Primary Asset Protection Against Lawsuits

When most small to medium RE investors contemplate protecting their assets against lawsuits, they tend to think of entities (such as corporations and limited liability companies). Entities are certainly important tools for asset protection and tax planning purposes. They are also quite "sexy" and make for fun party talk, not to mention easy sales pitches for "gurus". Unfortunately, many investors tend to focus on entities to the point of neglecting other forms of asset protection. Such a narrow focus is likely counterproductive and may well increase liability. As such, I thought I'd make a few points that the convention carnies often fail to mention:

1) Entities Are the Last Line of Defense: An entity comes into play once a plaintiff/creditor attempts to collect on a judgment. Specifically, the entity can limit the persons from whom a creditor may collect (e.g., the creditor can go after the assets of the entity, but not those of its owners). To get to this point, several things must occur:

- The plaintiff sues for a significant sum of money;
- The suit is not dismissed and plaintiff follows through in court;
- The defendant and plaintiff fail to settle the lawsuit (a huge portion of lawsuits are settled out of court);
- The plaintiff wins the lawsuit;
- The defendant's insurance does not cover the judgment arising from the lawsuit.

In short, the entity's liability shield comes into play once everything else has gone wrong. Having an entity as a back-up certainly makes sense….but doesn't it make at least as much sense to not get to the point of desperation to begin with? Read on to learn how to minimize the chances of ever having to actually use that entity.

2) Know What Gets Real Estate Investors Sued and How to Prepare: The top three items that get small-to-medium REI investors in hot water are:

- Contract Disputes;
- Negligence; and
- Deceptive & Unfair Business Practices.

Contract Disputes: All too many lawsuits arise from contracts that were poorly drafted or never drafted. Contracts are THE primary tools of an RE investor's trade. I never fail to be amazed at how many deals are conducted based poor or no contracts. Some hints with regard to drafting contracts:

- Free contracts are worth what you paid for them. Good contracts are result of careful drafting, long experience (even if someone else's) and review by a qualified attorney. Using contracts straight out of a course or off of the internet without careful modification is like bring a knife to a gunfight. If you are too cheap to have an experienced lawyer work on your contracts, you do not belong in the RE game.
- The purpose of operating agreements (or partnership agreements, joint-venture agreements, bylaws, etc.) is to communicate with business partners while you are

still on good terms. Once a disagreement arises, negotiating a solution is MUCH harder, even if the disagreement is perfectly reasonable and in good faith. Operating agreements lay out the solutions to problems before a dispute occurs. Such agreements take a lot of time and thought to craft – they are expensive in terms of your time and money (to pay for others' time). Handshake partnerships are made at your peril and are often much more expensive than a good operating agreement would have been.

- Contracts with tenants, sellers and buyers should be tilted in your favor, but not be grossly unfair. Contracts that are too one-sided will turn a court or jury against you, at a minimum. Never underestimate the role that perceptions play when dealing with other humans….if a court or jury thinks you are an SOB, no good will come of it. Such perceptions are very often much more important than the law itself (remember the Mark Fuhrman trial, I mean OJ Simpson trial?). Also, if a contract is too one-sided, a court can explicitly refuse to enforce it as "unconscionable" or "shocking to the conscience of the court". By all means, tilt a contract to your advantage – but avoid grossly unfair terms.
- Contracts should be understandable and reasonably simple. If one party can argue that they did not understand a contract and a court agrees, the court can set aside or amend the contract. The more convoluted a contract or the less sophisticated the parties, the more likely that a court will set aside or amend it. Simple (yet thorough), easy-to-read contracts are much more likely to be enforced. Before complicating a deal, be sure that the benefits justify the burdens. For example, do not use a land trust unless a land trust is truly called for. Most people do not understand trusts of any sort. Trusts complicate deals. If a trust adds enough to a deal to justify the risk that arises from the extra complexity, by all means, use the trust. If you are using a trust because some guru said to do so, think twice, because the complexity created by the trust may outweigh any benefits it adds.

