ASSET PROTECTION FOR REAL ESTATE

by

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I. WHY ASSET PROTECTION PLANNING?

General Concerns

A. Periodic recessions, real estate and stock market crashes (e.g., 1989-1992 and 2000-2003) leave high net worth individuals (HNWI) unexpectedly facing creditors and claims.

Maybe next: bursting of the real estate/housing bubble?

B. Explosion of lawsuits, civil liability: the average American is sued 5 times.

C. Different sectors of HNWI periodically come under attack: accountants and lawyers, real estate owners and developers in 1989-1992, tech executives and directors and auditors in 2000-2003, e.g., Arthur Andersen partners after MCI, Enron, collapse of firm.

D. Inadequacy of and/or exorbitant cost of liability insurance. The almost instant material upward adjustment of insurance premiums after a claim means that, in effect, all insureds are really self-insuring.

E. A means to start over after economic disaster, near bankruptcy/near insolvency, a mechanism to separate new assets or Aclean assets@ from old liabilities associated with other assets.

F. An alternative to a prenuptial agreement or possibly a divorce property settlement.

G. To protect gifts and bequests to family members from creditors (and spouses) of those family members.

H. Clients want it, according to survey reported in September 2003

issue of Trusts and Estates, by Russ Prince and Richard Harris, AShelter from the Storm.@

Concerns Specific to the Real Estate Industry

I. Someone who presently owns or previously owned real estate with potential environmental liability associated, who is concerned that some day there could be a gigantic environmental liability assessed upon him or her.

J. A landlord who is worried about tenants defaulting on leases. Without paying tenants, he or she would not be able to carry loans on the property for a lengthy period.

K. A landlord with significant leases expiring in 6-18 months, facing potential loss of tenants needed to carry the financing on the project to more desperate landlords willing to make uneconomical deals, or facing renegotiation of rents downward to a level inadequate to carry financing on the project, if the recession continues.

L. A developer with a project under construction concerned that he or she will not be able to find sufficient tenants to fill it, that tenants to whom the project is pre-leased may default if a recession occurs.

M. A developer with significant borrowed funds in land or site work concerned he may be unable to find construction or permanent financing if a recession arises, able to carry the financing for a finite period but facing the prospect of deteriorating land value and inability to complete.

N. A developer or owner of any real estate-related business facing a need to renew within 6-18 months a general line of credit or other loan, concerned his bank may refuse to renew the loan for no good business reason. In a recessionary environment it may be impossible to find another bank to take over as lender.

O. An investor/speculator with a land loan coming up for renewal in 6-18 months, recognizing that if a recession looms, his or her bank may not renew the loan, even if there has never been a default, another bank may not take it on in such a real estate and banking environment, recognizing the unlikelihood of being able to sell the land, even at a moderate loss, in such a market.

P. A real estate developer or investor with substantial contingent

liabilities maturing in the next few years (e.g., as guarantor or jointly and severally liable with financially weak general partners or co-tenants in common) concerned if another recession occurs.

Q. An investor holding and carrying encumbered real estate but concerned that deteriorating value if a recession occurs might make it unreasonable in the next few years to continue to carry the acquisition loan on property which may end up having a value considerably below the encumbrances.

II. APPROPRIATE AND INAPPROPRIATE CANDIDATES FOR ASSET PROTECTION PLANNING

A. Good candidates: HNWI concerned about potential future creditors. Nervous and worried, or just cautious.

B. Bad candidates: clients already in deep trouble -- already been sued or threatened for past activity, on the brink or over the brink.

C. Can you help a client already in trouble? Maybe, but be very careful.

III. ASSET PROTECTION PLANNING SHOULD BE AN INTEGRAL AND INTEGRATED PART OF THE OVERALL ESTATE AND FINANCIAL PLAN.

A. If the suggestion does not make sense as good estate planning and financial planning in the absence of creditor problems, it does not make sense.

B. This Aother business purpose@ -- estate planning/financial planning -- will serve as a defense against the claim that the transfer was motivated by the intent to hinder, delay or defraud creditors, and therefore ought to be set aside.

C. Consider using an Affidavit of Solvency to protect the client and protect the advisor; have the client swear before a notary as to his balance sheet and pending and threatened claims.

A. Keep in mind that a reasonable goal of asset protection is to permit a more advantageous settlement with a future claimant, not necessarily to completely protect the asset.

A. Especially be careful of clients with problems with IRS or any other federal agency, or who may be involved in tax fraud, money laundering, drug trafficking, funding of terrorism or other illicit activities.

A. Ethical and malpractice issues (See AAsset Protection Planning: Ethical? Legal? Obligation?@ by Gideon Rothschild and Dannie Rubin, Trusts and Estates, September 2003, and AWhat Every ACTEC Fellow Should Know About Asset Protection,@ by Duncan Osborne and Elizabeth Schurig, ACTEC Journal of Asset Protection, September/October 1997, Vol. 3, No. 1, and January/February 1998, Vol. 3, No. 3, and March/April 1998, Vol. 3, No. 4.)

IV. FRAUDULENT CONVEYANCE ISSUES

Fraudulent Conveyance Statutes. Modern fraudulent conveyance laws in English common law jurisdictions, including Virginia, have their origin in 16th Century England, in the Statute of 13 Elizabeth (12 Elizabeth Ch. 5 (1571)). Virginia=s law will be discussed because the author is familiar with it and it is typical of the law of virtually every state. Virginia has enacted two fraudulent conveyance statutes:

A. Intentional Fraud. Every gift, conveyance, assignment or transfer of property, real or personal, made with the intent to delay, hinder or defraud current or anticipated future creditors of the transferor is voidable. Virginia Code ' 55-80. See Abbott v. Willey, 479 S.E. 2d 528 (1997), involving President Clinton=s friend Mrs. Willey.

