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Don't Let Your Risks Devour Your Assets

By Danferd Henke

Business is never risk-free. You know that, and that's why you put your business into a corporation or LLC. You shouldn't stop there, however, when considering how to reduce your risks. Take the following example, which is deliberately exaggerated to make a point.

Fred Fandango is the sole owner of a manufacturing business that produces two main products, produced by two separate divisions. One makes metal parts used in the brake assemblies of large trucks and the other plastic components, which Fred supplies to manufacturers of children's toys. The business has produced enough income for Fred to acquire a waterfront vacation home in the San Juans, a modest 20-unit apartment building in Ballard, and a commercial real estate building in Kent, as well as a nice portfolio of mutual funds. Fred also owns the real estate where his business is located. Fred owns all of the stock in his business and all of his properties outright, in his own name.

Last week, Fred was summoned home from his vacation in Paris. His Ballard apartment building had caught fire in the middle of the night. Unfortunately, not all of the tenants escaped the blaze. The Fire Department's preliminary assessment is that faulty wiring caused the fire.

Two days later, a process server delivered a summons and complaint naming Fred's company as a defendant in a Mississippi lawsuit. The complaint alleges that one of Fred's parts failed in the brake assembly of a tanker truck, causing the driver to lose control of the truck. It horse-shoed, taking out two passenger cars and spilling highly-toxic chemicals over the road and into a near-by stream. Fred turned over the impending fire claim and the lawsuit to his various insurers, each of whom promptly reserved all rights concerning coverage and informed Fred that his insurance limits may not be adequate to cover all the claims.

Finally, yesterday, Fred received a letter from a consumer watch-dog group, alleging that the plastic component his company sells for children's toys contain compounds known to cause cancer in rats if ingested and inquiring about his testing procedures.

Fred's situation is an exaggerated perfect storm of real and potential liability. However, the exaggeration illustrates the central point that nearly all of Fred's assets both create risk and are exposed to risk. Fred's apartment building, as well as all of his other real estate, creates risk. Inherent in the ownership and operation of rental real estate is the risk that someone will be hurt or someone's property will be destroyed as the result of a fire or other calamity. Likewise, each of Fred's company's business divisions creates risk that someone may be hurt by the product or that the product will cause another form of loss.

These sorts of operational risks are sometimes referred to as "inside risk." But each of the inside risks also creates the potential for "outside risk" – the risk that the damages resulting from the operational liability could be collected from other assets, assets that had nothing to do with the risk or the loss. In Fred's case, the damages resulting from the operational risk of the fire at his apartment building could be collected by the forced liquidation of Fred's other assets, including the stock in his business, the real property on which it operates, Fred's other properties, and his

mutual funds, even his home. While a loss in one of the business divisions might not spillover to Fred's other assets, thanks to the corporate shield, the damages from the loss certainly could be collected from the assets employed and created by the other business division.

How to create protection

What could Fred have done to protect himself, his company, and his assets from loss, or at least total loss? The first line of defense, of course, is the one-two punch of common sense and insurance. Fred should have understood the risks that his business and other assets posed. Periodically, Fred should have conducted risk audits of his business and his holdings, in consultation with his lawyers, accountants, and insurance advisors to estimate both the nature and extent of the risks he faced. Fred should have, and thought he had, adopted an adequate program of insurance coverage for those risks.

But what if Fred's insurance coverage is insufficient or unavailable for a particular risk? Fred could have segregated his assets from each other, thus confining the risk of loss to the asset that created the risk. For example, although Fred operates his business in the form of an entity, providing him with the benefits of the corporate shield to liability, Fred could have applied the same strategy within his business to shield some of its assets from operational risk. Fred could insulate the profitable plastic component manufacturing business from the risky brake-part manufacturing division, and vice versa, by operating the two divisions as separate subsidiary entities instead. The failed brake part would not have exposed the plastic component business to loss. (See Dirk Bartram's article below.) Likewise, Fred could have employed a separate LLC to own the real property on which the business operates. He could hold each of his other properties in its own LLC, segregating the risk created by each property from the value of the others.

Is this sort of risk management/asset protection program for everyone? In these times, the answer is "yes" for most businesses and people, at least for these minimal measures. Even though there are set-up costs and on-going administrative expenses, segregating one's assets in separate entities has become a commonplace strategy for reducing exposure to the evermore creative claims we all experience.

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