

HOW TO STRUCTURE YOUR REAL ESTATE OWNERSHIP TO PROTECT YOURSELF FROM LAWSUITS by Jay W. Mitton, MBA, JD and Dale West

In today's complex & increasingly litigious world, real estate ownership can easily become a nightmare reality. Whether you own real estate for your business or as an investor, ownership is a liability, plain and simple, both from a legal and tax standpoint. I advise my clients to never hold property in their personal names.

With a new lawsuit filed on average about every two seconds of every day of the year it's too dangerous to hold property in your own name. Because of this, there are a number of legal "entities" so that your name does not appear on public records as the owner and you're protected in the event of a lawsuit against you.

A PRIMER ON ENTITIES

Entities are the legal "structures" used to separate and protect the financial, taxable, legal, and other important areas of our lives and businesses. ***There are many entities I recommend to my clients, such as trusts, corporations, limited liability companies, etc. Often these legal entities work together.*** One simple entity frequently used for real estate is a land trust. This instrument gives you complete control as the primary beneficiary, but the public records only show the name of your chosen trustee. At the same time, your trustee must follow your directions regarding the trust, leaving you in control of its disposition.

You must always anticipate that litigation, liens, wrongful termination actions, seizures, levies, and EPA actions can financially destroy you.

Though this instrument is used to provide privacy, it does not provide the greater lawsuit and asset protection available through limited partnerships and limited liability companies when a serious plaintiff is about to sue you. Many well-intended advisers have seen their clients lose assets in a land trust. As a precaution, go for the greater protection and see an expert asset protection attorney.

If you want to protect yourself in today's sue-hungry society, you must learn to design multiple entities to ensure your financial survival. You must always anticipate that litigation; liens, wrongful termination actions, seizures, levies, and EPA actions can financially destroy you.

Carefully review the nature of your business and professional activities. Can you logically divide that business or professional activity into two or more separate entities? Without appearing trite, the more entities the better. While the process of dividing up ownership of your assets may confuse your banker, it can definitely save your assets.

REAL ESTATE USED IN YOUR BUSINESS

Business real estate should generally be owned by an entity other than the business itself. In most situations, you can gain substantial asset protection by separating the real estate ownership from the entity that is using the real estate. If owning and leasing real estate is your business, the real estate should be owned by other entities such as limited partnerships or trusts. The business operation itself should be a separate, distinct legal entity such as a corporation.

I have a client who owns three apartment buildings. He has legally placed the buildings into three separate limited partnerships. If one limited partnership is sued because of faulty wiring in the apartment building it owns, the other limited partnerships and their assets will be protected. Sometimes, additional protection is provided by structuring the ownership in this way, then leasing the buildings to an operating corporation to manage them. Many attorneys believe this approach provides enhanced protection.

In our law firm, my associates and ***I generally recommend to clients that real estate used by a business should be owned by a separate legal entity, and then leased to the business.*** For example, we recommended to a group of eight Dallas doctors that they transfer title to their building into a limited partnership owned by the eight doctors and their families.

This was accomplished. The limited partnership then leased the building to the physicians' medical

practice, which was incorporated. In the event of a malpractice suit against the doctors, the real estate owned in this manner was now generally immune from loss. Had the doctors done nothing, a malpractice lawsuit could have resulted in the loss of the entire medical complex.

ACCUMULATE AND PROTECT

Most business owners in this country are vulnerable to this kind of loss. They spend much more time accumulating wealth than on protecting that wealth. The written lease between the entities is critical. We generally advise our clients to structure the lease so that all liability flows to the tenant. This means that your business or professional corporation has the task of maintaining the premises, providing upkeep and repairs, insuring the property, and defending it in case of a lawsuit. The tenant should be fully responsible for all defects, and he/she must agree to be solely responsible for making the real estate safe and usable by all who come on the premises. This is our rationale:

A woman who had tripped and fractured her hip was awarded \$600,000 in a suit against the people associated with the office building in which she was injured. The court was then forced to decide who should be required to pay the damages. The owner of the building was absolved of responsibility because the property had been leased under a tightly drawn agreement that made the lessee responsible for the maintenance of the property. It also provided that, in the event of any legal action, the lessee would be obligated to indemnify the owner.

In a similar case in Louisiana, the owner of real estate used by a fishing camp was not liable when someone fell through some steps and was injured. The lease held the owner harmless for any hazard of which he had not been notified, and the tenant had assumed the responsibility for maintenance and upkeep. The lease further provided indemnification to the owner.

LEASE PROTECTION

Generally, a lease is one of two types. The first type contains clauses designed to protect the owner (lessor) of the real estate. The second type is designed to protect the tenant (lessee) by transferring many of the responsibilities back to the owner. It is dangerous to simply use a lease form that you purchase at an office/supply store. It is well worth your time and expense to have a lease agreement drafted that protects you if you are either the real estate owner or the tenant.

Some lease forms provide a list of key issues such as property taxes, insurance, window breakage, wiring, and painting, as well as major and minor maintenance. Space is provided where those signing can check whether the tenant or the owner will be responsible for each type of expense.

My general approach with clients is that real estate used in a business should be held in a limited partnership. This is because of the advanced lawsuit protection afforded by these entities.

While another option is titling the real estate in the name of a separate corporation, this strategy may create major tax problems. Real estate could also be placed into the living trust of the less vulnerable spouse, or given to the children or conveyed to a children's trust for their benefit. This last arrangement has the additional advantage of allowing the rents and lease income from the real estate to go to the children, often reducing the overall income taxes owed by the family.