1. Regardless of the transferor's intent, a bona fide purchaser for value takes good title, assuming the transferee had no notice of the fraudulent intent. On the other hand, if the transferee had notice of the fraudulent intent, the transferor's creditors may attach the property transferred. The transferee will be deemed aware of the fraudulent intent if he or she has knowledge of such facts and circumstances as would have excited the suspicions of a man of ordinary care and prudence.

2. "Hinder", "delay" and "defraud" are not synonymous. A transfer may be made with intent to hinder or with intent to delay, without any intent absolutely to defraud. Any of the three intents is sufficient.

3. There may be a fraudulent transfer even if fair consideration is paid.

4. Reference to "future" creditors in fraudulent conveyance law is not to every person who someday may become a creditor of the transferror. For example, the court in Oberst v. Oberst, 91 B.R. 97 (U.S. Bankruptcy Court, C.D. California 1988) distinguished between what it termed "bankruptcy planning" and hindering creditors. The court stated that "if the debtor has a particular creditor or series of creditors in mind and is trying to remove assets from their reach, this would be grounds to deny the discharge. If the debtor is merely looking to his future well-being, the discharge will be granted."

   In Klein v. Klein, 122 N.Y.S.2d 546 (1952) the court blessed prophylactic transfer to protect against a potential future hazard as "no more than insurance against a possible disaster," and not a fraudulent conveyance.

   In Tcheropnin v. Franz, 475 F.Supp. 92 (1979) the court stated that one of the requisite elements for finding a conveyance to be fraudulent is that there must be an existing or contemplated indebtedness against the debtor.

B. Donative Transfer by Insolvent Transferror. As to existing creditors, gifts are voidable without any finding of intent to delay, hinder or defraud, but the attacking creditor must prove that the transferor was insolvent or was rendered insolvent by the transfer. Virginia Code ' 55-81.

1. Creditors of the transferor have no claim under this section --

   ? if they were not creditors at the time of the transfer.

   ? if fair consideration was paid.

   ? if the transferor was solvent after the transfer.

A donor is insolvent when he has insufficient property to pay all his debts. Hudson v. Hudson, 249 Va. 335 (1995), Shaia v. Meyers, 206 Bankr. 410 (Bankr. E.D. Va. 1997).

C. Voiding the Transfer. A creditor's suit is necessary to void the

conveyance. Virginia Code ' 55-82. The burden of proof is upon the one attacking the conveyance and the fraud must be proved by evidence that is clear, cogent and convincing, McClintock v. Royall, 173 Va. 408, 4 S.E.2d 369 (1939). Although the fraud must be proven and is never to be presumed, Land v. Jeffries, 26 Va. (5 Rand) 599 (1827), the evidence necessary to satisfy the court may be and generally is circumstantial, Witz, Biedler & Co. v. Osburn, 83 Va. 227, 2 S.E. 33 (1887), and courts have frequently held that there are certain indicia or badges of fraud from which fraudulent intent may be inferred, prima facie. The statute of limitations for actions under ' 55-81 to set aside a transfer not made for valuable consideration is 5 years. In re Massey, 225 Bankr. 887 (Bankr. E.D. Va. 1998).

D. Badges of Fraud. These include:

1. retention of an interest in the transferred property by the transferor;

2. transfer between family members for allegedly antecedent debt;

3. pursuit of the transferor or threat of litigation by his creditors at the time of the transfer;

4. lack of or gross inadequacy of consideration for the conveyance;

5. retention of possession of the property by transferor;

6. fraudulent incurrence of indebtedness after the conveyance;

7. secrecy about the transfer;

8. deviation from normal activities;

9. transfer of all (or substantially all) of debtor's property; and

10. transfer to family members (but cases of family transfers are surprisingly unpredictable, depending on the "flavor" of the facts).

Armstrong v. United States, 7 F. Supp. 2d 758 (W.D. Va. 1998). Hyman v. Porter, 37 Bankr. 56 (Bankr. E.D. Va. 1984), Hutcheson v. Savings Bank, 129 Va. 281, 105 S.E. 677 (1921). When the evidence shows a prima facie case of fraud, the burden of proof

shifts to the party seeking to uphold the transaction to establish that he or she intended to accomplish bona fide goals as a result of the transfer. If a conveyance is set aside under Section 55-82, the Court will put the parties to the conveyance in the same position as if the conveyance had never taken place. Judgment creditors may interrogate the debtor under oath about all matters involving his or her assets. Virginia Code ' 8.01-506, et seq.

E. Definition of Insolvency. Virginia Code ' 55-81, supra, uses the word "insolvent" but does not define it. But see cases cited at 2. B. above. The Uniform Fraudulent Conveyance Act (which Virginia has not adopted) provides that a person is deemed insolvent if, at the time of a transfer, the present fair salable value of the transferor's non-exempt assets is less than the amount required to pay his liabilities on existing debts. The Bankruptcy Code defines insolvency of an individual as the financial condition in which the sum of the person's debts is greater than all of the person's property, at fair valuation, exclusive of property transferred, concealed or removed with intent to hinder, delay or defraud creditors, and property that may be exempted from property of the estate under the Bankruptcy Code. 11 U.S.C. ' 101(31). This is generally known as the "balance sheet test." Insolvency is generally presumed if the debtor is not paying debts as they come due.

F. District of Columbia Law. Conveyances made with the intent to hinder or defraud are voidable. D.C. Code ' 28-3101-3103. There is no special rule for donative transactions rendering the transferor insolvent, as there is in Virginia.

G. Maryland Law. Like Virginia, Maryland law provides a presumption that a transfer without full consideration is fraudulent if the transferor is or is rendered insolvent, without regard to fraudulent intent. Ann. Code of Maryland, Commercial Law Volume, ' 15-204. Conveyances made with the intent to hinder, delay or defraud present or future creditors are voidable. ' 15-207. There are similar rules regarding conveyances without consideration by persons in business or about to be in business with inadequate capital remaining or without fair consideration by persons about to incur debts beyond his/her ability to pay. ' ' 15-205 and 15-206.

