Avoiding The Biggest Mistakes Real Estate Owners Make When Dealing With Partners and Investors

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Even seasoned investors make certain mistakes that have potentially expensive and devastating consequences to the very investment that brought them together. In this article, Jeffrey H. Lerman explores some of the biggest of those mistakes.

At some point in every real estate investor's career, he or she most likely will end up dealing with a partner or investor. Combining resources with a co-venturer can yield many benefits: a source of expertise that may otherwise be lacking, somebody to share and hedge the inevitable risks accompanying real estate investment, and additional capital to name a few. Yet in starting up these ''mini-businesses'' (after all, real estate investment is a business), it is surprising how often even seasoned investors make certain mistakes that have potentially expensive and devastating consequences to the very investment that brought them together. This article explores some of the biggest of those mistakes.

Partner v. Investor

At the outset, it is important to define and distinguish ''partners'' and ''investors''. Although two people getting together to own real estate may ultimately structure their venture in something other than a general partnership (e.g., a limited liability company, a limited partnership or a corporation), for convenience this article will refer to these co-venturers simply as ''partners.'' For purposes of this article, ''investors'' are solely investors of money (although many ''investors'' have earned their place in a deal by investing ''soft dollars'' in the form of real estate broker commissions, equity in the real estate that forms the basis of the deal, or ''sweat equity''). In the context of the securities laws, these investors would be called ''passive investors.'' The significance of this distinction will become evident.

The Set-Up

Assume two individuals have decided to collaborate on an investment. One of them, Jack Hammer, is a general contractor who found a great deal—an existing apartment building with ''upside potential'' if certain improvements can be made—but lacks the necessary capital and expertise to acquire and operate the investment. The other, Rich Green, is a seasoned, successful real estate investor with deep pockets. This is a typical scenario and provides the backdrop for this discussion.

#1—Not protecting personal assets by holding title in an entity

Many partners hold property as either tenants-in-

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common or general partners (either by intentionally forming a general partnership or, by doing nothing, finding themselves in a *de facto* partnership). This is potentially a huge mistake as each partner is jointly and severally liable to the full extent of the law and all of their individual assets are fully exposed and ''at risk''—not only for their own misconduct but also for the misconduct of their partner! Accordingly, the first and perhaps the most important decision partners must make is whether to form an entity to maximize protection of their personal assets.

Is an asset protection entity always advisable? Generally speaking, yes. However, this is a business decision the clients must ultimately make themselves. No matter how large or small the investment, partners should conduct the following analysis:

(1) estimate all potential maximum liabilities associated with the investment (e.g., personal injury, fire, earthquake, contractual lawsuits from tenants, vendors, contractors, etc.);

(2) determine how much of these liabilities may be insured against (caveat: an insurance policy is no guarantee of payment if a claim is submitted; the courts are filled with insureds' lawsuits for allegedly improper carrier denials of claims);

(3) evaluate all remaining potential liability, and;

(4) engage in a cost-benefit analysis to determine if the cost of setting up and maintaining an entity is worth the asset protection benefits an entity can provide.

In virtually all cases, this analysis will probably result in the conclusion that an entity makes sense; while an insurance company may deny an insured's claim, a properly formed and maintained entity should always give precisely the protection expected.

#2—Not identifying conflicts of interest before hiring the same lawyer

In the example, Rich and Jack have very different circumstances. Those differences may result in material conflicts of interest. For example, they may have different tax objectives. Rich may be looking for, or at least have no problem with, losses as they may provide a shelter for his other income. Jack, on the other hand, probably needs his first deal to be a ''winner.'' They most certainly have different abilities to contribute capital. Rich is the ''deep pocket'' while Jack has only ''sweat equity'' to contribute. They very well may have different holding period preferences. Rich may be a ''buy and hold'' investor while Jack may want a quick turn to leverage into his next investment. Similarly, Rich and Jack may have conflicting exit strategies. Rich may want to effect a 1031 exchange while Jack may want to pull his money out for other purposes. With these types of conflicts, it may be a mistake for Rich and Jack to hire the same attorney; a single lawyer representing both parties will probably not represent either side as aggressively as she would if she represented just one of the partners.

Does this mean partners should always hire separate counsel? No. On many occasions, one lawyer is still retained for joint representation (with appropriate disclosures of conflicts of interest by the attorney and signed waivers of those conflicts by the clients). This is consistent with the collaborative, non-adversarial spirit that brought the individuals together in the first place and keeps fees down. However, it is essential to recognize and discuss these conflicts thoroughly to minimize surprises later.

#3—Not getting tax advice upfront

The decision as to how to how to do business with partners is as much tax-driven as it is business-driven. Different ownership structures, with their myriad of issues involving contributions, profits and losses, all have their own tax implications. It, therefore, is essential to get one's tax advisor involved from the beginning. This requires, at a minimum, calling one's accountant, telling him of the proposed deal structure and asking three simple, yet powerful, questions:

1. Given my tax situation, do you see any problems with this deal?
2. How can I maximize my tax benefits in this deal?
3. How can I minimize any adverse tax consequences in this deal?

To best protect oneself, a copy of any proposed ''partnership'' agreement (whether it be an operating agreement for an LLC, a limited partnership agreement, or some other document that details the salient points of the business relationship) should also be sent to the accountant for final review and comment before signature.

