REDUCING RISKS OF HOLDING TITLE TO COMMERCIAL REAL ESTATE

A Practical Guide For Managing Liability

By Daniel S. Gonzales *December 2010 - San Jose, CA*

SHOULD YOU BE CONCERNED?

Ownership of commercial real estate is enjoyed by a privileged few. If you are among them, you are in the fortunate position to benefit from many advantages. You can probably identify dozens, from increased cash flow to substantial tax breaks to enhanced collateral.

One of the most significant, yet least heralded, of these advantages may be the opportunity to develop and exercise sound business judgment. It is true that amassing the wherewithal to acquire real estate frequently, but not always, requires business acumen. Active participation in commercial property ownership, however, always demands skill and discernment to safeguard and increase the value of your holdings.

Certainly, it is useful for an owner of commercial real estate to possess a fundamental understanding of the importance of balancing costs and benefits in making business decisions. The myriad of choices you face as a property owner demands that you have an effective, efficient means of response. Being able to perform timely and economical cost-benefit analyses can make the difference between success and failure in owning property.

Consequently, it's in your interest to be able to rely on the most expert advice and intelligence available to you to inform your decisions. Many of the least understood and repeatedly ignored risks can arise in connection with your directly holding title to real property as an individual. This is why, when it comes to matters concerning title, experienced commercial real estate owners regularly turn to legal counsel for authoritative guidance. In this guide, I suggest the use of limited liability companies as one means of mitigating the risks of holding title to commercial real estate.

WHAT DIFFERENCE DOES TITLE MEAN FOR YOU?

Even commercial real estate owners who are knowledgeable and prudent in their business affairs can leave themselves exposed to catastrophic financial harm from failing to identify or address certain risks. Bankruptcy courts are overflowing with countless cases of businesses that have been decimated as a result of unanticipated or neglected liabilities. By overlooking or ignoring seemingly minor but substantively critical issues, you could lose everything that you've worked so hard to build over the years.

Most people are generally aware of obvious risks to their assets. Fire, theft, automobile collisions—the resultant damage or injury that these can inflict in connection with your business and/or personal activities is probably well known to you. While significant, these sorts of risk can usually be mitigated through liability and other types of insurance. A seemingly innocuous detail, however—the manner in which you hold title to commercial real estate—can prove calamitous.

In the whirlwind of activity that occurs when title to real property is conveyed at the conclusion of a purchase and sale transaction, you might not pay much attention to the way you take title to the property. Yet the manner in which title to your commercial real estate is held could place all of your businesses and assets in grave peril. This is especially true when you share ownership of a property. This risk arises as a result of taking title to real estate as an individual without arranging for any sort of vehicle for mitigating or eliminating the liabilities associated with such ownership. In the absence of such a vehicle, the level of your risk exposure from your own unrelated activities and, in the case of co-ownership, third-party liabilities, will be at the mercy of state law. Again, the risk is often greatest, yet least likely to be addressed, if you are one of several persons who take title to a property individually as co-owners. As described below, co-owners have to worry that their property might be subject to liabilities arising not only from their own activities but also from those of their co-owners. This guide is designed to help you understand and protect against such risks.

WHAT ARE YOUR RISKS?

Holding title to commercial real estate as an individual exposes you to a number of separate and distinct types of liability. In addition to the more commonplace and commonly understood threats described above, one major source of risk is exposure to liability arising in connection with economic activities other than the commercial real estate in question. Several, but by no means all, of these risks are outlined below.

Imagine, for example, a person who holds title to both a car wash and an office building in his individual capacity. Such an individual is in danger of allowing both assets to be subject to liability arising solely out of one of his properties. Creditors having claims relating to the operations of the car wash need not be limited to pursuing collection of their claims against the car wash property alone but could also seek to collect their claims against the office building property, even though their claims have nothing to do with the office building. The mere fact that title to both properties is held in a person's individual capacity means that claims relating to one property may be enforced against the other property, or against both properties, and not just against the property from which the claim arose.

When title to commercial real estate is held by more than one person in their individual capacities, additional risk factors apply. First, in the absence of an agreement among the co-owners, their respective rights are governed by state law as owners of undivided pro-rata shares of the property in question. In California, those rights may differ substantially from the parties' intentions. For example, each co-owner has an absolute right to occupy and possess the property for his or her own purposes and may not exclude any other co-owner from the property. As is easy to imagine, should one co-owner decide to exercise this right, the result could be chaos—or worse in the view of other co-owners.