V. BANKRUPTCY - FEDERAL AND STATE EXEMPTIONS AND NEW 2005 BANKRUPTCY ACT

A. A new federal bankruptcy law took effect in 2005.

B. Each state may designate which assets are exempt for creditors

in bankruptcy, e.g., notoriously Florida and Texas exempt the full value of even lavish homes under the AHomestead@ Exemption. The new federal law tightens that somewhat, providing that Homestead Exemptions (like those in Florida=s and Texas=) apply only if a debtor has lived in those states for at lease 40 months before filing bankruptcy. Otherwise the exemption is only $125,000.

C. In the last 8 years at least 6 states have adopted asset protection trust legislation: Delaware, Alaska, Rhode Island, Nevada, Utah and most recently New Hampshire. Transfers to such domestic asset protection trusts can still be used to shield assets from bankruptcy creditors, but the new federal law does permit bankruptcy judges to review transfers to such trusts for up to 10 years before bankruptcy to see if such transfers were made with intent to hinder, delay or defraud the bankruptcy creditors. But proving such fraud is not easy. Congress refused a proposal to simply void transfers to such trusts over $125,000 with 10 years of a bankruptcy filing.

The new bankruptcy law has no impact on offshore asset protection trusts or domestic Aspendthrift@ trusts for the benefit of third parties. See AKeeping Some Hiding Places,@ by Albert B. Crenshaw, The Washington Post, March 20, 2005.

Many states, such as Virginia, have limited bankruptcy exemptions: Tenancy by the Entirety property; partnership interests; ' 529 Plans; IRAs to a limited extent.

VI. HOW TO AVOID THE CLAIM THAT A CREDITOR HAS BEEN DEFRAUDED

A. Consider Affidavit of Solvency.

B. Do asset protection planning in the context of estate planning, tax planning, financial planning, probate avoidance planning.

C. Do asset protection planning early, before the client has creditors.

D. Discourage greed. Be satisfied to materially improve the client=s position. Hogs get fat, pigs get slaughtered.

E. Avoid Aover-the-line@ transactions which are too late for clients already in trouble, beware of felonious motives in your clients.

Know your client.

VII. PROTECTING PERSONAL RESIDENCES

One of the two largest asset categories on the average American balance sheet is personal residences, and prudence dictates that consideration needs to be given to protecting real estate interests from claims of prospective future creditors. (The other largest asset category is retirement plans which have broad protection from creditor claims under statutory and case law.)

A. Tenancy by the Entirety Property. A debtor client may transfer property into tenancy by the entirety with his/her spouse or retain property held in that form of ownership. A tenancy by the entirety is defined by the following characteristics:

- ? Each spouse has an undivided one-half interest in the asset.
- ? Neither spouse may sever the tenancy unilaterally. Both must sign on any conveyance.
- ? The property automatically passes outright at the death of the first spouse to the surviving spouse.

1. In many jurisdictions, including Virginia, Maryland and the District of Columbia, tenancy by the entirety property is immune from creditors of either owner, e.g., on contract or tort liability of either, but obviously NOT immune from creditors of both. Allen v. Parkey, 154 Va. 739, 149 S.E. 615 (1929); Vasilion v. Vasilion, 192 Va. 735, 66 S.E.2d 599 (1951); Ragsdale v. Genesco, Inc., 674 F.2d 277 (4th Cir. 1982); In re Sefren (Maryland), 41 B.R. 747 (Maryland 1984); State v. One 1984 Toyota Truck, 533 A.2d 659, 311 Md. 171 (1987); Warman v. Strawberry (D.C.), 587 F.Supp. 109 (1983). Proceeds of sale of tenancy by the entirety property is also held as tenants by the entirety. Bruce v. Dyer, 524 A.2d 777, 309 Md. 421 (1987); Potts v. U.S., 408 S.E.2d 901 (Va. 1991).

   In Virginia a deed which conveys a marital home to husband and wife Aas joint tenants with full common law right of survivorship@ created a tenancy by the entirety, and proceeds from the sale of the property are exempt from claims of non-joint creditors in Bankruptcy Court under ' 522(b)(2)(B). In re Zella (Mitchell), 196 BR 752, aff=d 202 BR 712 (1996).

   See Lock, Key & Tenancy: Tenancy by the Entirety in the District of Columbia, Maryland and Virginia, by Brent R. Jacques and Paul D.

> Pearlstein, *The Washington Lawyer*, September/October 1993.
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> In Rogers v. Rogers, 257 Va. 323, 512 S.E.2d 821 (1999) the Virginia Supreme Court, in refusing to permit a creditor with separate judgments against husband and wife to levy on real estate held by them as tenants by the entirety, noted its previous statements, made Aclearly and without equivocation,@ that entireties property is exempt from the claims of creditors who do not have joint judgments against the husband and wife. Separate judgments against each do not qualify.

A 2000 Amendment to Virginia Code Section 55-20.1 confirms that a principal family residence that husband and wife own as tenants by the entirety will not lose its immunity from the claims of their separate creditors if they convey it to their joint revocable or irrevocable trust or in equal shares to their separate revocable or irrevocable trusts, so long as (1) they remain husband and wife, (2) the trusts continue to hold title, and (3) it continues to be their principal family residence. This resolves the tension between desire to protect the home from claims of a creditor of one spouse and the desire to divide title for estate tax planning purposes, to fund the spouses= respective applicable credit amount bypass trusts. Now both goals may be accomplished.

A 4th Circuit opinion (Estate of Reno v. C.I.R., 916 F.2d 955 (1990)), interpreting Virginia's apportionment statute, Section 64.1-160 et seq., of the Code of Virginia, to allow a testator to direct that the entire burden of estate taxes be placed on a co-tenant by the entirety, was thought by commentators and many members of the Bar to indicate a breach in the doctrine cited above. The decision was widely criticized by many, including the Virginia Bar Association, which at the suggestion of the Wills, Trusts and Estates Section of the Virginia Bar Association, filed an amicus curiae brief in support of a petition for rehearing.