#4—Not getting estate planning advice upfront

People who are acquiring assets most likely have somebody they want to provide for when they are gone. If an investor has an estate plan already in place, he or she should get an estate planning lawyer's input before taking title to a new investment to make sure the acquisition is consistent with that plan. The estate planner may, for example, have concerns regarding how ownership is vested (e.g., in a trust?), or strategies to enhance the overall estate plan (e.g., taking title in a family limited partnership to take advantage of certain valuation discounts). Failure to be aware of these strategies and integrate appropriate action into the investor's plan may undermine the investor's estate plan and have severe economic consequences to the investor's heirs. If an investor does not have an estate plan, he or she should definitely get one—if not before taking title, then as soon thereafter as possible.

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#5—Not selecting an entity in time

Partners, when they ultimately do get around to thinking about availing themselves of entity protection, may not handle this decision until much later than they should. Perhaps they consider this after they open escrow on a deal, or after they get the loan commitment or after they close escrow. All of these are, in certain respects, too late. In each instance, a decision to form an entity at any of those times may require further negotiation with, and approval by, a seller or lender. Those approvals, especially from the lender, may cost the partners money (for example, additional underwriting fees by a lender) and may ultimately be denied.

The best time to make this decision is just before presenting an offer on a property, when the partners have the most leverage in the purchasing negotiation. Then, the offer can be written in the name of the entity. The lender will underwrite the entity's application. Most important, all lender approvals will directly benefit the entity.

#6—Not putting the agreement in writing

It is surprising how often partners to go into deals without agreement—written or oral—as to the essential issues that invariably arise throughout the property ownership cycle. These partners are frequently long-time friends who believe that their past friendship will carry them through all future potential disagreements. Or, perhaps Rich is an ''old school'' investor who believes ''my word is my bond'' and intimidates novice Jack into trusting him enough to go forward without a written agreement. Big mistake.

An agreement is defined as a ''meeting of the minds.'' Given the number and complexity of issues confronting property owners—from the date they write the offer to the date they close escrow on the sale—and the owners' differing backgrounds, circumstances and objectives, it is naive and imprudent to think that any two people could have a meeting of the minds on all these issues if they do not discuss them, reach agreement and put that agreement in writing at the beginning of the deal. Proceeding without such an agreement is the wrong place to save money when investing in real estate.

#7—Not including a buy-sell agreement

One of the most important discussions partners can have going *into* a deal is to figure out how they are going to get *out* of the deal. Like lawsuits, it is much easier to start a partnership than to end one. Say, for example, something happens to Rich or Jack that prevents them from continuing their active involvement in the deal. The surviving partner now is left to deal with a stranger: the other partner's heir or trustee. This deprives the surviving partner of whatever control and certainty resulted from dealing with his former partner. No partner should have to be thrust into involuntary partnership with a stranger. The solution: a buy-sell agreement.

The buy-sell agreement is not a separate document. Rather, it is simply a provision in the main operating agreement between the partners. It typically identifies certain ''triggering events,'' the most common of which are death, disability, withdrawal, expulsion and bankruptcy. It then details what will happen in each of those instances. Usually, the partners agree to give the surviving partner a right of first refusal to buy out the other partner's interest. The agreement also should set forth the procedures and formulas that will apply to this purchase including timing, valuation, and dispute resolution. The benefits of such an agreement are many: the partners can keep ''outsiders'' out, ensure the continued existence of the entity, ensure continuity of management, reduce involvement of co-owners not meeting their obligations and avoid valuation disputes. All of these benefits go straight to the economic bottom line.

#8—Not considering what happens if more money is needed

As basic as it may seem, it all too often happens that partners go into a deal without considering what happens if their best-laid plans falls short: what happens if more money is needed? Who decides how much is needed? If additional cash calls will be made, how long will the partners have to come up with the money before they are in ''default''? What happens if one partner has the money, but one does not? Should the cash-rich partner make a loan? If so, should that loan be to the entity or to the cash-short partner? On what terms? Should the partner not carrying his weight have his interest diluted? After how many cash calls should the partners just call it quits? Many of these never get asked, let alone answered.

#9—Not complying with securities laws

Many real estate owners fail to realize that if they bring in an investor whose only involvement in the deal is to contribute money, that investor will most likely be deemed a ''passive investor'' in the eyes of the securities laws, thereby triggering potentially the entire panoply of federal and state securities regulations. Many of these deals may be eligible for various exemptions to these laws. However, even then, certain affirmative steps must be taken to determine which exemptions apply, what procedures to follow to avail oneself of the correct exemption, and what documents are nonetheless required to evidence compliance with the applicable requirements of those exemptions. The real estate owner who ignores these critical compliance issues could find herself subject to a disgruntled investor's rights and remedies under the securities laws.

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#10—Not considering a tenancy in common for future 1031 exchange

If two or more partners want to provide maximum flexibility when they sell their property, combining into a single entity may present a problem. Say, for example, the partners want to take advantage of the tax deferral benefits provided in an Internal Revenue Code Section 1031 exchange. If they are bound together in an entity, they must stay together in the exchange and into the next investment. They will not have the flexibility to go their separate ways in two different exchanges.

The solution: as long as partners unwind the entity structure at least one year before they sell the property and convert their ownership to a tenancy in common, they will have the option to invest in separate ''upleg'' deals and still proceed under Section 1031. Many partners, however, do not have this kind of foresight. Accordingly, the safest procedure may be to take title from the beginning as tenants in common with their own separate entities.

The synergistic benefits of two or more real estate investors combining resources are undeniable. However, the path to a successful investment partnership experience is lined with many traps for the unwary. Real estate counsel can add tremendous value to their client relationships by educating their clients upfront as to the foregoing traps.