The Partnering **Guidebook**

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Thanks for taking some time to read through this Guidebook before meeting with one of our attorneys. We created this Guidebook as an introduction to partnering in real estate. This will give you a greater understanding of the basics of partnering, making our meeting more productive so we can focus on your specific needs. You should also keep this Guidebook readily available for future reference. We look forward to meeting with you.

Partnering is a great way to increase your ability to invest in real estate. But it brings a number of additional considerations and protections that are very important. It can get very complicated very quickly, depending on your needs. We evaluate every partnership on its own. That is why it will take more time to consult with you and prepare your documents. We also have numerous video educational materials on our website. To really understand the many issues related to partnering, you should educate yourself as much as possible. When partnerships go south, it can get ugly.

There is also a difference between partnering with your spouse and partnering with a non-related person. We include non-married relatives (like a brother or mother) with non-related persons. This is due to the fact that intra-family partnerships often become much more problematic because of the personal relationship of the partners. We see just as many, if not more, issues arise with these partnerships than when working with other investors! Please take care when partnering with family members.

There are three parts to this Guidebook: Part 1 describes the common partnering structures and vehicles; Part 2 is about the terms one needs to consider including the partnership agreement; and Part 3 discusses common issues and pitfalls that arise in partnering.

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Part 1: Partnering Structures

This first section gives you a background on the types partnership structures. There are numerous ways to partner and different types of business entities. Each has its own benefits and drawbacks. But knowing these differences will help you understand the other issues in partnering.

Also, be aware that in each of these structures there is an "agreement" that defines the duties, roles, ownership and etc. of the partnership. In an LLC it's called an "operating" agreement and the partners are called members. In a partnership, it is called a "partnership" agreement and the partners are called partners. In a joint venture, it's called a "joint venture" agreement and the partners are called joint venturers. And, finally, in an asset holding trust, it is called a "beneficiaries" agreement and the partners are called beneficiaries.

The "agreements" regardless of the words to describe them, are VERY similar. We will discuss this "agreement" in the next section.

1. First, what do we mean by structure?

The structure of the deal means both the type of legal business entity you decide to use and the terms you reach with your partner to include in that entity. We will start with the four most common types of partnering legal entities.

2. The Limited Liability Company

This is probably the most common type of business structure for partners as most people are very familiar with an LLC. If you need some background on the LLC, please refer to our Limited Liability Company Guidebook. It has great information about this business structure.

The LLC has a number of benefits when partnering with someone. The LLC is a separate legal entity from the partners (called members in an LLC). This provides very strong legal protection for both the assets owned by the LLC and the partners. If there are lawsuits, the LLC is sued, not the partners. You can take your ownership in this LLC as an individual or through another one of your business entities for added protection. It really is the go-to structure.

As a separate legal entity, it has its own tax ID and can get its own bank account. It exists as the “business” for the entire partnership. So, a single “thing” is running the partnership. With one bank account, all income and expenses flow through that account, making your bookkeeping easy. It helps prevent comingling of funds with the partners’ other businesses and accounts. It also makes auditing the books of the partnership easy. Auditing the books is a big deal in partnerships.

The LLC is also allowed to own real estate. Therefore, all assets of the partnership can (and absolutely should) be titled (owned) in the name of the company.

The LLC will be set up as managed by a defined manager(s) (who can also be one or more of the members). This means the person(s) that are responsible for doing the daily work can simply run the business while the other partners can take a passive role.

All tax matters flow through this single entity. Your accountant will file a partnership tax return (most likely, but an LLC can elect to file an S-Corp tax return as well) and issue K1 Statements to each member. The members then report their allocation of taxable gain (or loss) on their personal tax returns. This keeps money and taxes very clean and simple. You can distribute profits at any time.

What we said above is the simplest way to partner in an LLC. That is, each partner has a percentage ownership of the LLC and all tax allocations and distributions are split according to that percentage ownership. However, as you will see below, you are not bound by that structure. Partnerships can become very customized and tax allocations can be done differently than profit distributions.