In an en banc review, the 4th Circuit reversed the panel decision and held that under Virginia law a decedent's will cannot apportion all estate taxes against tenancy by the entirety property. Estate of Reno v. C.I.R., 945 F.2d 733 (4th Cir., 1991). The Court held that Virginia law unequivocally forbids a testator from alienating entireties property by will, and that apportioning the taxes to this property would be the "functional equivalent" of this. In effect the Court refused to permit Mr. Reno from impairing at his death entireties property he could not have impaired during his lifetime.

2. Rent proceeds held in a couple's joint bank account cannot be reached by the husband's creditor, when those proceeds came from property owned by the couple as tenants by the entirety. Rental proceeds are no different in character from sales proceeds from land held by the entireties. Putting the rental proceeds into a bank account held by the couple as joint tenants does not change the character of the proceeds. Kenbridge Building Systems v. David W. Love, (VLW 91-H-320, Circuit Court of Richmond). The decision did not indicate whether funds had been commingled in the joint account.

3. Conversion to tenants by the entirety on the eve of bankruptcy may be characterized as a fraudulent conveyance. In Re White, 28 B.R. 240 (Bankr. E.D. Va. 1983).

4. Property held as tenants by the entirety passes automatically to the surviving spouse at death, avoiding probate. Avoidance of probate may be cited as a legitimate motive for the transfer and as evidence that it was not intended to defraud creditors.

PLANNING OPPORTUNITY: Where only one spouse is facing a potential liability, and the marriage is secure, consider shifting property (including personalty) owned jointly or by the spouse facing the potential liability into tenancy by the entirety. In the case of real estate, there is no need to go through a "straw man;" the conveyance may be from the fee owner spouse directly to himself or herself and his or her spouse as tenant by the entirety with common law rights of survivorship. Section 55-9, Code of Virginia. To put themselves in a position to use this opportunity, clients should strive to avoid having their spouses assume joint liabilities with them, e.g., to the extent possible avoid having spouse co-sign loans, loan guarantees, performance bonds, contracts, etc.

PLANNING DILEMMAS: If the client would not otherwise give his property at death to his or her spouse outright, the use of tenancy by the entirety distorts the client's estate plan, for instance if the client would otherwise leave the property to the spouse in trust or to his children or other family members. Moreover, putting separately owned property into tenancy by the entirety makes it much more likely the other spouse will be accorded a substantial interest in such property in the event of divorce.

B. Taking or Shifting Title in the Name of One Spouse. If one member of a married couple faces the risk of a claim or liability and the other clearly does not (e.g., an ob/gyn married to a stay-at-home dad), consider taking title in the name

of or shifting title to, the Asafe spouse@ or a revocable trust of the safe spouse. This can frequently be justified in splitting assets between the spouses for estate tax purposes, to give each sufficient assets to take advantage of his and her respective estate tax exempt assets. In this context the Aexposed@ spouse might be left with assets not subject to creditors= claims but useful for estate tax purposes, e.g., term insurance payable to her estate or revocable trust.

C. Encumbrance. The only thing attractive to a creditor about a personal residence is its equity. So a home which is or becomes heavily encumbered will not become a target of creditors. If a risk of liability exists, keep the home heavily encumbered and refinance the equity out and reinvest the equity removed in a protected manner, for instance in a family limited liability company or limited liability partnership.

D. Refinance Equity to Offshore Asset Protection Trust. Some offshore trust banks in jurisdictions with good asset protection trust statutes have a program to

S lend money to U.S. homeowners to refinance virtually all of the equity out of the U.S. home, securing the loan with a mortgage or deed of trust
S with the understanding that the resulting cash borrowing will be used to establish with the same institution an asset protection trust to be invested in a diversified portfolio of managed securities

Using this technique, it is often said, is the means of putting your U.S. home in an offshore trust.

E. AUglifying@ Your Residence to Prospective Future Creditors. Often it is worth considering an approach which is subtler than giving away an exposed asset, as such a gift is relatively easier to challenge as a fraudulent conveyance. In the alternative, consider approaches which do not remove the asset from your balance sheet but make the asset relatively less attractive to creditors.

1. Qualified Personal Residence Trust (QPRT) Under Internal Revenue Code Section 2702 and Treasury Regulation Section 25.2702-5(c).

A debt-free personal residence, an attractive asset to a prospective creditor, may be made much less attractive where it is conveyed by the owner irrevocably to a QPRT in which

S it will be owned by a third party trustee
S for some fixed period of time it will be held for the exclusive use of

the transferor, but

- S at the end of the fixed period of time it will automatically be conveyed to remainder beneficiaries, typically the transferor=s children

Under federal transfer tax law this is an excellent discounting technique to get a valuable principal residence or second home through the transfer tax system at steeply discounted values and normally gift tax free: for gift tax purposes the value of the gift is discounted by the present value of the retained interest. If 45 year old parents retain a 20-year retained interest, the gift tax value will probably be some 25% of the fair market value. And if the transferor parents outlive the term, all future appreciation is out of their taxable estates. So this technique has a weighty estate tax planning justification to rebut a charge of fraudulent conveyance. And while a creditor might be able to attach the parents= retained interest, the value of this is so relatively low -- the creditor could lease the target property for the balance of the retained term but could not sell it or disturb the remainderman=s right to take -- that the creditor will normally look elsewhere or settle. In the meantime, the transferring parents have retained the right to live in their home for many years undisturbed.

2. Other uglification techniques

- S Contribution of residence to family limited liability partnership (AFLP@) or family limited liability company. But beware of bad tax cases where personal residences are held in FLPs and no rent is paid
- S Contribution of residence to New Hampshire Apurpose@ trust or other irrevocable trust
- S Installment sale or private annuity sale of residence to younger generation family members with long, slow payout (while the relatively small income stream could be attached, the value of the home could not be reached.)