Let's say, for example, that several persons in their individual capacities co-own a building in an industrial park and all but one of them think it's a good idea to lease the building to an established, D&B-rated firm engaged in software engineering. Before this can happen, however, the rogue co-owner decides to lease the building to a new company in the hardware fabrication business and the new company not only has weak financials but also employs hazardous substances in its manufacturing process. Under state law, in the absence of a valid agreement regarding management of the building that would prevent such a unilateral action, the majority of the co-owners cannot prevent the rogue co-owner from leasing his interest in the building to the new company. At most, they could take control of partial interests in the building alongside the new company. This would not, however, prevent the new company from occupying part of the building. The end result would be a costly, messy lawsuit among the co-owners, the new company, and possibly the D&B-rated firm if it had already entered into an agreement in principle to lease the building. A further costly complication could ensue from the increased risk of hazardous substances contamination resulting from the new company's tenancy, which could affect every owner's interest in the building, not only the rogue co-owner's.

In addition to the rights described in the example above, each co-owner also has the right to seek the partition of the property among the co-owners or the sale of the property as a whole by filing a lawsuit. Furthermore, each co-owner has the absolute right to sell or borrow against his or her own interest in the property, regardless of the wishes of the other co-owners. It will be obvious to you that the exercise of these rights could wreak havoc on the financial health of commercial real estate, with attendant undesirable consequences for co-owners.

Similarly, claims by a third party against a co-owner of commercial real estate that arise in connection with his or her other assets or businesses can be enforced against that co-owner's interest in the co-owned commercial real estate. In that situation, while the other co-owners' interests in the co-owned commercial real estate technically are not subject to the third party's claims, as a practical matter, any third-party claim against one co-owner's interest in commercial real estate will jeopardize the entire property and, consequently, also the interest of every co-owner. When title to commercial real estate is held by more than two individuals, each owning a variety of business and personal assets, the permutations of risk can be alarmingly high.

To summarize, holding title to commercial real estate in your individual capacity can create a substantial amount of risk for you and your other assets, and your risk is magnified substantially when title to that real estate is held with another person or persons.

WHAT SHOULD YOU DO?

In view of the many risks associated with holding title to property in your individual capacity, the law has over the years developed a variety of mechanisms to deal with them. They include the use of tenancy-in-common agreements, incorporation, limited partnerships, and limited liability companies. While a detailed analysis of each of these structures is beyond the scope of this guide, their respective advantages and disadvantages are broadly described below.

Tenancy-in-common agreements, generally speaking, are contracts among co-owners that spell out the specific rights and responsibilities of each co-owner. These agreements are commonly used in connection with residential real property, but they may also be used for commercial real estate. They are quite useful in dealing with conflicts among co-owners and the allocation of liabilities among co-owners because they provide a guide for all parties' duties and obligations as well as specify conditions under which an owner's interest or the entire property can be sold (i.e., buy-sell rights). Such agreements, however, do not provide any protection for the property against risks arising out of each owner's other assets or businesses or from third-party claims against other co-owners and thus are of limited utility in this regard.

The use of corporations as vehicles for holding title to commercial real estate has a long history and provides protection not only in the event of conflicts among co-owners but also against personal liability for claims against the corporation. Moreover, a title held by a corporation is insulated from direct claims arising against the co-owners because only the co-owner's shares of stock in the corporation—and not the real estate itself—are subject to those claims. Corporations are, however, subject to cumbersome and relatively expensive continuing legal housekeeping requirements to allow individual shareholders to maintain limited personal liability with respect to claims against the corporation. Consequently, they are not a cost-effective means of limiting liability for most owners of commercial real estate.

In addition, these "C" corporations, as they are designated under the Internal Revenue Code, are subject to an additional level of income taxation. The corporation, as a separate legal entity from its shareholders, must pay tax on its own income in addition to the tax that the shareholders must pay on that income when the corporation distributes income to them. This tax structure contrasts with the situation in which title is held by an individual, and, consequently, "C" corporations are not a desirable option for many people who own commercial real estate. "S" corporations, which enjoy the limited liability of corporations but are treated as partnerships for tax purposes and are not subject to double taxation, are still burdened by a variety of legal formalities and restrictions. Consequently, "C" corporations are usually not cost-effective for many owners of commercial real estate.

Limited partnerships also enjoy significant use as a means of holding title to commercial real estate, especially among different generations of family members in connection with their estate plans. Limited partnerships are created through a partnership agreement, have most of the traits of partnerships, but are also similar to corporations in certain notable ways. In particular, the limited partners in a California limited partnership enjoy limited liability so long as they are not involved in the management of the limited partnership. Responsibility for the management of the limited partnership—along with personal liability—belongs solely to the general partners, subject to the terms of the partnership agreement. This structure is particularly helpful when there are classes of individuals who, either owing to lack of inclination or qualification, may not want an active role in the management of the property. For example, younger family members or passive investors, may want or need to rely on more expert managers, such as older members in a family or investment advisors. While a limited partnership provides a useful means to reduce liability without incurring an additional level of income tax liability, the loss of management control by the limited partners in favor of the general partners may be too high a price to pay for all but the least active real estate investors.

