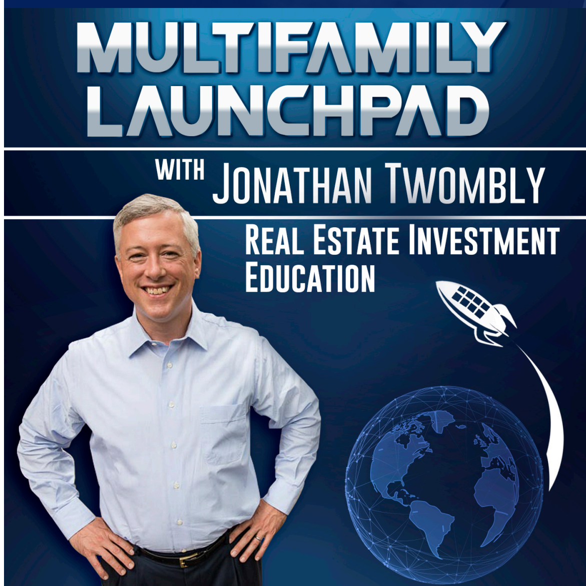

Protecting Your Assets with Insurance and LLCs

Module 11 – Video 2

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Video Overview

What's covered:

- Why you need an asset protection strategy
- Why you need insurance
- Why you need corporate entities
- Piercing the corporate veil

Disclaimer

- I am an attorney, but I am not YOUR attorney.
- You may not rely on anything here as legal advice.
- You must obtain your own corporate lawyer to make sure that you establish entities correctly for your situation.


Asset
Protection

Asset Protection

- As you build the business, you will have more to protect from potential creditors.
- It is essential that you structure the business correctly from outset, rather than having to restructure later, after you have grown.

Asset Protection

- What do you need to protect?
  - Your personal assets from claims against your business
  - Your business assets from claims originating against other business assets

Asset Protection

- What kind of claims?
- Injuries to tenants, guests, workers, vendors, or anyone else who enters the property
- Unpaid bills from vendors
- Claims by lenders
- Claims by shareholders

Asset Protection

- How do you protect the assets?
  - Insurance
  - Limited Liability (corporate entities)


Insurance

INSURANCE

- Insurance is a contract that protects you against covered events, that are generally *accidental*.
- Insurance pays you for damage you incur, such as when you suffer fire, flood, hail, theft, etc.
- It pays third parties for damage they incur that you are responsible for. It also covers the cost of defending lawsuits by third parties.
- You are only covered up to the policy limits. If the policy limits are exceeded, you are liable for the rest.
- Insurance does <u>not</u> cover claims by creditors, such as lenders, vendors, etc. Only claims that are accidental in nature.

Insurance

- For your property to be adequately covered, you need various forms of insurance, including general liability, property & casualty, umbrella, excess, and flood.
- If you are doing syndications, you should also obtain Directors & Officers (D&O) and Exceptions & Omissions (E&O) insurance
- The most important consideration is NOT price – it's the insurer's reputation for paying claims. DO NOT skimp here.
- Contact your insurance broker to understand what insurance you will need to cover your assets and business.

Corporate Entities

Corporate Entities

- Corporate entities allow you to separate your business assets from your personal assets
- They are considered separate legal "persons" from you
- They can be held legally liable without it affecting you personally – for example, liabilities under contracts
- Essential to your asset protection strategy because they provide "limited liability"
- If you maintain the corporate formalities, your liability is limited to your ownership stake in the entity

Corporate Entities

- The basic types of corporate entities are:
  - ✓C corporations (Inc.)
  - ✓S corporations (Inc.)
  - ✓Limited Partnerships (LLPs)
  - ✓Limited Liability Companies (LLCs)
- Tax and operational advantages and disadvantages to each, which are beyond the scope of this program
- Consult your lawyer and accountant to determine which makes the most sense for you

Limited Liability Companies

- Most people choose LLCs because of their simplicity to set up and their tax pass-through status (only one layer of taxation)
- Called a “company,” but most LLCs are structured like sole proprietorships (single-member LLCs) or partnerships (multi-member LLCs)
- Partners are called “members” rather than shareholders, and own “membership units” rather than partnership shares
- LLCs are managed by a “manager” who can be a member or a non-member
- Manager who is a member is called “Managing Member”; manager who is not a member is called a “non-member manager”

Limited Liability Companies

- LLCs have two great advantages
  - Limit your liability to your investment in the company
  - Are a "pass-through" for tax purposes
    - Are not subject to double-taxation like C corporations
    - Net income to LLC is taxed once as regular income to the partners

Limited Liability Companies

- LLCs have at least one great disadvantage: “Phantom income”
  - You personally owe tax on earned income even though you have not actually received the cash from the LLC
  - Happens when the company retains earnings for re-investment; members still owe tax on the retained earnings, even though they did not receive the cash
  - Most people find that the possibility of phantom income is less of a problem than double taxation