F. Homestead Exemption. In some jurisdictions, e.g., District of Columbia, Florida, and Texas, there are generous bankruptcy exemptions whereby personal residences may not be forfeited to creditors in bankruptcy, but rather, are preserved and protected for the homeowner.

G. Homeowners Insurance/Umbrella Insurance. As to liabilities arising out of the ownership of the home itself -- e.g., hurricane and tornado and flood damage which can destroy the value in a home -- or torts, for instance from slip-and-fall or deaths in pools, which can trigger huge claims against homeowners, adequate homeowners insurance, with generous (and generally inexpensive) umbrella coverage is the most obvious basic protection.

As to threats against equity in a home arising from liability not related to the home but related to operation of boats or cars, again generous umbrella coverage is a prudent prophylactic.

H. Single Owner LLC. If a homeowner or husband and wife as co-homeowners put their residences in an LLC, does that offer effective asset protection? Almost surely not.

VIII. PROTECTING RESIDENTIAL INVESTMENT PROPERTIES

Particularly since the bursting of the Atech bubble@ in the stock market in March 2000 many Americans seeking a safer growth investment medium than the tremendously volatile stock market have diverted investment capital to residential rental properties.

Things investors like about residential rental properties include the following:

? appreciation in housing has been more reliable, less volatile than the stock market

? such properties hold the potential of producing positive cashflow if rental income exceeds expenses, especially factoring in the tax benefits, including depreciation

? real estate is a Ahard asset@ with intrinsic value that stock does not have. You can at least personally use it and enjoy it.

Problems with residential investment include

? need for down payment, normally substantial

? need for substantial borrowing

? illiquidity: depending on the market a house may take months to sell

? inherent management problems: finding tenants, negotiating leases, evicting tenants, repairs and maintenance, frequently on emergency basis

? risk of law suits

The risk of litigation against the landlord arising out of the landlord-tenant

relationship may arise from landlord-tenant disputes over refund of damage deposits, maintenance and repair, Aslip and fall@ by tenant or tenant=s guest or landlord=s or tenant=s contractors; fire, flood and storm damage, etc. If a single investor or husband and wife own residential rental property in their own names, they are fully liable to satisfy any uninsured claim from their other assets, real or personal.

So, for example, if a couple owning their home as tenants by the entirety and their savings and investment accounts jointly own a rental home as tenants by the entirety, and a tenant or repairman drowns in the home=s pool or trips down the basement stairs and becomes paralyzed, if their relevant insurance is not adequate to cover the claim, which is quite likely, then the landlord=s own home, savings and investments would be exposed to judgment and execution against him or her or them.

Several strategies to protect personal assets from claims arising out of the ownership and management of residential rental property are worth considering:

A. <u>Establish separate LLCs to own each residential rental property</u>. LLCs are cheap and easy to establish. If the investors are meticulous about conforming all written arrangements to the LLC ownership, i.e., titling the property in LLC name, executing the lease in LLC name, signed by a party denominated as the AManaging Member,@ carrying insurance in LLC name, executing all management and maintenance contracts in LLC name by the Managing Member, insisting that rental checks be drawn and deposited in LLC name, etc. -- observing all formalities consistently to reflect LLC ownership -- the only asset that should be exposed in a lawsuit arising out of the rental arrangement should be the rental property and any (presumably small) amount of cash that might be held in the LLC name. Other assets, investment and personal assets, of the landlord should not be exposed to claims.

<u>Problem</u>: Residential property acquisition loans obtained by LLCs are Anonconforming,@ i.e., they may not be sold on the secondary market to Fannie Mae, Freddie Mac, etc. as some 90% of all mortgages are. Therefore such mortgages would have to be obtained from banks (typically smaller ones) and private investors willing to hold the loans for the long term. While investment loans will virtually always bear a higher interest rate than personal use mortgage loans, investment mortgages by an LLC will typically be at an even higher rate than a personal investment loan. But all things considered, the differential should be slight and the protection thereby afforded should justify the small added monthly expense.

So an investor who expects to build up a portfolio of residential investment properties should establish each from the beginning in a separate LLC (e.g., the

name might be the address followed by ALLC@) observing the formalities noted about with respect to each property.

Of course it is somewhat cumbersome to invest in this way and, as noted, there is some extra cost, but in our litigious society it is probably worth it.

It would be somewhat simpler to hold all investment properties in one LLC, but then all properties in the LLC are exposed to any claim arising out of any one.

B. LLC and LLP Interests Are Creditor Immune. If multiple parties are involved collectively as co-owners of multiple residential rental units, they may use separate LLCs or limited liability limited partnerships (LLLP) or limited liability partnerships (LLP) depending on the term used in their state, to hold each individual property, observing all of the formalities with respect to each property. In the case of LLPs and LLLPs, all documents are signed by the Managing Partner who would be named in a Partnership Agreement defining the rights and obligations of each party. In an LLC with multiple owners the comparable document is an Operating Agreement, and all documents are signed by a denominated Managing Member. Careful attention to the negotiation of the terms of those agreements by the parties to them, each of whom ideally would be represented by separate counsel, should limit the exposure of the partners and members to suits by and against each other.

