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Top 10 Ways To Protect Your Assets: Novice To Advanced Strategies

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Goal: To explain how to deter a lawsuit and a possible judgment at a fraction of the cost

Real estate is the most hotly contested industry…it is not a matter of IF you will get sued, it is a matter of WHEN and what position you will be in to deal with it. Not to worry, I'm going to show you the essentials of how to protect yourself right now with strategies you can put in place in only a week! I am board certified to practice law in both New York and Texas, and I choose Texas law to protect my clients.

Texas law provides for some of the most aggressively protective structures to defend against judgments and creditors. It's a age old saying "so and so has gone off to Texas" to express that there is no chance of collecting on a debt because it is so darn difficult to get at someone who has properly legally maneuvered themselves to avoid their debts. The good news is you don't have to be a resident of Texas to take advantage of its protections!

The Following is a list of the topics discussed in my recent Bigger Pockets podcast describing how real estate investors encounter legal risk in the form of lawsuits and judgments as well as steps they can take to protect themselves. They are numbered since we addressed them in this order the in cast, and references the number therein as well. Remember, wealthy people do not own assets, they control them and benefit from them.

1. **Liability in real estate.** Just as insurance protects your home in case you have a fire, an asset protection plan protects your home in case there is a lawsuit filed against you. An asset protection plan reduces your exposure to legal liability. Liability is a legal term used to describe "risk". Specifically, lawyers are worried about the risk of litigation. Litigation is both time consuming and extremely costly. Have you ever hear that most cases settle on the Courthouse steps? That's because the risk of losing a lawsuit can wipe you out,

and most people choose to feel a little pain from the greenbacks slipping out of their pocket then losing their entire poker stack. Keep in mind that even a case that settles means that the parties have only mitigated their risk regarding a judgment, they are nevertheless stuck with paying their attorney's fees up to that point. That means as the Defendant, not only do you have to pay the settlement, you also have to pay your attorney bills. Even in a simple case, the attorney fees alone can be $10,000 easily. Ask any attorney, and they'll tell you that's actually cheap for any form of substantial litigation. A proper asset protection plan cuts the attorney bills short and should get you of the lawsuit quickly. **The asset protection plan should drain the opposing sides will to fight as well as their ability.** The other side will only pursue a lawsuit if they think they can collect on it. After all, a judgment is just a piece of paper unless it can be used to foreclose on your real or personal property. A properly structured asset protection plan removes the assets from the other sides grasp.

2. **Insurance.** It is necessary but not sufficient. Insurance protects the condition of the property itself, an Asset Protection plan protects your "ownership". Your insurance policy likely only protects you in case of negligence or "accidents". Dollars to donuts says your insurance policy doesn't protect you against intentional acts, check the document and call your agent. What type of intentional act could get you into a lawsuit? How about making any statement regarding the condition of the property, the condition or history of the house, the plumbing, construction, etc. Any of these statements could be sufficient to maintain a cause of action, a lawsuit against you, for fraud. Fraud doesn't mean that you're a bad guy, the practical matter is that it is an allegation that you intentionally mislead the other side. I believe all my clients when they say they didn't mean to mislead the other side, but nevertheless the other side feels that way and now we have to sit in a courtroom and figure out where 8 random people in a box (a jury) think about the situation. Nevertheless, since you intended to make the statement, your insurance company will classify that as an intentional act and likely deny coverage and their obligation to defend you. So, even with an insurance policy you're still left out in the cold with nowhere to turn except to an expensive attorney billing like mad so that she can hopefully pull you out of the hole you thought you'd never end up in.
3. **How judgments work.** If you lose a judgment you'll end up with a lawsuit against you. A judgment is a nasty beast that can rear its ugly head and tear down your entire investment village. Say you have a modest judgment rendered against you for $50,000 (I've seen numbers this high even in landlord/tenant lawsuits). The victor will then attempt to foreclose upon your property and take the proceeds of the sale to satisfy the judgment. For example, your portfolio is as follows: you purchased a $300,000 apartment with 3.5% down because you took advantage of the FHA ($11,500 in equity), you bought another condo for $100,000 with 25% down ($25,000 equity), and you just finished paying off your car which is now worth $25,000 ($25,000 equity). The judgment holder could foreclose and sell all three of these properties, and further be entitled to the attorney fees regarding the seizure and sale, which could be $3000 each (making the total amount of the judgment $59,000). First goes your apartment and equity to the judgment holder ($47,500 remaining in the judgment), next goes your condo ($22,500 remaining in the

judgment), and then you see your car getting towed away and sold (-$2,500 remaining in the judgment). Since the sale of the car was more than the amount of the judgment you'll actually get a check in the mail for $2,500, but that's barely enough to keep you out of tears while you're riding the bus and have nowhere to live. If only your property wasn't in your name, you'd still be watching your big screen and not smelling the homeless guy who just got on.

