Advance Planning Can Cut Liability Risks

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A prospective client (Richard) asked for my help with a difficult legal and financial problem. I've changed the details slightly but here is the gist of the matter. Richard is a physician, earning a solid living and in 2005 he purchased an office building near Philadelphia that was leased entirely to the State of Pennsylvania. The lease had five years to run but the broker assured him that the State had been a tenant there for 20 years and wasn't likely to move. He bought the property for $2.5 million with an 80 percent loan. The problem is that the State has now given notice that it will be moving out in a few months and with no rental income from the property Richard won't be able to carry the $15,000 monthly negative. What should he do? If he stops making the payments the lender is likely to foreclose on the property and obtain a substantial deficiency judgment. Richard's personal savings and the equity in his home are subject to a collection action on the judgment and his 25 years of savings and hard work are certainly at risk.

"What were you thinking when you bought the property" I asked Richard. "Did you consider what would happen if the State didn't renew the lease - with you on the hook for a $2 million loan?"

"Never occurred to me." he said. " I just thought it was a good deal with a chance to make a lot of money down the road."

This scenario is not unusual these days and I may get 10 or so similar calls each week. In every case the caller has purchased a business or a rental property and the income has dropped substantially over the last two years. The choice is whether to keep dipping into dwindling savings to make the payments, hoping to forestall a collection action for some time, or to give the property back now. In either case substantial losses will be incurred, far beyond the initial investment.

Underestimating Risk

In my experience, this common failure to properly measure and plan for business risk often represents a greater and more realistic financial threat than any other source, including possible malpractice claims. I don't think anyone knows what causes these lapses in judgment but it might be a combination of factors. When everyone is caught up in a rising market the question of what happens if things don't work out is rarely considered. Over-enthusiasm and optimism about a new deal seems to suppress some degree of critical, cautious, thinking. It may also be true that the real legal and financial risks of a particular deal are not always completely understood, even by those who consider themselves experts in the field. For example, analyzing a real estate purchase requires a sophisticated understanding of financing, comparable rents, the quality of the location and the credit risk of the tenants. A buyer without a thorough knowledge of this information is open to the wider risk of unexpected developments.

I've heard many people justify risk taking with that standard mantra that big risks should produce big rewards. Nothing could be further from the truth. In fact, those who are the most financially successful usually get that way by taking the least amount of risk - not the most. These financially gifted individuals are able to resist market exuberance and develop a high level of knowledge about each facet of a particular deal. It's true that sometimes big risk takers get rich. Luck can be a good short term substitute for skill but as a rule the big risk takers end up broke (unless the Government bails them out).

Limiting Potential Liability

I'm certainly not suggesting that no one should ever go forward with a business deal simply because there are risks of financial failure. What I do believe is that whenever a new venture is planned, the degree of risk should be objectively analyzed. What is my risk of loss? How much can I lose if things go wrong or unexpected events materialize? Will I lose just my initial down-payment or do I have liability for the full loan? Richard certainly would not have purchased the property if he had known that he could lose all of his accumulated savings.

Once the amount at risk is calculated, the question becomes how well can I limit this potential loss through proper business structuring and asset protection. Sometimes the purchase can be structured through the use of business entities such as corporations or Limited Liability Companies to limit the potential loss to a finite and acceptable amount. In addition, it is usually possible to protect personal assets from the liability associated with a particular deal if the planning is completed at an early stage. Once the total amount at risk of loss is known, the issue of whether the deal is worthwhile from an economic standpoint can be intelligently addressed.