Even if a creditor obtains a judgment against a debtor partner, a partnership interest may not be a very attractive asset for the creditor to go after. The Uniform Partnership Act ("UPA"), the Uniform Limited Partnership Act ("ULPA"), and the Revised ULPA as adopted in Virginia do not permit a court to make a creditor a partner in the partnership if the creditor levies on the partnership interest. All the court can do is give the creditor a "charging order" whereby the creditor may garnish future distributions from the partnership to the interest levied upon but not dissolve the partnership. This principal of Virginia law was reaffirmed in a 1994 Fairfax County case, First Union Bank v. Allen Lorey Family Ltd., VLW 094-8-328. But see Crocker National Bank v. Jon R. Perreton, 208 Cal. App. 3d.1, 255 Cal. Rpts. 794 (1989), which held that a creditor was not limited to a charging order and was able to attack and sell the debtor's limited partnership interest. If the debtor has the ability to see to it that no distributions will be made from the partnership, and the creditor knows it, the partnership interest will be an unappealing target for the creditor. Moreover, the creditor with a charging order may be subjected to tax on the phantom partnership income. See paragraph IX.C.2.c. below. Interestingly, the California cases flowing from Crocker were expressly cited in the Fairfax County First Union Bank case, and the court declined to follow those California precedents. See An Update on the Partnership Charging Order and Observations on Partnership Planning, by J. Richard Duke

and Patrick H. Davenport, Journal of Asset Protection, Winter 1999, Volume 1, Number 1.

Is an LLC as Good a Vehicle as a Family Limited Partnership? Yes. Typically today an LLP or LLC would be used to avoid the unlimited liability of the general partner in a traditional limited partnership. See Bankruptcy Implications of Member and Member-Managed Interests in Limited Liability Companies, by Jack F. Williams and Chink in the Armor: Piercing LLC Veil and Other Exposures of Members for LLC Obligations, David S. Newfeld, both in Journal of Asset Protection, Winter 1999, Volume 1, Number 1.

B. Leases. The leases on such properties should be carefully crafted by knowledgeable real estate attorneys to immunize the landlord to the extent possible from liability, to minimize it when it cannot be avoided, to shift responsibility to the tenant wherever reasonably possible, and to provide as the exclusive remedy, if the drafting attorney thinks it is appropriate, mandatory use of alternative dispute resolution with a mediator or arbitrator in which the identity of those selecting the facilitators and the rules governing the procedure are crystal clear, and perhaps awarding legal fees to the prevailing party, naming a favorable governing law.

IX. PROTECTING UNIMPROVED LAND

Many of the points made in VII and VIII relate to investment in raw land. One point to keep in mind is that in general risk of liability should be less on raw land not leased. If leased or otherwise commercially exposed, e.g., for timbering, or for mining, the risk of lawsuits from those using it or anyone damaged by them obviously increases greatly, and the same considerations of using LLCs or LLPs or LLLPs should be evaluated.

And even with respect to land on which no commercial endeavor takes place, lawsuits are not unknown and risks of same should be carefully evaluated. For instance, there are numerous cases reported in newspapers we have all seen in which trespassers on trail bikes or ATVs or hunters have sued owners of the land on which they were trespassing. These cases have led to the indispensable use of posted ANo Trespassing - Private Property@ signs to deter the argument that the user of it did not know he was trespassing and to facilitate the owner=s argument that a trespasser does so at his own risk. Posting such signs liberally at access points to the property is a worthwhile and inexpensive precaution.

Conservation and scenic easements granted to a municipal government or tax-exempt organization (e.g., The Nature Conservancy) may have benefit in addition to the tax benefits: such easements may diminish the attractiveness of

land so encumbered to creditors. In effect such easements may Auglify@ the land from the prospective of potential claimants examining a target=s balance sheet for low-hanging fruit.

X. PROTECTING COMMERCIAL INVESTMENT PROPERTIES: OFFICE BUILDINGS, WAREHOUSES, RETAIL, APARTMENT BUILDINGS

Based on the foregoing analysis it is evident that single or multiple owners of commercial investment properties should hold each separate property in a separate limited liability entity, typically LLC or LLP or LLLP, possibly in an S Corporation, to limit the susceptibility of the owner=s personal and other investment assets to claims arising out of the operation of the commercial property, so that the only asset exposed to claims arising from the property is the property itself. It should be evident that commercial property of all kinds generates numerous claims of great variety from tenants, visitors, outside repairmen, and maintenance staff. All written agreements and communications must be scrupulously made in the name of the entity and signed by a Managing Member or Managing Partner or President with appropriate authority.

It is equally obvious that claims among multiple owners of such property against one another and against the manager are common, and these are best avoided by a carefully crafted agreement among all members (Operating Agreement), partners (Partnership Agreement) or shareholders (Shareholders Agreement) in the negotiation of which, ideally, each owner would be represented by separate counsel.

Leases on such property are the principal mechanism for limiting claims by the tenant against the landlord, and also for holding the tenants liable for claims from tenants= visitors and tenants= repairmen. The leases on such properties should be carefully crafted by knowledgeable real estate attorneys to immunize the landlord to the extent possible from liability, to minimize it when it cannot be avoided, to shift responsibility to the tenant wherever reasonably possible, and to provide as the exclusive remedy, if the drafting attorney thinks it is appropriate, mandatory use of alternative dispute resolution by a mediator or arbitrator in which the identify of those selecting the facilitators and the rules governing the procedure are crystal clear, and perhaps awarding legal fees to the prevailing party, naming a favorable governing law.

As to the risk of claims from outside repairmen, to some extent these may be mitigated by the contracts between the owner and the contractor, which may limit owner=s liability or to some extent shift risk to the contractor, and deft counsel should be able to tailor ongoing contracts and company policies for outside contractors to limit the risk of claims.

As to the risk of claims from maintenance staff, to some extent these may be mitigated by the employment contracts with such staff and by the adoption of appropriate employment policies. Skilled employment counsel working with the owner should be able to do much to ameliorate the risks of employment related suits.

Managers of the entity should protect themselves from internal claims by co-owners and external claims by tenants, guests, outside contractors and employees by insisting on appropriate levels of comprehensive officers liability insurance at the owner=s expense, and sophisticated liability insurance underwriters can facilitate the best coverage available from the best insurer at the cheapest price. And the Manager, represented by knowledgeable employment counsel representing himself or herself, not by the company=s counsel who is, after all, on the other side of the table -- should have a written employment contract with comprehensive guaranties of officer=s liability insurance coverage and broad indemnification rights for defending any charge or claim the manager may experience other than for gross negligence or criminal misbehavior. The manager should definitely be indemnified for Amere negligence,@ as U.S. courts and juries have set the bar unfortunately low to prove such a claim. The Manager should negotiate the right to select his own counsel to defend him, and to have his legal fees paid currently as billed by the employer.