Negligence: Question: If a tenant trips and falls in a rental unit, is the landlord liable? Answer: It depends. The legal theory of negligence determines whether the tenant can successfully sue the landlord. For the landlord to be negligent in most states, he must fail to meet his duty to care for the property in a reasonable manner and must have knowledge that there was a defect on the property. What is "reasonably" required varies from state to state and jury to jury. A few pointers on negligence:

- Learn your state's rules. For example, in Ohio, a landlord is not required to shovel the sidewalks in winter – but once he does shovel them, he must continue to do so. Other states have different rules in where shoveling snow, maintaining exterior lighting, responsibility for locks, etc are concerned. Find out what is required and in which areas landlords tend to stray. The rules are not necessarily intuitive or rational (e.g., landlords have been held responsible for dog bites inflicted by tenants' dogs).
- Whether or not the landlord knew of a defect is crucial. For example, if the landlord didn't know that a tenant's lock was faulty, the landlord is unlikely to be held negligent if a criminal enters a unit as a result and causes damage. A word of caution: Tenants will lie and claim they told the landlord about the lock. It is up

to the landlord to document repair requests in a credible manner that will stand up in court. "He said/she said" is not good enough.
- Many courts hold that a tenant need not prove actual knowledge by the landlord with respect to defects in common areas (e.g., broken lights in the parking lot). In these cases, the courts often hold that a landlord should know what's going on in common areas (also known as "constructive knowledge"). The landlord should regularly inspect common areas, accompanied by a credible witness and document what was found and what was done about it.

Deceptive & Unfair Business Practices: Every state has passed broad consumer protection laws that prohibit deceptive or unfair business practices. If a state attorney general goes after a real estate investor, the lawsuit is almost invariably based on these statutes. Some tips:

- Deceptive: The term "deceptive" is extremely broad, especially when dealing with unsophisticated customers or complicated concepts (e.g., "creative" techniques). The best way to avoid issues with "deception" is to use a strong, straightforward and clear disclaimer when transacting business. The disclaimer is basically a crystal-clear summary of a transaction and makes the risks and rewards to all parties clear. Such summaries/disclaimers are especially important when dealing with people who are under duress (e.g., in foreclosure), because an Attorney General will not hesitate to accuse an investor of taking advantage of a "poor victim who was in a bad way and didn't understand what they were signing". In addition, strong & clear language should be used to explain transactions that involve non-standard techniques (e.g., taking properties subject to the deed) or lots of moving parts (e.g., anything involving trusts).
- Unfair: In general, a transaction has to be very one-sided to be considered legally "unfair"….but an angry judge or jury can and will nail an investor who strikes them as unscrupulous. Deals & documents should be tilted in an investor's favor whenever possible – but they should not be grossly one-sided. Two examples of practices that are bait for accusations of unfairness:
    - You buy a property subject to the deed and reserve the right to give it back if the deal goes south….basically, heads, I win, tails you lose. The benefit of a true purchase & sale is that the investor has a deed to the property and therefore complete control over it. The seller has given up the property. In exchange for giving up all control and benefit associated with the property, the seller receives assurances that the problem property is completely off their hands - permanently. Taking the benefit from the seller (that is, the deed) without relieving them of the corresponding burden (that is, the problem property) would strike many (myself included) as unfair. If you want an "out", try a sandwich lease-option – it's commonly understood that a tenant, unlike a purchaser, can bail on a lease when it expires.
    - When selling on lease option, some investors nullify the option for the smallest of defaults (e.g., you were a day late on paying). If the tenant/optionee paid a significant amount for the option or has built significant equity in the underlying property, a hair-trigger default

(especially if the tenant/optionee was willing to cure the default) is prime meat for an accusation of "unfair business practices".

Bottom Line: Know what gets investors sued and protect against such issues with reasonable, straightforward paperwork that sets forth rational terms in a clear and concise manner. That kind of documentation and business practice makes a lawsuit less likely and a victory more likely if a lawsuit does arise.

<u>3) Carry & Understand Insurance</u>: Insurance is not a substitute for entities and entities are not a substitute for insurance. Carry liability insurance that covers your business as a whole. Such policies can be negotiated with knowledgeable insurance agents or brokers. A policy that has a significant deductible should help keep the cost reasonable – the proper purpose of insurance is to cover large liabilities, as opposed to covering all liabilities. Understand what the policy excludes from coverage and focus on those items. For example, if the policy excludes dog-bite, lead paint and mold issues, your company should pay extra attention to managing those items. Choose a coverage amount that gives a plaintiff a strong incentive to settle (e.g., at least $1 million). Make sure that all the relevant persons, entities and trusts are covered by the policy.

Between ethical business practices, strong but straight-forward contracts, up-front summaries of a contract's terms, a documented chain of evidence and a thorough understanding of what a business' insurance covers, the odds of avoiding, settling or winning a lawsuit go up significantly. By all means, use entities – but also work diligently to ensure you won't need them for asset protection.