

# Lawsuit Protection for Rental Real Estate

Robert J. Mintz, Esq.

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Ownership of rental properties has become a popular investment strategy during the real estate boom of the last ten years. More than ever our client's holdings now consist of apartments, office buildings, shopping centers and single family houses for rent. In many cases, the appreciation in value of these properties far exceeds everything else the client has saved from his medical practice over the years.

The downside of all this, from a legal perspective, is that real estate activities are a strong magnet for lawsuits and the risk from buying, selling or owning property is near the top of the liability scale. Ironically, in many areas of the country, the lawsuit risk to physicians from their real estate dealings may be greater than the threat from a malpractice claim.

Should you avoid real estate investment because of the high liability potential?, Definitely not. If you feel the economics of a particular deal are sound, don't let the asset protection tail wag the investment dog. But it does make sense to take appropriate steps to minimize the associated risks. In this article in our series on asset protection I'll show you how we analyze a case involving rental real estate-the issues which are presented and the strategies which we have used to accomplish the proper results.

## **Inside and Outside Liability.**

The key to properly structuring real estate activities is understanding the concept of *inside* and *outside* liability. Inside liability is a lawsuit risk that is produced by the property itself. That is, something associated with the property may cause you to be sued. A tenant can be injured on the property or you might have a dispute with a buyer or seller. A lawsuit over these types of claims creates some amount of jeopardy for your other properties and savings. The first part of the asset protection planning is to insulate and shield you from any liability arising out of the property so that you don't expose your other assets to this lawsuit risk.

Outside liability is the risk presented by your other activities-your medical practice or business dealings or teenage drivers. A lawsuit from any one of these sources poses a potential threat to all of your holdings, including the equity in your properties. Most commonly, clients are concerned that a lawsuit from their practice could cause them to lose their investment properties. The second objective of the planning is to protect the properties from any outside risks.

## *Lawsuit Risks from Real Estate*

What are the risks from real estate activities? The problem that we have found is that the law treats the property owner as the guarantor of the safety of his tenants. If anyone is injured on a property-for any reason and regardless of fault-the owner will generally be held responsible. That is a big legal burden and it's easy to see how lawsuits-frivolous or not-are easily generated in this type of system.

There is a detailed discussion of this issue at <http://www.rjmintz.com/litigation-trend/popular-deep-pocket-defendants/the-property-owner> "Popular Deep Pocket Defendants". But, for now, briefly we know that lawsuits and real estate are closely linked. Real or alleged injuries to tenants and their guests are regular occurrences or can be calamitous from a fire or natural disaster. Serious injury to even one person might create a potential liability exceeding the amount of insurance coverage. A client of ours owned an apartment building that collapsed in the Northridge earthquake in 1994, and 17 people were killed.

Other types of problems might not be covered by insurance at all. When you sell a property that subsequently decreases in value, due to a change in the market, there is commonly a lawsuit from the buyer for undisclosed defects in the property. That happened to a friend of mine. He sold a rental house in 1991 and then the housing market dropped sharply. The buyer sued him to rescind the sale and for the return of all of his money. He alleged that the house had numerous hidden faults which the seller failed to inform him about. These types of cases are a standard practice in the real estate business whenever there is a decline in value. In California and other parts of the country, allegations of mold contamination-often difficult to prove or defend-are the basis of a new wave of lawsuits filed by property buyers against their sellers.

## **Limited Liability Companies**

The good news is that this inside liability, the threat of a lawsuit from a tenant, visitor, buyer, seller or lender, can usually be contained by using the correct legal structure to hold the property. Almost always, this is accomplished with a type of entity known as a Limited Liability Company (LLC) (Read more about LLC's at <http://www.rjmintz.com/Chapter6.pdf>)

An LLC is a relatively new type of legal entity. It was conceived as an alternative to traditional corporations and partnerships. Typically, corporations protect the owners against personal liability for business activities but involve complicated tax and record keeping problems. Partnerships generally minimize the tax problems but offer no liability protection.

A new entity-the LLC-was proposed and created to overcome inherent limitations and restrictions with the then permitted legal entities (corporations, general partnerships, limited partnerships and trusts). The legal problems associated with each of these formats is discussed in detail at <http://www.rjmintz.com/limited-liability-company/llc-case->

[study/inside-and-outside-liability](#) “The LLC Compared to Other Techniques”.