XI. PROTECTING INDIVIDUAL REAL ESTATE DEVELOPERS

Real estate development is a highly cyclical business, and periodic slow-downs and even Acrashes@ (1989-1992) are almost inevitable. Accordingly, real estate developers should structure their behavior and assets in such a way that when the inevitable down market occurs, it may be weathered successfully.

A. Consider Using a Marital Agreement. Spouses of individual real estate investors should insist on marital agreements containing express assurances that --

? the non-developer spouse will never be asked to give a personal guaranty of a development or other business loan, recognizing that the non-developer spouse has a right to refuse to guaranty any development or other business loan.

? the family home will never be pledged as collateral for any development or other business loan.

? Such agreements should include all features assuring enforceability,

including separate legal representation of each spouse.

B. Keep the Spouse Uninvolved in the Business. Do not name the spouse to serve as officer or director of the business, to insulate the spouse from any sort of claim arising out of the real estate development business.

C. Keep the Spouse Off Loan Guarantees. While it may not be possible in the early stages of a developer=s career to avoid spousal guarantees of development loans, it should be the long-term goal of every individual real estate developer who is in a secure marriage to get to a point where the developer can keep his or her spouse off of loan guarantees, so that family assets may be protected by putting and keeping them in the spouse=s name or in tenants by the entirety with the spouse. When the developer spouse goes to borrow and a spousal guaranty is requested by the lender, and collateral security in the developer=s home is requested, the developer=s inability to offer these because of binding marital agreement will put the developer in the best position possible to bargain for lending arrangements which do not include those two features.

D. Put Assets into Spouse=s Name or Tenancy by the Entirety. Real estate developers in stable marriages may work over time to move assets into their spouse=s name or, in jurisdictions in which tenancy by the entirety offers effective creditor protection, into that form of tenancy.

E. Developers Should Have Enough Assets in Their Own Name Exposed to Liability or Default to Obtain Financing, But No More. This is a delicate balancing act for which no explicit guidance may be provided. As a developer cultivates banking relationships and credibility based on past loan repayment performance and successful development projects, the developer will have more and more credibility with lending institutions and more flexibility. Developers need to be attuned to how much they must keep and maintain on their own personal financial statements to get financing, and maintain in their own name only as much in value as they must, stripping out of their own names and moving into the spouse=s name or tenancy by the entirety or other protected structures (e.g., family LLCs or LLPs or offshore asset protection trusts) surplus assets.

F. Avoid Betting All Accumulated Assets on Each New Development Project. The nightmarish scenario for a developer is that after a good 10-15 year run of successful projects, the developer continues to Abet@ all of the developer=s accumulated net worth on each subsequent project until the eventual downturn unexpectedly catches him and he loses everything. Develop an approach of gradually Amoving poker chips off the table,@ gradually moving assets to a status where they are not shown on the current balance sheet submitted with the loan application and are not standing behind the developer=s personal guaranty.

G. How Strong is the Developer=s Marriage? Obviously moving assets into the spouse=s name will not, in retrospect, seem like a good idea if the spouse eventually asks for a divorce. In jurisdictions where tenancy by the entirety offers effective asset protection, titling assets in that way may be more prudent than putting them in the spouse=s name, assuming in each case the spouse is not personally guaranteeing the loans. And as in divorce, a spouse will probably have a claim to 50% of the development profits during marriage even if titled in the developer spouse=s name, there may be no downside to tenants by the entirety. In jurisdictions where tenants by the entirety does not exist or is not an effective defense against creditors, another protected mechanism, such as family LLC or LLP or offshore asset protection trust, may be used.

H. Liabilities Other than From Loan Defaults. In addition to loan defaults developers are obviously subject to claims and liabilities of other varieties, in contracts and tort, and developers should avail themselves of the various asset protection techniques discussed herein to protect themselves from those claims. If the developer is securely married and if the developer=s spouse has no association with the development business which could make the spouse a target or co-target of business claims, titling assets in the spouse=s name or in tenants by the entirety with the spouse in jurisdictions in which that offers effective protection may be considered.

XII. WHAT DOES NOT WORK

A. Holding Real Estate Investments in Individual Name. As previously noted, if investment real estate is held in individual name, the owner=s personal home and other investment properties are exposed to the risk that they may be attached to satisfy claims arising out of the ownership of the property. Such claims may arise from tenants, guests, outside contractors, maintenance personnel employed by the owner, even by trespassers.

B. Holding Real Estate Investments in Revocable Trust. Revocable Trust assets are completely susceptible to claims against the Settlor (creator) of the trust.

C. General and Limited Partnership. The national real estate market collapse of 1989-1992 demonstrated to all partnerships the risk of holding real estate in traditional general or limited partnerships. In a general partnership all partners are jointly and separately liable for claims arising out of ownership of the property, whether from tenants, guests, outside contractors, maintenance crew or trespassers. A claimant may arbitrarily and randomly select one partner to pursue or, having obtained judgment against the general partnership, arbitrarily and

randomly enforce it against any one or more partners, ignoring others.

Prior to the 1989-1992 real estate market fiasco almost all commercial and investment real estate in the U.S. was held in limited partnerships, so that at least the limited partners were immune to claims. But individual general partners were completely exposed to liability and to satisfy claims from their personal assets. Although this general partner=s risk was often mitigated by forming a corporate general partner, numerous plaintiffs challenged as fraudulent the establishment of thinly-capitalized corporate general partners and there were tax restrictions on that. So corporate general partners generally had to have material capitalization, and that was exposed to claims.