Insurance
vs.
Corporate
Entity

Insurance vs. Corporate Entity

- Although some people claim you only need one or the other, you really need both, because they serve different purposes
- **Insurance** makes you whole for covered items that are *accidental* in nature:
  1. Reimburses you for damages you suffer from covered events
  2. Reimburses you for damage claims you owe to third parties
  3. Reimburses your legal fees for defending third-party claims
- Insurance protects you against only things that are covered and only up to the policy dollar limit; you are liable for everything else
- If you only have insurance, then your personal assets are at risk for un-covered damages and damages over the policy limits

Insurance vs. Corporate Entity

- Corporate entities do 2 things:

1. Prevent insured losses over the policy limit from affecting your personal assets
2. Prevent uninsured losses from affecting your personal assets

- What kind of uninsured losses?
  - Anything accidental that is not covered under your policy
  - Normal losses that happen in business
    - ✓Don't have enough money to pay a vendor? With a properly run entity, the vendor cannot obtain payment from you personally.
    - ✓With no entity, the vendor can collect a judgment against your personal assets; insurance does not cover these normal business losses.

Insurance vs. Corporate Entity

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- Example of claim exceeding insurance limits with no corporate protection:
  - Claim judgment is $3,000,000
  - Insurance policy limit is $1,000,000
  - Property is worth $1,000,000
- $1,000,000 is left on the claim. You must satisfy from your personal assets.

Insurance vs. Corporate Entity

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- Example of claim exceeding insurance limits <u>with</u> corporate protection (LLC):
  - Claim judgment is $3,000,000
  - Insurance policy limit is $1,000,000
  - Property is worth $1,000,000
- You have no personal liability beyond your ownership in the LLC, so the plaintiff can only collect $2,000,000.

Insurance vs. Corporate Entity

- What happens when you put multiple properties under the same LLC?
  - Claim judgment is $3,000,000
  - Insurance policy limit is $1,000,000
  - Property 1 is worth $1,000,000
  - Property 2 is worth $1,000,000
- Even though the plaintiff's injury happened on Property 1, you will need to hand over the keys to both properties to satisfy the judgment
- For this reason, keep your properties separate
- It is for this reason that commercial lenders require you to have a separate LLC for each property – they don't want to lose their property because someone was injured on one of your ***other*** properties

Insurance vs. Corporate Entity

- What if it's a contract dispute, rather than a damage claim? (Like an unpaid vendor)
- Insurance: no coverage
- No corporate entity: they can come after your personal assets for payment
- Corporate entity: they can only come after corporate assets for payment, even if the corporate assets are not enough to satisfy the claim

Insurance vs. Corporate Entity

- If you are doing business as an LLC, a plaintiff has no legal right to collect from you personally
- They can only collect against the LLC
- Everything inside the LLC is at risk
- Everything outside the LLC is safe
- Insurance will defend the LLC and reimburse it for covered claims up to the policy limit

Piercing the "Corporate Veil"

Piercing the "Corporate Veil"

- The "corporate veil" is the fancy lawyer's word for corporate separateness, which courts will respect unless you abuse it
- Corporate protection is not absolute – you can lose it
- It won't protect you if you use it to commit fraud
- Also will not protect you if you disregard the separateness of the corporate entity

Piercing the "Corporate Veil"

- Consequences of the corporate veil being pierced:
  - You lose all limited liability protection
  - A creditor against the entity can reach your personal assets or other business assets

Piercing the "Corporate Veil"

- How do you avoid the corporate veil being pierced?
  - Run your business properly
  - Observe the corporate formalities
  - Keep separate accounts
  - Keep good records
  - Hire a good bookkeeper/accounting firm
  - Keep separate entities separate
  - Don't commingle your assets with the entity, and don't commingle assets between entities
  - Don't use the entity to pay expenses for you or for another entity without documenting/accounting for it properly and paying the entity back

Piercing the "Corporate Veil"

- How do you lose corporate protection and set yourself up for a successful veil-piercing claim?
- Do the things real estate gurus tell you to do to save taxes!
  - ✓ Buy personal items (like cars) through the LLC
  - ✓ Take "business" trips with company money
  - ✓ Run personal expenses through the LLC
- Losing corporate entity protection is hard, because the default legal rule is to enforce corporate separateness
- **However**, these guru recommendations are exactly the things a good plaintiff's attorney will use to prove the LLC is a sham, the court should disregard the corporate entity, and the plaintiff can collect from your personal assets
- Don't do them!

Q&A IN THE FACEBOOK GROUP

Next up:

Module 11 – Video 3
Structuring Your Real Estate Business