

Protecting Against Real Estate Losses

Published in MDNetGuide November 2006

By Robert J. Mintz
Copyright 2007

The types of issues raised by my clients are often a reliable indicator of major changes in the economy. What we are hearing at this point is that the decline in property values is beginning to have a serious impact throughout the country. Many of our physician clients have been active real estate investors over the past few years and they are concerned about the financial and legal consequences if the market weakens further. Stated more directly, falling prices create potential liability to lenders which can jeopardize other savings, not invested in real estate. In this column we can look at the extent of the risks presented and suggest the planning options to be considered to deal with these risks.

Declining Property Values

The full extent of the downturn in the real estate market isn't known at this point. Some experts predict a "soft" landing, pointing to historically low interest rates and continuing economic growth. But many of my clients, who are experienced real estate investors and have seen similar conditions before, are quietly preparing for the possibility of a much more dramatic drop in prices. The scenario that they describe unfolds like this: Most property owners believe they can afford to wait it out rather than sell their property when the market begins to cool. To avoid slashing the asking price by 20% or 30%, they simply take it off the market, anticipating an eventual rebound. The problem is that not everyone can afford to be patient. Builders, developers and investors may be unable or unwilling to support a negative cash flow for a project which has little or no equity remaining, resulting in foreclosure or a return of the property to the lender. With no ready buyers out there, the choice for property owners facing a payment squeeze is to cut the price or hand it back to the lender in foreclosure.

How does this affect you if others are forced to sell or lose a property in foreclosure? Well, that sale now establishes a new value for all other similar properties. Even if it's the only one sold (or foreclosed) that sale price is the new "comp" which must be used to value other properties. Your home or investment property is effectively "marked down" in value based on the price per foot or other appraisal method used to value the other property and some or all of your equity is eliminated. Suppose your neighbor can't afford the increase in his adjustable rate payments and his \$1 million house is sold or foreclosed for the \$800,000 loan amount. Then, you try to refinance your \$1 million home which will now appraise out for only \$800,000. The most you can now borrow is \$640,000,

which is not enough to pay off the existing loan. If you have no need to refinance or sell, then this loss of value in your home is probably not a big concern. But if you have a substantial investment in properties, whether or not you want to sell, the loss of equity is real and may produce direct financial consequences.

The Risk to Personal Assets

In a broad sense, the lender may foreclose on a property if the payments aren't made. In most cases, depending on the law of your state, the lender may then proceed against you personally, if the value of the property doesn't cover the amount of the loan. Generally, the lender can take the property and then obtain a "deficiency" judgment for any balance due. Then, your other assets can be collected to satisfy the debt and the related expenses. Many people are surprised to learn that they can lose far more than their original investment in a property. During the last decline, in the early 1990's, banks and other lenders were highly aggressive in pursuing personal assets to satisfy unpaid loan amounts.

Some states do not allow a lender to pursue your personal assets in particular situations. For example, in California, for loans made to purchase a residence, the lender's only remedy is to foreclose on the house. Whatever it's worth, that's all he gets. But if the original loan was replaced in a refinancing or the loan was used to buy investment property, then the lender has full access to all available assets to cover any shortfall in the value of the property.

Commercial and investment real estate has always presented risks of legal liability from tenants, visitors and buyers and we've discussed these risks and the appropriate asset protection strategies in previous articles (See "Lawsuit Protection for Rental Real Estate" MDNetGuide Sept. 2005– http://www.mdng.com/departments/2005-Sept/pc_mintz.htm). Now, those with large loans or personal guarantees face potential lawsuits from lenders if property values decline to a greater degree. Appropriate planning to protect personal assets can mitigate these risks but as always, we advise you to consult with your local attorney for advice on proper strategies based on the law in your state and your particular circumstances.

***Robert J. Mintz, JD**, is an attorney and the author of the book *Asset Protection for Physicians and High-Risk Business Owners*. To receive a complimentary copy of the book call 800-223-4291 or visit www.rjmintz.com*

*****End*****