Use of a limited liability company to hold title to commercial real estate is an increasingly popular and functional option for reducing the risks of ownership of commercial real estate. In particular, a limited liability company (also called an "LLC"), which is a relatively new form of business organization, can be an extremely effective mechanism in those cases in which you own or co-own commercial real estate, are actively involved in its management, but find the responsibilities of forming and maintaining a corporation too onerous and wish to reduce the risk of holding title to the commercial real estate without incurring an additional level of income taxation. Limited liability companies provide the flexibility to allow property owners to have either an active or passive role in the management of the property as a "member" of the LLC (the name given to owners of a limited liability company) while giving them the benefits of limited liability and the ability to be taxed as a partnership, thus avoiding the double taxation of incorporation.

In California, a limited liability company is established through a filing of basic articles of organization with the Secretary of State; it is accompanied by a nominal filing fee and subject to an annual $800 franchise fee. The specific provisions for governance of the company are documented in a contract among the members called an operating agreement. This agreement, which sets forth the rights and obligations of the members of the LLC, can be finely crafted to address the specific requirements of its members, both collectively and individually. In being able to do so, it is functionally similar to a tenancy-in-common agreement, e.g., providing for the respective management obligations of each member and for buy-sell rights.

Unlike a tenancy-in-common agreement, however, a limited liability company offers the advantage of being able to limit its members' risk of loss to their investment in the LLC. In the context of this discussion, their investment would be the commercial real estate transferred into the limited liability company. For example, two individuals could co-own in equal shares several office condominiums, among other valuable business assets that each of them hold individually. If the co-owners then place title to the condominiums into an LLC in which they are the sole members holding equal membership interests and contribute no other assets to the LLC, unless the liability relates to fraud or similar wrongdoing by either member, the LLC's liability is then limited to the value of the office condominiums. Neither member of the LLC may be held personally liable for the LLC's liability in excess of that value solely as a result of his or her status as a member.

Furthermore, once a property is transferred into a limited liability company, it is protected from claims against the individual members by third parties. Only a member's interest in the limited liability company, not the property itself, is subject to a third-party claim. Using the example of the office condominium co-owners in the example described above, if one member of the LLC incurs a claim in favor of a creditor arising from one of his or her other business assets, the creditor may seek to recover his claim out of the member's interest in the LLC but may not recover his claim against the office condominium directly.

If the administrative cost can be justified by the value and cash flow arising from a commercial real estate asset, liability and risk can be further limited by the use of a "single-asset" limited liability company. In such a case, each commercial real estate asset is held in a separate limited liability company, which insulates each asset from risks associated with other assets. It should be noted that limited liability companies in California are subject to a tax on annual receipts in excess of $250,000. This tax should be factored into any cost-benefit analysis of the advantages and disadvantages of using LLCs in any particular circumstance.

It is difficult to overstate the value of reducing the risks associated with title. Even seemingly benign situations such as family businesses holding commercial real estate can be fraught with problems. A few years ago, I represented a co-owner of a family-owned LLC whose assets included commercial real estate and related business holdings. Disputes had arisen among family members regarding the operation and management of their holdings. My client was being excluded from making decisions, which, she believed, put the family's assets at risk.

Since the family's commercial real estate and business interests had already been put into a limited liability company, I was able expeditiously to assert my client's rights to an accounting and buyout under the terms of their operating agreement and California law, thereby preserving the value of her interest in those holdings. Without a limited liability company in place, this dispute would have been even more costly and difficult.

Recognizing the potential for harm that can arise from ownership of property is the most significant step you can take towards protecting yourself. Depending on the circumstances, each method described above for dealing with the risks of holding title, as well as others, can provide valuable benefit to individuals owning or co-owning commercial real estate.

WHAT CAN YOU DO NOW?

In the nearly 25 years that I have practiced real estate and business law, people have often asked my advice on how best to protect themselves as owners of commercial real estate. The information provided in this guide gives you several ideas to consider. Ultimately, since every situation is unique, identifying the best strategy for addressing your needs and wishes requires the sort of analysis that can occur only through a frank, open discussion between you and an experienced attorney. I would be more than happy to meet with you to discuss your options and help you develop the most suitable approach to dealing with your commercial real estate concerns. For matters such as these, I offer an initial half-hour of consultation without charge. Please contact my office for an appointment.

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