By Jacob Stein

Asset Protection as a Line of Defense

Real estate developers, builders and investors are frequent targets of lawsuits, particularly suits by lenders for defaults and suits by homeowners for construction defects.

Most developers spend fortunes litigating these cases, file for bankruptcy or simply throw up their hands in a sign of surrender. In recent years, more and more have turned to asset protection.

"Developers and investors will always be targets of lawsuits. The only way to change that is by removing a plaintiff's financial motivation."

Asset protection deals with structuring asset and business ownership to make it either impossible or, at least, very expensive for a litigant or a creditor to reach the assets of a defendant-debtor. If a developer's business and personal assets are impossible or too difficult to collect against, a plaintiff's attorney will either not file the lawsuit or will be a lot more willing to settle on terms that are favorable to the developer.

Different structures are used to protect different assets. Here are some of the more common structures:

Personal Residence. An arm's-length cash sale is the best way to protect the residence because it is much easier to protect liquid assets than real estate. While this technique affords the best possible protection for the residence, it is also the most radical and may result in additional income taxes. Two alternatives to an outright sale are an equity strip or a sale and leaseback of the residence. The contribution of the residence to a limited liability company or a limited partnership may be another way to protect the personal residence.

The final available alternative to protect a personal residence is to transfer the ownership to a trust commonly referred to as a personal residence trust. This is a trust that allows the homeowner to retain complete control over their property while obtaining a great deal of asset protection without any tax consequences.

Rental Real Estate and Other Non-Liquid Investments. Some of these techniques may be used to protect rental real estate, businesses, intellectual property, collectibles or other valuable assets. These assets may be transferred into irrevocable trusts, sold for cash or on installment basis or encumbered. However, for assets other than a personal residence there are much better and simpler ways to achieve as much or more protection: an LLC or a limited partnership.

Assets owned by a debtor through an LLC or a limited partnership are not deemed owned by the debtor because these legal entities have their own separate legal existence. This means that a plaintiff suing the debtor will no longer be able to reach the assets of the LLC directly.

Interests in LLCs and limited partnerships are also not subject to attachment by a plaintiff. This is known as the charging order protection, which limits a plaintiff's remedy to a lien against the distributions from the legal entity, without conferring on the plaintiff any voting or management rights. The debtor, who remains in control of the entity, can defer distributions and the plaintiff has no way of enforcing the judgment against the debtor's LLC, the limited partnership interests or the assets owned by these entities.

Liquid Assets. Liquid assets may be protected through many of the techniques described above, including LLCs, limited partnerships and irrevocable trusts. In addition to these techniques, liquid assets may also be protected with a special asset protection trust based in a foreign jurisdiction, as some foreign jurisdictions go out of their way to protect trusts and their assets. The assets transferred to a foreign trust are usually liquid, such as bank accounts or brokerage accounts, but they can also include intellectual property and interests in legal entities, among other things. Most of these trust structures are established in a way that allows the debtor to be the only one who can know what assets are owned by the trust and the only one who can access the funds of the trust.

Real estate profesionals will always be targets of lawsuits. However, asset protection is a simple and effective means of changing the plaintiff's financial analysis and making the debtor "judgment proof." As with any other planning, asset protection is a lot more effective when implemented in advance. —SOCAL

The views expressed in this article are those of the author and not Real Estate Media or any of its publications.

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