (although case law has expanded this protection to revocable inter vivos ["living"] trusts that own the property used by the settlor as his or her principal residence);
2. The homestead is the permanent residence of the owner or a legal or natural dependent of the owner;
3. If the homestead is located within a municipality, the homestead is limited to one-half acre of contiguous land; and
4. If the homestead is located outside of a municipality, the homestead is up to 160 acres of contiguous land.

LIFE INSURANCE

Life insurance proceeds payable upon the death of a resident may be exempt from the claims of creditors of the insured and will inure for the exclusive benefit of the beneficiary of the policy unless the insurance policy provides otherwise, or unless it is payable to the insured's estate. Some states limit the amount of death benefit that is so exempt; other states limit the types of policies so exempt, such as group life policies; and some states exempt policy proceeds depending upon the relationship of the designated beneficiary to the insured.

CASH SURRENDER VALUES AND ANNUITIES

The cash surrender value of a life insurance policy and the proceeds of an annuity issued to a resident may not be subject to attachment, garnishment, or legal process in favor of any creditor of the person whose life was insured or who was the beneficiary of the annuity unless the life insurance policy or annuity was purchased for the benefit of the creditor.

QUALIFIED PLANS

Money or assets payable to a participant or beneficiary from or in a retirement or profit-sharing plan that is qualified for tax purposes under the Internal Revenue Code, including IRAs and college savings plans under Section 529 of the Internal Revenue Code, may be exempt from claims of the participant's creditors.

TENANCY BY THE ENTIRETY

In jurisdictions where available, many physicians rely on ownership of property as tenants by the entirety with a spouse because a creditor of only one individual spouse cannot reach such property to satisfy its claim without the consent of the other spouse. Tenancy by the entireties is a form of ownership available exclusively to spouses; and must be distinguished from joint ownership with right of survivorship or JTWROS. However, this form of joint ownership is an ill-advised asset-protection planning strategy in the event the non-obligor spouse dies first. In that case, all of the assets will become owned exclusively by the surviving obligor spouse.

ENTITY PROTECTION

Limited Liability Company

A limited liability company (LLC) is a hybrid entity that combines the limited liability of a corporation and the flow-through taxation of a partnership. Based upon recent decisions arising out of the federal bankruptcy courts and certain state courts, other than with respect to a *single member* LLC, a court may "charge" a member's interest in an LLC with payment of the unsatisfied amount of the judgment with interest. In many states, the limitation of a judgment creditor's remedy against an interest of a member in an LLC to a "charging order" against the debtor-member's membership interest is the exclusive remedy that a creditor may use to satisfy a judgment, and other remedies are not available to a creditor attempting to satisfy a claim.

Because the judgment creditor is entitled only to the rights of an "assignee" of the interest, but no rights as a successor member, the charging order is apparently the only remedy of recovery available to a judgment creditor. From an asset-protection perspective, the charging order protection is an important and valuable benefit to the professional LLC form of business entity, as compared with a professional corporation (PC) or professional association (PA). The shares of stock representing an ownership interest in those other professional business entities can be attached in satisfaction of a judgment against the shareholder; or perhaps may trigger a buy-out of the shares upon an involuntary transfer in accordance with the terms of a shareholders' agreement, which exposes the cash down payment and promissory note to attachment in place of the shares.

Limited Liability Partnership

A limited liability partnership (LLP) is a general partnership that has registered as an LLP and has the same qualities as a general partnership except that the liability of its general partners may be limited in certain circumstances. The charging order protection applicable to the members of LLCs is similarly available to partners of LLPs.

Limited Liability Limited Partnership

A limited liability limited partnership (LLLP) is a limited partnership that has registered as an LLLP and has the same qualities as a limited partnership except that the liability of its general partners (and its limited partners who may be deemed to be liable as general partners) may be limited in certain circumstances. Since, in the context of a family LLLP, the general partner is typically responsible for determining the amount and timing of partnership distributions, the right to receive distributions may be of little value to the creditor. Worse yet, the charging order may subject the judgment creditor to income tax as though the creditor were the owner of the partnership interest. The flow-through tax treatment applicable to partnerships provides that the creditor may have to pay tax on a share of partnership income whether or not any distributions of income have actually been made by the partnership to the partner.

SPENDTHRIFT TRUSTS

If the creator of a trust (commonly referred to as the "settlor" or "grantor") wants to make sure the beneficiary's interest will be preserved and protected from the beneficiary's debts and obligations, can the settlor impose restrictions on the interest to preclude voluntary assignment of the trust assets? If so, will those restrictions prevent the beneficiary's creditors from reaching the trust's property?

Obviously, once a beneficiary receives a distribution from the trustee, the beneficiary is free to use the distribution as he or she wishes, and it becomes an asset, subject to the claims of the beneficiary's creditors indistinguishable from his or her other assets. A settlor's expression of intent as to restrictions on the use and purpose of the distribution is precatory at best and cannot protect the beneficiary from the beneficiary's own actions once he or she receives the distribution. At that point, the beneficiary has a legal interest in the assets, no longer simply an equitable one.

