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Insulating Your Assets From Lawsuits

It's Doable, But You Have to Act Ahead of Time

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If you listed your financial fears, you might include a repeat of 2008's market meltdown, losing your job and getting your identity stolen. But somewhere on the list, I suspect, would be another major worry: getting sued.

That risk can loom large if, say, you are wealthy, a doctor or have your own business. By the time you're slapped with a lawsuit, it's likely too late to protect yourself, so you need to act ahead of time. Here are some key weapons in your "asset protection" arsenal:

Retirement accounts. Got lots of money in individual retirement accounts, 401(k) plans and other tax-sheltered retirement plans? Good news: "Getting money into a 401(k) and IRA is a great way to get creditor protection," says Pittsburgh accountant and attorney James Lange.

Creditors might come after your assets because you lose a lawsuit or you have unpaid debts. If those debts force you to file for bankruptcy, your IRA, 401(k) and other retirement accounts will most likely be protected.

But the protection isn't absolute. For instance, retirement accounts remain vulnerable if you owe federal taxes or child support. In addition, the Supreme Court ruled this month that an inherited IRA isn't protected in bankruptcy, unless you inherited the account from your spouse.

What if the problem isn't bankruptcy, but rather you lose a lawsuit resulting, say, from somebody getting injured at your home? In that situation, employer-plan assets should be protected.

What about your IRA, including rollover IRA? You need to look at state law, advises tax attorney Adam Bergman of New York's IRA Financial Group.

"If you have a judgment against you and you don't file for bankruptcy, most states will still protect your IRA from the judgment," says Mr. Bergman.

Real estate. Many states have homestead exemptions that protect your principal residence if you lose a lawsuit. The extent of that protection, however, varies. Florida and Texas are renowned for their robust homestead exemptions, while other states might protect only a portion of your home's value.

Alternatively, you might gain some protection by titling your home using "tenancy by the entirety." With this ownership arrangement, which is available to married couples in some states, an asset can't be sold unless both spouses agree. This means the home might be protected if one spouse gets sued, because the other spouse could block the home's sale. It wouldn't help if both spouses were sued.

Umbrella liability insurance. Creditors can easily get at money in regular taxable accounts. What to do? You might buy umbrella liability insurance. This is typically bought from the insurer that provides you with auto and homeowners insurance, and it offers additional liability protection.

Pay careful attention to a policy's exclusions. For instance, while an umbrella policy should protect you if you're sued because of an incident at your home or while driving, it likely won't help with liability arising from your business dealings or if you deliberately damage somebody else's property.

Business structure. If you're self-employed or run a small business, there's a risk that business problems could threaten your personal assets. To fend off that risk, you might operate the business as an S corporation or limited-liability company. An LLC is the better bet, reckons Jeffrey Verdon, a lawyer in Newport Beach, Calif., because it's harder for creditors to take your share of the business to satisfy a personal debt.

Asset-protection trusts. Lawyers often suggest establishing an asset-protection trust if you have significant assets or if you're a doctor, real-estate developer or in another profession that tends to attract lawsuits.

These trusts are irrevocable, meaning you can't take back the assets. Instead, distributions are at the discretion of a trustee, who could stop payouts if there were a legal judgment against you. Asset-protection trusts can be established both in the U.S. and overseas. Mr. Verdon favors overseas trusts, which have been more extensively tested in court.

He believes it's worth considering a trust if you can fund it with at least $500,000. The price tag, however, is steep. A domestic trust might cost $10,000 to $20,000 to set up, while a foreign trust could cost $35,000 to $40,000, plus costs for administration and money management.

"It's a lot less expensive than replacing the assets lost in a lawsuit," Mr. Verdon notes. "If setting up the structure results in the case being settled for less than it otherwise would, then it's worked, in our view."

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