One drawback is the other side of the coin from the benefit of the solid nature of an LLC. If one partner doesn't pull her weight or provide the services or finances she is supposed to, getting rid of her can be difficult. It is hard to "take away" someone's ownership in an LLC. Your documents can provide a mechanism for removing a member for failure to comply with their duties. However, these do get ugly and can end up in court.

Another drawback is the opposite side of the coin from the benefit of a single tax return. While this makes the finances clear, you will have to pay an accountant to file a tax return every year. This can become burdensome if you are doing a lot of separate partnerships. For example, we have clients that "credit" partner with numerous friends and family. This creates a lot of tax returns.

As a general rule of thumb, the LLC is recommended for long-term partnerships with partners you know well or have worked with before. This could be conducting a wholesaling business or holding long-term rentals with a partner. If you are planning on doing a single flip project, you might want to consider a different structure.

3. How are "Distributions" and "Tax Allocations" different?

Since we just mentioned "tax allocations" and "distributions" above, now is a good time to briefly explain these terms. **However, you should discuss ALL tax matters with your CPA!**

1. Tax Allocations: First, LLCs are considered "pass through" entities for tax purposes. That means the LLC itself does NOT pay any taxes. It simply files an informational partnership tax return with the IRS. This tax return lists the members and their proportionate share of taxes. The LLC then sends a K1 statement to each member indicating their share of taxes. Each member then must report that tax on his or her personal tax return (or the tax return of their entity if that's how they took ownership in the partnering LLC).

At the end of each year (December 31, or another date defined by the LLC as their fiscal year), the LLC must "clear" its books. That means all income and expenses are tallied up, your CPA works her magic and a bottom line is determined. That bottom line will be positive (gain) or negative (loss). This is the TAX GAIN or TAX LOSS.

There are other considerations to determine taxable gain or loss (like depreciation and equity payments) than just money in and money out of a bank account. Tax allocations are totally on PAPER—what your CPA does, NOT what you see in the bank account! A tax gain is considered the company's profit.

So, it's important to understand that tax allocations are DIFFERENT than distributions!

If there is a tax gain, you report this as "income" on your tax return and YOU PAY taxes on it. If there is a tax loss, you get a "deduction" on your tax return, lowering your overall tax burden.

Note: As with all real estate endeavors, you should discuss taking tax losses with your CPA! There can be limits on how much you take as a loss. And you can spread losses out over time. This is a discussion with your personal tax advisor!

2. Distributions: Distributions are when the LLC transfers CASH dollars out of the company bank account and into each member's bank account. This means "cash" and you will see the deposit in your bank account. Then you can spend that money however you want. What you receive in cash distributions may NOT (and probably will not!) equal your share of the company's "profit." Remember, those are different terms! You may have a greater (or possibly lower) tax burden than what you think.

NOTE: LLCs are NOT required to distribute cash to the members. You can decide to leave the money in the company bank account for future needs. HOWEVER, that doesn't change the tax filing at the end of the year. Remember that the company's books are "cleaned" at the end of each year and K1s are issued. If there was a taxable gain allocation that wasn't distributed in cash, you will end up paying taxes on income that never went in to your bank account!

3. Special Allocations: As we will discuss below, you do not have to allocate tax gains or losses according to percentage ownership. When allocations (gain or loss) are different than a member's percentage interest, they are called "special" allocations.

4. Special Distributions: As we will also discuss below, you do not have to distribute cash according to percentage ownership. You can treat partners differently and provide "special" distributions to them.

Now, back to our partnering structures!

4. The Limited Partnership

We discussed the LLC structure above. The limited partnership ("LP") is very similar. The one glaring difference is in liability. In a partnership, someone must be a "general" partner! A general partner is the "manager" of the partnership AND IS LIABLE for acts of the partnership. Since LLCs don't require a general partner it has become the go-to choice of business entities. Very few people create partnerships for partnering. But when they do, our recommendation is to have another business entity be the general partner for better liability protection. This does make the structure a bit more complicated as a "business" is running another business. The "limited" partners are just like members of the LLC; they are protected from liabilities of the company.

A partnership (and there are numerous variations!) is a stand-alone entity with a separate tax identification number, bank account, tax return, K1s, take title to real estate, and etcetera, just like an LLC. So it has all those same benefits and drawbacks as an LLC.

