Equity-Stripping – An Asset Protection Technique

There are lots of little things that you can do to make it less likely that someone can take all your money away in a lawsuit, whether malpractice-related or otherwise. Sometimes these little things are cheap and easy and without significant adverse consequences, like titling your house properly. Other asset protection techniques are expensive and involved, and may decrease investment returns or increase your taxes. You definitely want to think twice before implementing these, and really weigh how much that asset protection is worth to you.

One asset protection technique you should be familiar with is the concept of equity-stripping. This basically means taking money from a position where it is exposed to a lawsuit, and putting it somewhere where it isn't. There are lots of variations, but here are a few examples. In my state, only $20,000 of equity in my home is protected from creditors. Since I have a lot more equity than that in the home, there is well over $100K exposed to any lawsuits that may come my way. I carry lots of insurance that would hopefully cover any loss, but it's possible that my liability could exceed my insurance and I could have to sell the home to meet a judgement. If I wanted to eliminate that risk, I could "equity-strip" the equity out of my home. This is generally done by taking out a loan, by either refinancing the home or taking out a home equity loan. I would then take the money and put it into my 401K or Roth IRAs, buying cash value life insurance, or perhaps use it to buy a boat in my wife's name. The point is that it is no longer exposed to my creditors, so not only do I not lose the equity, but I can't be forced to sell my house either. The downsides, of course, is that I would have to pay refinancing fees, interest on the loan, and a higher rate on the rest of my loan. Paying down the mortgage might be a far better return on my money than buying life insurance, and certainly better than buying a boat!

Some doctors worry about the equity in their practice, usually in the accounts receivable, but also theoretically in the building, property, or medical equipment. You can take out loans against all this stuff, stripping away the equity and reducing your liability exposure. You can even start another company that owns your practice, or just your equipment, and lease it back to yourself. This is often called "factoring" the accounts receivable. Sometimes you don't even increase your costs by doing this. For example, you could take out a loan against the accounts receivable and pay off the real estate loan with it (but have the real estate owned by a separate entity than the practice.)

Real estate can be protected to different degrees in different states. For example, in Texas, your primary home has essentially unlimited asset protection. If you owned a home in Texas and a home in my state, guess which loan you might want to pay down first?

Equity could also be stripped in the event of untoward financial events. For example, let's say you lose your job and can no longer make payments on your home, even though it is half paid off. Most people would opt to sell the home in this situation and preserve your equity. But if you couldn't sell it for whatever reason, you could refinance or take out a home equity loan to strip out the equity, then let it get foreclosed. (assuming you could sucker someone into loaning you money after you've lost your job.) I'll leave the ethical ramifications of that for the reader to decide, but it's not going to hurt your credit score any more to default on two mortgages than to default on one.

Reducing the amount of assets exposed to a lawsuit can often be a good idea, and equity-stripping is one way to do so. Consult legal counsel and perhaps even an accountant before taking such a drastic asset protection measure, and remember you have to do it BEFORE you get sued for it to do any good.

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