The foundation for acceptance of "spendthrift" trusts is found in the common law concept that maximum effort should be given to the objectives and intentions of the settlor. Historically, the general rule has been that the interest of a trust beneficiary, including the right to income from trust corpus, is alienable by the beneficiary. Additionally, the interest of a beneficiary is liable to be taken in satisfaction of his or her debts and obligations.

However, under most state laws trust assets may be protected against dissipation by a beneficiary or levy by creditors through creation of a spendthrift or similar protective trust. Provisions vesting discretion in the trustee to determine the time, amount, or manner of payments to the beneficiary likewise were recognized as valid. Historically, however, a spendthrift trust has been created to provide a fund for the maintenance *of another* while securing the fund against the beneficiary's own improvidence or incapacity.

Accordingly, although a physician may not be able to create a spendthrift trust to protect his or her own assets, it may be advisable for a physician's parents to create a spendthrift trust to protect the physician's inheritance from the claims of his or her creditors.

DOMESTIC ASSET PROTECTION TRUSTS

The general rule in the United Sates provides for nonrecognition of self-settled spendthrift trusts (i.e., trusts in which the settlor retains a beneficial interest and the trust instrument states that this interest cannot be alienated, either voluntarily or involuntarily). However, several states have now enacted legislation allowing self-settled asset protection trusts. Missouri was the first state to adopt asset protection trust legislation in 1989. The legislature in Alaska enacted milestone legislation in 1997 in an attempt to compete with foreign situs asset protection trusts, and the legislature in Delaware quickly followed suit. In 1999, asset protection trust legislation was adopted in Nevada and Rhode Island. There are now 13 states that permit a settlor to transfer assets to an irrevocable trust containing spendthrift provisions with respect to a settlor's creditors under certain conditions. Hawaii became the most recent state to adopt such trusts effective July 1, 2020.

FOREIGN ASSET PROTECTION TRUSTS

A new arrow becoming popular in the quiver of the overall estate or financial plan designed for wealthier clients, including healthcare professionals who have substantial practices or have been successful entrepreneurs and investors outside of their practices, is the establishment of an offshore asset protection trust (APT), commonly referred to as a "nest egg trust."

To begin this discussion, it must be clearly understood that if a transfer of assets is made for the *purpose of and with the intent to hinder, defraud, or delay a creditor*, then any such transfer will be deemed a *fraudulent transfer* and can be overturned by a United States court. Among the relevant "badges of fraud" are transfers of so much of one's assets so that the individual will be rendered insolvent.

A nest egg trust is an irrevocable trust established in a jurisdiction outside the United States for the primary purpose of protecting assets of the individual creating the trust. The trust isn't intended to shelter all of the individual's assets, but only provide a level of financial security, or a nest egg, in the event of a catastrophic financial crisis.

The costs of establishing and maintaining an offshore trust are rather substantial. The individual should have sufficient assets to justify the startup and ongoing expense, particularly in view of the fact that the individual will not be transferring all of his or her assets to the trust. Practically, the offshore trust is suitable for consideration by professionals, such as doctors, who are concerned about potential malpractice exposure, businesspersons who are concerned over the threat of increasing commercial litigation, and retirees who wish to preserve and protect assets they've worked long and hard to accumulate.

It is important to remember that this is not a fraudulent scheme or a strategy to avoid creditors or evade taxes. In fact, a nest egg trust is not appropriate for an individual already engaged in litigation or actively trying to avoid payment of an enforceable obligation.

APTs are usually established with banks or trust companies that are chartered in foreign jurisdictions where local laws provide very favorable conditions. For example, the local laws of many of these jurisdictions make it more difficult for a creditor to challenge the validity of property transfers into the trust. As in the United States, however, the trust is established by the execution of a written trust agreement, or settlement, between the creator of the trust and the financial institution serving as trustee.

From an income tax perspective, the arrangement is deemed a grantor trust, which means that *all of the income must be reported by the creator of the trust*. It must be clearly understood that there is no income tax benefit, shield, or protection accomplished by establishing a nest egg trust.

Furthermore, unless the trust is properly structured, the creator can be deemed to have made a completed gift for federal gift tax purposes at the time he or she transfers property into the trust. Notwithstanding the gift tax issue, so long as the creator retains a right to income or any benefit from the trust, the value of the trust also will be included in his or her estate for federal estate tax purposes. The trust, therefore, should be structured and coordinated as part of the creator's overall tax and estate plan.

A negative to this planning strategy is that a nest egg trust has to be irrevocable, because if the individual retains the power to change or revoke the terms of the trust, a court will generally allow a creditor the same access to the trust as reserved by the debtor.

To preserve some degree of indirect control and accountability, the trust arrangement can be structured to allow the creator to appoint a "trust protector," who must approve all actions taken by the trustee. So long as the protector is independent from the creator, the trust should maintain its irrevocability insofar as the creator is concerned. ■