Partnerships work well when there are a large number of partners who are mostly "passive" financial investors (like in large syndications) or more complicated partnering arrangements or as a more solid joint venture situation. Note, an LLC does not have a limit on the number of members, so it can still work with large numbers.

5. The Joint Venture

A joint venture agreement (JVA) is just a CONTRACT. It is NOT a business entity. That is the biggest difference you must understand. Because it's not a legal business structure, it does NOT get a tax ID, CANNOT get a bank account, does NOT file a tax return and DOES NOT provide any liability protection!

Obviously, then, when using a joint venture structure, we ALWAYS recommend doing the joint venture with some business entity that you own, and NOT as an individual.

As you can imagine, the JVA is a contractual arrangement defining the roles and duties of the joint venturers (partners). The partners are bound by contract. The agreement itself will look a lot like the operating agreement for the LLC or the partnership agreement for a partnership. So, when we discuss "terms" of your partnership below, the issues will be the same.

Since the joint venture can't get a bank account, partners must keep tabs on their own income and expenses and report them on there entity's tax return. More often, it is agreed that one of the partners will get a separate, dedicated bank account in the name of their own LLC but use it exclusively for this joint venture. Other people are not comfortable with this arrangement.

But, since the JVA doesn't file a tax return and does not issue K1s, someone must keep track of income and expenses and tell the other partners. Normally a bookkeeper can handle this. But it is not as clean, for tax mattes, as an LLC or partnership. This does create a benefit, however. It can save you money at tax time as you don't have to pay your accountant to prepare and file any tax returns. Once someone figures out the taxable gain or loss, each partner reports their own percentage on their own tax returns.

It can be easier to get rid of partners or shut down a joint venture. Since this isn't a legal entity and not registered with the state or IRS, it is more easily dissolved. The partners (if they agree) can simply walk away with no additional work. Remember, though, that it is a legally binding contract. A partner can sue you for lack of performance!

A joint venture agreement cannot take title to property. So, the partners must decide how the property is to be owned. There are several options here. First, each joint venturer can own a fractional interest of the property as a tenant in common. This puts a lot of people on title so when you sell the house, everyone will need to sign closing docs. But it does secure everyone's rights to the property. Another option is for one of the partners to own the property in her LLC and then the others can secure their rights with a notice of interest or a note and deed. This will prevent the owning-partner from selling the house out from under the others and can simplify transactions. Another way is to use an "Asset Holding Trust" with the partners as beneficiaries. See below, and please read our Asset Holding Trust Guidebook for more information.

We often recommend using a joint venture arrangement when you are partnering with a lot of different people on, say, single flips or credit partnering on a few rentals, and when one partner is taking the main active role and the other is mostly passive in their roles. The main partner does everything (like management and bookkeeping) and the other simply gets a check every now and then. We do not recommend a joint venture for other longer-term deals, more complicated arrangements (like when there are special allocations or special distributions) or more than two partners.

6. The Asset Holding Trust

First, if you are going to use this type of structure for your partnership, PLEASE READ our Asset Holding Trust Guidebook first! You must understand how this type of trust works. Many real estate investors call this a “land” trust. But unless you live in a “land” trust state, it is very different. It certainly provides a number of benefits. But there are other important issues to understand.

Using the Asset Holding Trust (AHT) as a partnering vehicle is like combining the JVA with a trust to hold title to the property. In this case, the “agreement” is actually called a “beneficiaries” agreement instead of a “joint venture” agreement.

While an AHT is a separate legal entity (like the LLC or LP), it is cumbersome to get an EIN and a bank account. And to do so, you must registered the trust with the state as a “business” trust, notify the IRS and file a tax return. People like the AHT for the privacy and not having to file a return. So, really, the AHT “works” like a joint venture agreement for tax and accounting purposes. This means that the beneficiaries of the AHT must either keep their own books or appoint one of them to do it for everyone else.

Also, like a JVA, there is NO liability protection in an AHT. So, if you are going to use this vehicle, we recommend using one of your own entities to be the beneficiary (partner).

