



Investing In Real Estate?

Consider a LLC to limit liabilities.

By **Jesshill E. Love III & Todd J. Wenzel**

Investment properties can create liabilities. Things like parking lots, laundry rooms, staircases and tenants themselves can all bring liabilities to the property owner. Precautionary measures should be taken to protect the investor and his or her investment, and forming an LLC may very well be the first step in sound risk management.

A limited liability company, or LLC, is presently the favored asset protection vehicle for most real estate investors. An LLC combines the best attributes of a corporation and a partnership. With it, the investors' personal assets, including the primary residence, are generally protected from claims by creditors of the LLC. The investors gain personal liability protection, tax advantages and other benefits, as well.

Setting up an LLC is a relatively simple task. While the common layman can fill in and file all the necessary forms, it is recommended that an experienced attorney be retained to perform this important undertaking. Be wary of on-line sites that offer LLC incorporation for a flat low fee. Although these sites provide a seemingly economical option, they fail to provide the requisite level of personal attention needed to properly prepare the LLC Operating Agreement. The Operating Agreement is the written document that controls the operations of the LLC, and the LLC can be affected tremendously by the quality of this document. The proper expertise and attention in drafting the Operating Agreement will pay dividends down the road when it comes time to a buy-out of an LLC member, dissolving the corporation, distribution of profits or appraisal of members' shares for sale or transfer. The cost of legal representation in this area is clearly justified by the amount that will be saved on future litigation expense and headaches. The age-old adage is appropriate here: An ounce of prevention is worth a pound of cure.

To illustrate the relative weight of this argument, let's examine two instances. In the first one, let's assume you own a two-story 4-unit townhouse complex with exterior stairs that reach the top units. Further, assume that a tenant, or a tenant's invitee or guest, trips on weather stripping at the top of an exterior staircase and is seriously injured. A claim and/or lawsuit will most likely be filed against the owner of the building.

If the owners of the complex are John and Mary Doe as joint tenants or in community property, they will be named defendants. If they have insurance for the building, the claim would be tendered to the carrier.

Let's further assume that the personal injury limit on the policy is \$1 million, and the trip and fall result in the paralysis of the victim. Likely, the damages of the victim will exceed the policy limit with pain and suffering and future medical care required. This scenario would leave Mr. and Mrs. Doe personally liable for any judgment over \$1 million. All assets held in the Doe's names would be sought to satisfy the balance of the judgment, including bank accounts, stocks or mutual funds or other real property investments. Such a claim could financially wipe out the Doe family.

Another way Mr. and Mrs. Doe could be exposed to personal liability is in the form of property damage that is not covered by insurance. One example of that is a slow roof leak in one of the 4 units

Separate LLCs should be used for each investment property purchased. This helps to ensure that liability against one property becomes self-contained.

described above that resulted in dry rot and mold within the walls of a structure. Likely, any resultant damages would be excluded from coverage under the mold exclusion, which is common in most insurance policies typically offered by carriers. If the dry rot affects a structural joist or beam, repair or replacement could be expensive. If the mold happens to affect the health of any of the occupants, any claim for mold exposure would not be covered. Under either scenario, the Doe family would be personally liable to remedy the condition for any ensuing damages.

Based on the two outcomes referenced above, the Doe family could be financially devastated by a personal liability lawsuit. What started as an investment plan to retire or put children through college has turned into an enormous liability that has shot through the financial fabric of the Doe family assets. The application of corporate protection with an LLC could have prevented this outcome.

Had the Does had their property in a LLC, they would have been able to restrict the recovery from the personal injury lawsuits to the assets of the LLC (i.e. the property itself and any applicable insurance). This is the application of corporate protection, and it would have sheltered the Does' remaining personal assets.

This assumes, of course, that the Does have properly maintained the LLC, not commingled personal funds with those of the LLC, or otherwise engaged in any form of fraud. These types of actions provide the personal injury plaintiff with an opportunity to pierce the corporate veil and seek recovery against the Does' personal assets. Assuming proper maintenance of the LLC and a deviation from commingling and fraud would have limited the injured party's recovery to the assets of the LLC—namely, the equity in the property and any applicable insurance.

Separate LLCs should be used for each investment property purchased. This helps to ensure that liability against one property becomes self-contained. While there are separate maintenance fees to be paid to keep each LLC in good standing with the California Secretary of State, savvy investors gladly pay such fees in order to contain liabilities relative to each investment.

Each LLC should also be separately insured. The premise, again, is to keep assets and liabilities separate. Once two or more LLCs are formed and separately insured, another sound strategy is to procure an umbrella insurance policy that acts as an excess policy over the policies insuring the separate LLCs. The umbrella policy is an additional layer of protection to shield the owners of the LLCs from potential liability, and it is a common product that insurance companies will be able to offer.

By taking appropriate steps in the context of asset protection, the real estate investor can enjoy the longtime benefits of owning investment property. Let another old adage apply: Work hard to buy and take care of your properties and, in time, your properties will take care of you. ■

Jesshill E. Love III can be reached at 650.364.8200 or jlove@rmkb.com. Todd J. Wenzel can be reached at 415.543.4800 or twenzel@rmkb.com.