Is Partner a Four Letter Word for Real Estate Investors?

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Just this week, as I have many times before, I had an initial consultation with an experienced real estate investor who had found a partner to help him to expand his real estate investing business a year or two ago, and is now in a costly and time consuming dispute over separation of his and his partner's interests. In my practice as a real estate lawyer working with investors, I have seen many partnerships last a long time and be mutually beneficial for the partners, and others come apart with explosive force leaving both financial and emotional damage. In my own investing, I have partnered with family members and business partners, with varying degrees of success and cooperation.

From all of these activities, I have developed some advice for those who want to team up with others for their real estate investing. First, though, let me clarify that I use the word partner in its generic, layman's sense, not its legal sense. I don't advocate anyone doing business in real estate, or any other type of business for that matter, as a general partner in a general partnership. General partners, at least in Pennsylvania, are jointly and severally personally liable for claims against the partnership, each can bind the other, and unless their agreement limits their fiduciary duties to each other, they can end up with an equitable interest in each other's separate similar business activities. This means if you and I are general partners investing in rental building A, and I buy rental building B thereafter on my own, you may have an equitable right to an ownership interest in building B.

I am talking about "partners" being two or more people who get together, and who determine how they want to structure an entity which they will own together as shareholders, members, limited partners or joint venturers to buy or otherwise invest in real estate.

Before you buy real estate together, before you even start to form entities with others, you should know what your prospective partners expect to put into and get out of the relationship, and what you expect, and whether those expectations match. Next, you need to analyze what time, money and credit each of you is willing and able to put into your shared venture, what

skills each of you has to contribute, what credit score each brings to any transaction involving credit, and if the others are married or in a long term relationship, how their significant other feels about them, about you, and about the business you and their other half are getting into.

If those exercises haven't dispelled the idea that working together on your real estate toward shared profit is a good idea, next you need to review the big issues likely to end your shared efforts, which I like to call the four Ds: Death, Disability, Divorce and Departure. Okay, departure is just a fancy name for someone wanting to leave, but the other three really are Ds, and departure makes it fit.

Death and disability end the person's ability to continue to contribute active services, labor, and even credit to your shared investing business, and can cause the survivor to have one or more new, unintended partners or owners in the business. If all the hard work is done, and the business now consists of continuing to hold and rent out properties, this might not be a huge problem. However, if your shared business is in a phase requiring all oars in the water, requiring daily personal effort from all owners to keep things going, and one of you is not able to do that, the burdens fall heavily on the remaining owner or owners, while the ownership interests remain unchanged and disproportionate to current efforts.

In a similar way, divorce can take away an owner's drive to put time into the shared business, harm their credit worthiness, and force the transfer of all or part of their ownership interest to their ex, through the power of equitable distribution in divorce courts. I have seen that the only thing worse than a dead or disabled co-owner, is being forced to have the co-owner's disgruntled ex as a third owner in your real estate business, especially if the ex still has unresolved issues over the divorce.

The final D, being that of departure, can be just as difficult as the others. If a co-owner has committed to a long term strategy for your shared real estate investing business, and just wants to bail on it half way to the goals, it forces substantial and often costly changes to the plan, which you don't ask for but are stuck with just the same.

If your co-owner in your real estate investing business is your spouse, then estate planning, long term care planning, and the property settlement rules and procedures in divorce court all help to address the problems. If your co-owner is a close family member other than a spouse, you can hope that these events can be dealt with informally through the family, and not with legal documentation.

However, in all other circumstances, and I believe often even with family co-owners other than a spouse, signed legal documents created before the event occurs combined with the purchase of insurance where practical are the best ways to deal with these events smoothly. We use shareholders' agreements for corporations, members' agreements for LLCs, and buy-sell agreements for limited partnerships to address the four Ds. We use key man life insurance when available and affordable to fund the buyout of the deceased owner's interest by the surviving owners or the entity. We have entities which can afford to purchase long term disability insurance on the owners to help ease the financial burdens of disability.

To lessen the burdens of future divorce on the business and remaining owners, we have each owner's spouse execute the agreement waiving not the value of their spouse's interest in the business, but their right to receive any part of the business as part of equitable distribution. This means it is more likely the spouse will get the house, cars or bank accounts to help to guarantee that your formerly married co-owner of the business gets to keep their interest in the business. Of course, this provision doesn't prevent the burdens of child support and spousal support, changed living arrangements, and overall changes in day to day life from affecting the divorcing owner's finances, time or attitude toward the business.

Typically, if a co-owner wants to leave the business voluntarily, we structure into the agreements a reduced value for their respective interest, covering some of the costs to remaining owners of having to separate asset values early. Their interest can also be bought out over time, preventing the other owners from bearing losses caused by the early liquidation of assets.

Of course the other important documents to deal with death or disability are on the personal side. Each co-owner owes it to the others to have a will to deal with death, and a power of attorney to deal with disability which prevents the handling of personal business matters.

Now that we have been through the foregoing discussion of the complications partners bring to your business, you can see why I often recommend to those who have knowledge, experience, time, and cash or credit that they may want to move forward in their real estate investing without partners. Often it is far simpler and more efficient to invest in real estate without partners. Not only do you get to make every choice, you get all the benefit of your successes, and the ability to change the course of your investing any time you feel the need. Sometimes, having a whole smaller pie is better than having part of a larger pie, any way you cut it.

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