But, like an LLC or LP, it can own the property (even though it’s not filed with the state!). So this solves the JVA problem of not being able to take title, and it provides privacy.

Further, the AHT can be used to hold title (for privacy purposes) in conjunction with any of the other partnering structures.

7. Shared Appreciation Note and Deed

Another, non-business entity option is what is termed the “shared appreciation” promissory note and trust deed. Here, no entity is formed. In its simplest definition, this is a vehicle whereby one partner acts as the “money” guy loaning the other partner the funds to do a real estate investment project. However, instead of receiving an interest rate on the loan, the lending partner gets a share of the profits, just like any other partner would. There is a promissory note (loan agreement) between the parties that defines the shared return. The lending partner is secured with a trust deed, see below. Of course, the promissory note can get as complicated

as the partners need it to be in order to define the partnering relationship. However, the more complicated it gets, the less useful the shared appreciation note becomes.

This vehicle works great where there are two partners—one doing the work and the other providing the funds—on a flip project. The lender doesn't participate at all in the project (like a silent, passive partner in an LLC or LP). The lender runs little to no risk (if the lender takes some managerial responsibility, he could be deemed liable for injuries that happen on the property even though he does not own it) and secured with a trust deed with the right of foreclosure. The lender doesn't even need his own business entity to partner. There is no tax return or K1s. The lending partner reports his income from the 1099 provided at closing, and the borrowing partner records it at a cost of the project and gets his money as proceeds from closing.

This is a great way to partner if the situation calls for it.

8. What is a syndication?

The simplest way to describe real estate syndications is that they are a means to pool money (partner) in order to do bigger deals. There are numerous ways to do this. One common real estate investment structure is the REIT, or Real Estate Investment Trust. In this case, someone creates a specialized trust, complies with any regulatory requirements to collect and pool money, brings on a number of investors as beneficiaries of the trust, and then buys and/or manages large real estate investments. The investors "own" a tiny fraction of the property and get a commensurate return.

This can also be accomplished through TICs, or Tenant-in-Common investments. We described above that, as a partnership in a joint venture, you can decide to own the property as tenants in common, each partner owning a fractional share of the property by actually being on title. Large TICs look like REITs except there is no trust, just some form of partnership agreement. Usually, each partner is free to sell off their fractional interest at any time.

The two structures above are often used with "self-directed" retirement accounts because they normally avoid the possibility of UBIT taxes and reduces or even eliminates the risk of prohibited transactions—see our Self-Direction Guidebook for more information.

REITs and TICs are also commonly used in 1031 exchanges when an investor relinquishing his property can't find a replacement or has excess funds that need to go somewhere. These are easy places to put money, sometimes in small amounts.

REITs and TICs can be very expensive to set up and run. So most investors don't go down the road of creating their own.

9. Regulation D

There are other ways of pooling money on a smaller (or even larger) scale than REITs or TICs. You can do it yourself.

The simplest way to put it is that the Securities and Exchange Commission (SEC) wants to protect grandmas from predatory scam artists looking to take their money. So, they put regulations on how you can raise funds. But, it also wants to encourage investment and economic development. So...

Most of these rules about raising money are found in Regulation D (or "Reg D") in the SECs list of regulations. There are many different ways (or sub-paragraphs) of raising money under Reg D, each with its own pros and cons. Generally, there are rules regarding 1) how much money you are looking to raise, 2) the kinds of investors you are looking to get money from, and 3) how you advertise to others that you're looking for money.

Newer rules on "crowd-funding" and other ways to legally raise and pool money are also developing. We cannot get into Reg D or these other topics in this Guidebook because it would take us far beyond the scope of what this Guidebook is about. If you are interested in raising money this way, we ALWAYS recommend that you discuss your business plan with a qualified SEC-experienced attorney. It's possible that you can just raise the funds on your own, or you may need to jump through the SEC's hoops.

Jumping through the SEC's hoops can be expensive for many reasons, mostly the liability of doing the legal work. But if you're looking for a lot of money, then it's definitely worth it to do it right!