As the same real estate collapse triggered numerous lawsuits against the accountants and attorneys and even architects and engineers who assisted the distressed real estate developers and investors, and most professional service firms at that time were organized as general partnerships, general partnerships and limited partnerships came generally to be regarded as obsolete and inadequate in affording protection from creditors for both professional service providers and for real estate owners and operators. As a result these groups lobbied state legislators to find a better form of business entity in which the same general limited liability afforded to owner shareholders of corporations could be made available to professional service providers and real estate developers, investors and operators. Quickly the LLC and LLP concepts were imported from civil law jurisdictions in Europe and made available in the 50 states and District of Columbia. These new forms of entity were so quickly and universally accepted that by 1995 virtually every professional service firm and real estate limited partnership in America had been converted (through a very simple statutory procedure) to an LLC or LLP or LLLP, and since then virtually every new professional service firm and real estate holding entity has been created as an LLC or LLLP.

The key advantage of LLCs and LLPs and LLLPs over the old entities is that if they are properly established and operated no owner is personally liable for debts or obligations of the entity. Assets of the entity are exposed to claims of creditors of the entity, but not assets of the owners of the entity. So now there is parity with owners of corporate stock, and members of an LLC or partners of an LLP are no more exposed to claims against the entity than shareholders of Microsoft are.

D. <u>Holding Real Estate Investments as Tenants in Common or as Joint Tenants with Right of Survivorship</u>. Tenants in Common are generally jointly and severally liable for claims arising out of the property owned, as are joint tenants. These are not appropriate forms in which to hold investment assets such as real

estate that may be prone to generating claims and liability.

E. Personal Guaranties/Joint and Several Liability. The most direct way of creating liability in a real estate investment, or any other type of investment, is to become primarily liable as the maker of a promissory note to a lender. A promissory note, the debt instrument, will normally provide that the multiple makers are "jointly and severally" liable, which means, as to the holder of the obligation, that each maker is primarily liable for the entire amount of the debt, although between the individual obligors, one would have the right to seek contribution against any other solvent obligor. The right of contribution, however, is somewhat of a hollow right because it only ripens after any obligor has paid the holder of the note the entire indebtedness.

F. Guaranties of Collection and Guaranties of Payment. Many people have had very expensive lessons in learning about the legal intricacies of the word "guaranty." As a guarantor, an individual or entity becomes liable for another's debt. Since it is a suretyship relationship, and sureties are a favorite of the law, a guaranty is never presumed, but rather must be shown by clear and convincing evidence. Moreover, by Virginia statutory law, Code of Virginia ' ' 49-25 and -26, unless a contrary intent is clearly reflected in the documents, a guaranty is first construed as a guaranty of collection, meaning that the holder of an obligation must first exhaust available legal remedies against the maker of the obligation before resorting to any remedies against the guarantor, whereas a guaranty of payment makes the guarantor primarily liable on the obligation and a holder can proceed to enforce the obligation immediately against the guarantor without first resorting to remedies against the maker. However, most banking documentation is structured to make the obligation of a guarantor a guaranty of payment and not a guaranty of collection, with the result that the lender may seek primary and immediate recourse against the guarantor without even pursuing the maker.

G. More Recent Legal Developments. Recent cases have reaffirmed the guarantor's direct liability, provided that the guaranty document provides for such direct liability, including the upholding of a confession of judgment provision in a guaranty agreement, overcoming the defense that the guarantor did not read the provisions of the agreement containing the confession of judgment language, and that right was not specifically discussed or bargained for during the negotiations between the guarantor and the lender. Atlantic Leasing & Financial, Inc. v. IPM Technology, Inc., 885 F.2d 188 (4th Cir. 1989). Similarly, the Virginia Supreme Court has upheld the liability of a wife pursuant to an unlimited guaranty for a loan made to her husband, noting that the Court has consistently held that a guaranty, unlimited as to time, but given in circumstances evidencing the guarantor's intent to cover a series of transactions, will be construed as a continuing one, and in this case, the language of the guaranty was plain and was enforced

according to its terms. Bank of Southside Virginia v. Candelario, 238 Va. 635, 385 S.E.2d 601 (1989).

H. General Partners' Liability. General partners of a partnership are jointly, but not automatically severally, liable with other partners for partnership debts. Virginia Code ' 50-15(b). However, personal guaranties, which are usually required, make general partners severally liable on partnership loans.

I. Limited Partners' Liability. Limited partners in a limited partnership are only liable for their agreed contribution to the partnership, and not any debts of the partnership, provided they do not participate in the control of the business (Virginia Code ' 50-73.24), unless the limited partner knowingly allows his name to be used in the name of the limited partnership and creditors extend credit to the limited partnership without actual knowledge that the limited partner is not a general partner. Virginia Code ' 50-73.24D. See IX.C. below.

J. C Corporation. It is virtually always a terrible idea to hold real estate in a C Corporation. The point of owning real estate is that it is expected to appreciate, and appreciated assets sold by a C Corporation are subject to one tax at the corporate level and then to a second tax at the individual shareholder level when the profit is distributed as a taxable dividend. Common sense and tax planning dictate that real estate should be held in a Aconduit@ entity such as a partnership (or S Corp) which does not pay tax at the entity level: all tax is paid only at the owner (partner) level. LLCs with multiple owners which hold real estate virtually always elect (as they may under the Acheck the box@ tax rules) to be taxed as partnerships.

XIII. GENERAL MATTERS

Liability Insurance. The first and most obvious level of protection with respect to all tort liabilities which could arise out of real estate is adequate liability insurance. Modern thinking about how much insurance is enough takes into account that plaintiffs will discover the liability limits of the insurance policy and amend pleadings to claim damages equal to whatever is available. So there is no point in over insuring, as you make yourself more of a target. And as successful claims will likely cause your premium to rise dramatically, and in that sense real estate owners and operators may be said to partially self-insure on a delayed basis, carry enough insurance to satisfy reasonable claims and use asset protection techniques above that level.