Legislation allowing the formation of Limited Liability Companies was enacted in all of the states by the early 1990’s.

Briefly, the key features of the LLC are:

1. Owners are called members. The law specifically states that no member is personally liable for the obligations of the LLC. That means that a member cannot be sued in connection with any matter concerning the LLC.
2. An LLC can elect to be taxed as a partnership. There is no separate tax at the LLC level (like there is with a corporation). All items of income or loss flow through directly to the Members personal tax return. Additionally, if it is structured with a single Member, the LLC can be disregarded completely for tax purposes and no federal filing is required.
3. An LLC is not required to maintain records such as minutes, bylaws or shares. Unlike a corporation, which can be legally pierced if it fails to follow the prescribed formalities, LLC law specifically states that an LLC is not required to do so. This is a significant advantage over the corporate form of doing business since many corporations become worthless due to the absence of adequate record keeping.
4. The steps that are required to create and use an LLC are spelled out in each state’s legislation. Generally there is an initial filing of the Articles of Organization with the Secretary of State. This document specifies the name of the LLC and the name and address of either the members or the manager. Then, an Operating Agreement must be prepared which specifies how the LLC will be governed and finally the property is transferred into the LLC with a deed.

Because the law specifically states that no member can be named in a lawsuit against the LLC, it allows us to achieve the necessary protection from inside liability. When a property is transferred to an LLC, then there is a subsequent claim regarding the property, you-as a member or manager-are insulated from the lawsuit. That’s an ideal result from an asset protection standpoint and it creates the ability to own real estate without the personal liability risk. In addition, because the LLC can be treated like a partnership or sole proprietorship for tax purposes there should not be any unforeseen tax or accounting problems. The lack of record keeping requirements and the general ease of administration are in contrast to the difficulties associated with ownership by a corporation.

### *Multiple Properties*

If there is more than one property the question is whether each property should have its own LLC or whether they should be grouped together. Under ideal circumstances each property should have its own LLC in order to isolate each property from the liability of

each other. For example, suppose we put three properties, A, B and C, each worth \$500,000 in a single LLC. Several tenants in Property A are injured in a fire. As plaintiffs in a lawsuit they would sue the LLC which then has exposure for the equity in all three properties. Instead, if A, B and C are each in their own LLC, if something happened at property A, there is no risk of loss for the remaining properties.

This generally sound advice needs to be tempered by the real world concerns about costs and complications. Each state has an initial filing fee and a renewal fee for LLC's ranging from about \$100 to a high of \$800 per year in California. In addition, each LLC may involve accounting or tax preparation fees which need to be considered. To the extent possible and affordable, multiple LLC's for different properties is a good idea but the additional costs need to be considered.

### *Protection from Outside Liability*

At this point we can see that the LLC itself will protect you from any liability associated with the property. But what happens if there is a lawsuit against you from your practice or any other dealings? Can a successful plaintiff take away the property or your interest in the LLC?

The answer is generally yes. A membership interest in an LLC is similar to other types of assets. If there is a judgment against you the creditor, depending on your state law, may be permitted to either foreclose on your membership interest or he can ask the court for a "charging order" which allows him to collect your share of any distributions from the LLC. Either remedy can cause you to lose a valuable property interest so additional planning to complete your asset protection should be considered. There are many different strategies available for protecting these LLC interests. Often, a Family Savings Trust provides a fairly neat and simple solution and you are advised to consult with your legal advisors to see whether this solution is appropriate for you. We have presented a discussion of the various strategies in "Covering Your Assets - Asset Protection Strategies" MDNetGuide March 2004.

### *Closing Argument*

Rental real estate often represents a significant portion of many people's investment portfolio. But owning and dealing in property can be a risky and lawsuit prone activity. The Limited Liability Company represents an excellent vehicle for shielding you from what we have called the Inside Liability. It is often worthwhile to put separate properties, each in their own LLC as long as the associated legal and accounting fees are justified by the value of the property. If you face any legal risks from your practice or other activities it is best to protect your ownership of any LLC by using a trust or other appropriate asset protection strategy. As always, discuss each of these issues with your professional advisors to insure that your planning is appropriate for your needs.