

# Real Estate: A Risky Business

By William Gibney, Esq.

Are you a real estate investor-turned-landlord? If so, you're in good company. On the heels of what may have been the biggest buying spree in Arizona history, lots of real estate speculators have added the temporary job "landlord" to their resume while they wait for the big profits. But great reward is rarely reaped without significant risk, and no one knows that better than real estate owners who lease their property.

## Why You're Vulnerable

While you wait for your investment to appreciate in value, leasing the property is a good way to provide cash flow. But don't fail to protect the asset in the meantime or the cash flow may end up in your tenant's bank account rather than yours. Most tenants have neither the pride nor the prudence of ownership. They may ignore a broken stair rail, a burned out light bulb, or gas leak-- until someone is seriously injured or dies because of the negligence. Even though you, the landlord, had been unaware of the problem, legally, you're the responsible party. That makes you a likely target of a lawsuit. How well are you protected?

## Is Insurance Reliable?

If you think your insurance policy will cover any potential claims, you're playing with fire. First, insurance carriers are denying coverage more than ever before. They'll find loopholes in your policy you never knew existed to dodge a claim. Worse yet, many judgments far surpass the policy limit, leaving you stuck with the balance of the bill--a bill that could easily wipe out your entire estate.

## Limited Liability Protection

Because of the inherent risk associated with real estate—whether it's residential or commercial property or raw land, the safest way to own real estate is through a limited liability company (LLC). An LLC limits your liability to the property that causes the damage or injury. The tenant who slips and falls in a rental owned by your LLC can't get a judgment against you personally, because you don't own it—your LLC does.

## Separate Hot from Hot and Hot from Cold

The mistake often made, however, is combining what I call "hot" and "cold" assets. Hot assets are high-risk assets, such as a rental property, medical practice or airplane which could cause injury or death. A family business is an extremely hot asset because of the

risk of employee lawsuits over harassment or discrimination coupled with the potential for injury on the job.

Every hot asset you own should be held in a separate LLC to fully protect your other assets. “Cold” assets are those unlikely to harm anyone, such as stocks, bonds, and mutual funds. They need to be protected from creditor claims as well, but should never be combined in an LLC that owns hot assets. Remember, all assets in an LLC are available to the plaintiff who sues you—not just the house he rents or the business that employs him.

By combining hot assets in a single LLC, you actually increase your risk. A better strategy is to layer the ownership of these entities—effectively building a family of LLCs.

### **Living Trust as LLC Member**

In my estate planning practice, I often recommend that a revocable living trust, rather than an individual, own an LLC. After creating the trust, it becomes the member of the LLC, thereby providing both estate planning and asset protection. Once we form the trust and first LLC, we have many options available to provide asset protection for an entire estate. Careful planning is critical though; improper structuring of LLC ownership can cause more damage than having no LLC protection at all.

### **Operating Agreement**

The most essential—and most often overlooked—element of an LLC is the operating agreement. Thousands of Arizona LLCs have no operating agreement at all—and tens of thousands more have boilerplate language in the operating agreement that fails to address the key protective powers. Lay people—and even lawyers—who rely strictly on Arizona’s LLC statute to write operating agreements face the grave possibility of the protective veil being pierced when taken to court. As LLC case law unfolds, I continually add provisions and client instructions to enhance the LLC’s protective capabilities. The LLC is by no means bullet-proof, but when it comes to asset protection, it far exceeds other forms of ownership.

### **See Your Attorney**

Although the forgoing applies to most cases, this information should not be deemed a legal opinion, because every client’s circumstances are different and could dictate varying applications of legal advice. Please consult an experienced attorney who is knowledgeable about asset protection regarding your individual needs.

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