A BASIC RULE TO FOLLOW

Although many entities are involved, the basic principle of asset protection is simple: ***Separate the operations that are vulnerable to lawsuit from the assets to be protected.*** Many professionals expect the day to come when accountants, attorneys, and financial planners become vulnerable to lawsuits, themselves, for poor advice. This could happen each time these professionals recommend the traditional approach of setting up one corporation to operate the business and hold all assets, rather than structuring businesses with multiple entities for maximum protection.

The courts will generally consider two corporations being set up as separate and distinct. They will agree that one is not merely the alter ego of the other, especially if all corporate formalities are maintained independently within the two separate entities. The mere fact that corporations share the same officer and directors, or even the same owners, will not automatically destroy the separateness of the corporations. Nor will it cause the courts to pierce the corporate veil.

Complete disregard of corporate formalities for your multiple corporations will, however,

cause multiple problems. The corporate veil will be pierced where a corporation is created or used for an improper purpose, or where the corporate form has been abused. Many factors are considered, including whether the corporation formalities have been disregarded, and whether the corporation was undercapitalized. Other factors may include whether there has been an intermingling of corporate and personal funds, whether there has been payment of corporate dividends, whether there has been siphoning of funds by the stockholders, and whether the debtor corporation was insolvent at the time.

The courts may also consider whether the same office or business locations were used by the corporation and its individual stockholders, or whether there was an absence of corporate records. They may also consider whether there are non-functioning officers or directors, whether there was a diversion of the corporation's funds or assets to non-corporate uses, whether there was failure to maintain an arm's length relationship, and whether there is domination and control of the corporation that is indistinguishable from the shareholder.

If two or more corporations or other entities are used, each must comply precisely with state laws. State and federal tax returns should be filed, meetings should be held, and advertising and promotion should be done in the name of each separate entity. Ask your attorney to help you design a checklist of the procedures that you must follow to maintain the separateness and independence of the two legal business entities. Remember that a corporation requires much more stringent compliance than does a limited partnership. For example, a limited partnership has no requirement for monthly, quarterly, or annual meetings.

AN IMPORTANT CHECKLIST

To determine whether two corporations are really separate and distinct, with neither accountable for the acts of the other, the courts generally look for the following:

- A lack of attention to corporate formalities
- Assets of the two corporations that are commingled
- Operations that are intertwined
- Evidence of complete domination and control by one corporation over the other

In another interesting case, a large conglomerate of family real estate businesses and multiple corporations was sued. The court found that the lines of control and responsibility were blurred among the many family businesses and inter-related corporations. For example, the various corporations had the same office, the same office staff, and the same directors and officers.

The court also found a great deal of financial intermingling between these companies. The court ruled that the corporations weren't really separate and distinct, but rather acted in unison as one entity.

The court also found a great deal of financial intermingling between these companies. Funds were shifted from one account to another, and the corporations did not deal at arm's length with each other. The court ruled that the corporations weren't really separate and distinct, but rather acted in unison as one entity. The courts also stipulated that each entity was therefore responsible for the debts of the others.

In yet another case involving a personal injury action, the employee sued the corporation for which he worked, as well as the parent corporation. Although the parent corporation was involved in the day-to-day activities and operation of the subsidiary corporation, the court concluded that the parent did not dominate and control the subsidiary.

The court observed that the two corporations maintained separate books, records, bank accounts, offices, and staff and that each consulted its own financial advisors, accountants, and stockbrokers. The court refused to pierce the corporate veil and hold the parent company liable for the judgment against the subsidiary corporation.

Now that you know the risks and advantages of using multiple entities, you must decide which structure is best for your businesses. Devise a checklist to help you pinpoint the compliance necessary to adhere to the rules and regulations governing those entities. Keep the entities as separate as possible.

Your financial survival in today's world depends on it.

ACTION CHECKLIST

If you are setting up a new business, use different entities, whether corporations or partnerships, to insulate valuable assets from operations that are likely to be sued. If your business is already ongoing, it isn't too late. Go to an asset protection expert to discuss ways to transfer assets from existing corporations to a more protected structure.

There are six good ways to do this:

1. Sell the assets to another entity from the corporation at a low but honest, fair market value.
2. Distribute corporate assets as tax-deductible salary and wages to corporate officers.
3. Make a list of all the real estate you presently own and how it is titled
4. Consider transferring real estate used by your business into a limited partnership or a limited liability company, or into your spouse's living trust or a children's trust.
5. Decide which entity would best hold the real estate, and meet with your attorney to create the entity and transfer the real estate.
6. Have a lease agreement drafted between your business and that entity, and scrupulously comply with all provisions of that lease agreement.¹

When the buzzards come after your hard-earned assets, it is too late! When it comes to protecting your assets, there is no time like the present to begin looking at the "big picture." When you feel the *need* to do it, it is probably already too late.

Do not get caught up in the procrastinating mindset that you can afford to wait until you have a few deals under your belt or until you make a certain amount of money. Every day you do not have adequate asset protection strategies in place, you are asking to be taken.

Many people who want what you have do not care about words like effort, labor, fruit, rewards, or for that matter words like honesty, integrity, truth, or justice. In fact, it may surprise you to know that there are many people who consider it their right to somehow have anything you do . . . whether they have earned it or not! They only care about getting as much as they can from whoever they can take it from. Do not let this be you.

Recognize that you have more than somebody else already, and they want what you have. Take the necessary steps to protect and preserve your assets now, so that as they grow, you and your family's financial future will be secure.

For more information, please attend our FREE ASSET PROTECTION seminar on May 21st at the Santa Clara Convention Center. Please see back cover of this issue for seminar times.

¹ *Cover Your Assets: Lawsuit Protection*, Jay W. Mitton, M.B.A., J.D. Crown Trade Paperbacks, New York, pgs. 171-188.