4. **Common Legal entities used to hold real estate**: yourself (sole proprietorship), LLC, and Trust. These entities are all referred to in the legal world as business organizations. When you hold property in your name personally, you are holding it yourself in a sole proprietorship. This is the most risky way to hold any property whatsoever. If you didn't know better, I'll forgive you but the law won't. People will be able to easily find your assets by searching your name in the county records and thereafter file suit against you, for any reason related to the property or not, and thereafter take your property. The LLC offers more protection. The LLC keeps someone from filing a suit against you personally and taking the property. They could only get their hands on the property held in the LLC if the LLC did something wrong. The difference is seen in the following hypothetical where you get in a car wreck and have no insurance, for example. As a sole proprietor in the property you own the property, so the Plaintiff is entitled to collect against anything you own. If the property is in an LLC however, you don't own the property, the LLC does, and the Plaintiff is still limited to collecting against you and your personal assets. So what type of LLC structure(s) do we want? A single LLC is not sufficient. We don't want the LLC that is conducting business to have any assets because someone might decide to sue it. Therefore, 3 LLC's are necessary. One LLC is an asset holding company for your flips, another for your buy-and-holds, and the last is the operating company. The first two hold the assets and never conduct any business. Just as if you had a property manager renting out houses, the operating company takes care of all the business.
5. **LLC/Series LLC:** The series LLC allows you to file one tax return for what is legally treated as separate LLC's. This is much simpler than having a new filing and LLC for each of your properties, which is the antiquated approach. LLC's and Series LLC's can be complicated because all of the corporate formalities must be kept regarding Taxes, Meetings, Minutes, Operating Agreement, Stock Certificates, etc. in order to ensure that the Court will recognize the LLC and give it the protections for which you established it. It is still formally undecided the level of paperwork necessary to maintain that each of the Series in a Series LLC is a separate company. It is worth noting here that the series LLC in Texas is relatively new in Texas case law, but there are strong indicators that it will be treated the same as it is in other states. Again with a Series LLC we will also want to keep an eye out for how the IRS will treat your organization similarly to how we looked at establishing single LLC's.
6. **Importance of a 2 member LLC.** A 2 member LLC is advisable to ensure that the Court does not view the LLC as an alter ego of yourself and thereby remove the corporate protections for which you established it. Pick your best friend or your mom and give them a 1% non-voting, non-saleable interest, not entitle to distributions interest. It's a small price to pay to avoid a Court removing all your protection. Your mom/friend will

have to agree to be bound by the corporation by signing the Operating Agreement, receiving stock, etc. in order to ensure that the Court does not look at their interest as a mere charade.

7. **Anonymity Trusts.** This advanced strategy is used to hide your assets whereas the prior business structures we talked about served to protect the assets from lawsuits. Anonymity trusts make it difficult for the judgment holder to find the assets they want to collect against, whereas the business organization makes it difficult to enforce the judgment against the assets once they find them. Since trusts in Texas do not have to be registered unless they are conducting business, much information regarding public filings can be obscured since nobody will know anything more than the name of the trust…not the name of the Trustee and certainly not the name of the beneficiary. Consider using a trust to hold the deed to a property as well as be the manager when you file your LLC and you've just created a very decent smoke screen to ward off creditors.
8. **Delaware Statutory Trust (DST) and Trust agreements.** A DST is similar to a series LLC in that you can establish various Series of investments inside of the DST. For asset protection, a DST is as good as an offshore account in many respects. Apart from its protections, the DST further provides fluidity in the investment, allowing shareholders to own a percentage of a series which they may be able to sell more easily than a property. This also allows for greater diversification for the investor to further reduce their risk. The DST is a valid method of exchange of property for 1031 exchanges making it an ideal way for investors to put their money in real estate. This is the structure that the big boys are doing. The up-front costs are higher than an LLC, but the protections are arguably greater and the ability to work with investors and have an authorized 1031 exchange transaction make it an attractive option.
9. **Irrevocable Trusts.** The irrevocable trust allows for asset protection and anonymity because it moves the property out of your name and into the name of a Trust. Once the property is in the Trust, the Grantor (you) no longer own it, and you can't revoke the trust to get the property back. There are some important issues that have to be considered when using an irrevocable trust, most importantly the gift tax issue. An irrevocable trust can be set up to hold a property where the beneficiary is an LLC which you own. This trust can also provide anonymity. Furthermore, a trust can enter into a contract, the deed can be held in the name of the trust, it can have a tax number, bank accounts, and run a business. If it is running a business though, it will likely have to register with the State.
10. **"Family Office"**: For fees far less than you can make on an average deal, an attorney can provide you with a yearly review of your corporate documents and ensure that your asset protection plan is up to date with the current laws. This service which used to only be available to those that were rich enough to have an entire "office" of attorneys is now available to the common investor for only the cost of a few billable hours. I explain it to my clients like this…you're an investor and you're probably pretty darn diligent about it if you've made it this far in the article about asset protection. You've crafted your skills and honed your abilities to capitalize on real estate deals and run the numbers to make sure you make money. Time is money, and spending the time to figure out legal issues costs you money. Think about it…when you're spending time agonizing about corporate

paperwork, and hoping that you did it right, or otherwise spending countless hours research your business organization, that is all money wasted that you would have had working your core business, the business you know well. Differ tasks that are your strong suits to other people no matter what they are and leverage your strengths to make more money. For this purpose of this article I'm suggesting you do so with your legal work, unless you happen to love it and are a legal savant (but then why didn't you become a lawyer anyway??)

TOP 5 Take-Away Action Items:

1. If you're not insured, get insured.
2. At a minimum set up a 3 LLC's (or a series LLC) to have a holding company for flips, holding company for buy and holds, and an operating company which enters into contracts, purchases property, collects rents, etc.
3. NEVER hold assets in your name. Wealthy people don't own property, they control it. You have to think like the wealthy to get wealthy.
4. Get a "family office". If your corporate paperwork and formalities aren't maintained correctly, it doesn't matter what strategies you use. A "family office" ensures your Asset Protection plan will actually protect you.
5. Cost of an Asset Protection plan is ½ the cost of the Attorney fees alone of the average single. Real estate is the greatest litigated industry…in this business it's not a matter of if you will get sued, but when. Being "nice" and "honest" won't keep people from suing you.