NOTE: There are very serious rules regarding "raising" capital, selling ownership in an LLC or partnership, and there are serious penalties if you break one of those rules. Please check with your attorney before raising any capital.

10. Securing Rights

The most solid way to secure your rights in a real estate partnership is to hold title to the property. If you have title, its yours and it's very difficult to take away. So most partners want to own the real estate. But, holding title to property can become complicated in partnerships. So we will summarize here.

One of the big benefits of an LLC, LP or AHT is that the entity itself can own title and all partners own their fractional share by way of their fractional ownership in the LLC or LP. This is why we like these structures: One entity is on title, partners share in that entity. It's clean and simple. But, a dishonest manager of an LLC, general partner of an LP or trustee of an AHT, could "sell" the property and take the money and run because those titles give the person legal authority to sign closing documents.

As we mentioned, the JVA cannot hold title. So you need to figure out how and who will be on title. This causes issues with some people as they are scared about protecting their interests without being on title.

So, lets discuss ways of holding title and protecting your interests.

1. Joint Tenancy: This is a way of holding title where all the people on title have "rights of survivorship." This means that as one person dies, the remaining take title in equal proportions. The last man standing gets the whole property. This is common with spouses. But it will not work with partnering as only human beings can be joint tenants.

2. Tenants in Common: This is the way entities (any entity) take title to real estate. There is no right of survivorship! Each tenant owns their "percentage" of the property. NOTE: Each tenant can also SELL their interest! This means you could find yourself with a new partner on the deal!

3. Trust Deed: This is a lien on property that must be cleared before the property is sold (in an insured transaction). That means the property can't be sold out from under the other partners. Normally it references a debt that that owner of the property owes to someone. But it can be used in partnering situations like we mentioned above, or used to secure a non-title-holding partner's interest in the property. A trust deed comes with the right of foreclosure. So, if the other partner doesn't comply with the terms of the partnership, the partner with the trust deed can foreclose and get the property.

4. Notice of Interest: A NOI is a cloud on title, meaning the property cannot be sold (again, at least in an insured transaction) without being cleared. This can prevent the dishonest partner from liquidating the asset and keeping the money. The NOI does not come with the right of foreclosure. Therefore, if the other partner fails in their duties, the one with the NOI must wait for the property to be sold to get his money out of the deal.

Part 2: Partnering Terms

Regardless of the type of partnering structure you decide to go with, nearly all the terms will be the same. Below is a list of important considerations that should be discussed with your partners before proceeding. Keep in mind, the two biggest causes of disputes are Money and Management!

Remember, once negotiated and decided, these terms are written down in some form of an "agreement," like an operating agreement or joint venture agreement, depending on the structure you choose. This is a critical document in any partnership. And, as a CONTRACT, it is completely customizable to YOUR SITUATION. This is where the real work (and legal time) begins. Do not enter into a partnership without something in writing that accurately reflects your arrangement!!

1. Contributions

A contribution is, basically, the opposite of a distribution. A contribution is what a partner provides to the partnership. This can be cash, property, goods, tools, services or just about anything else. It's easiest to think of contributions as either cash or services.

Who will contribute what? This is the first question you need to ask. Additionally, will these contributions be proportionate or disproportionate to the ownership percentages? Will John put up $10,000 while Mary puts up $20,000 in a 50/50 partnership? You can do it this way. You don't have to contribute in the exact proportions of ownership. Remember, sometimes one partner puts up all the money while the other provides only services. These decisions, and numbers, are up to you as you negotiate with your partners.

Capital Accounts: A capital account is an accounting (on paper) ledger of how much someone puts in and receives back from the partnership. For example, if John puts in $20,000 to an LLC, then his capital account shows positive $20,000. Now, let's say he receives a distribution of $5,000 (negative $5,000 on the ledger), his capital account is now at $15,000. This is just a reflection of what he puts in and takes out.

Remember when we mentioned "special" distributions? It comes up here. Let's say Mary puts up the $20,000 for the project and John does all the rehab work. They could define in the operating agreement (or other partnership document) that Mary gets 100% of ALL distributions UNTIL her capital account is at $0, then profits will be split 50/50. In other words, Mary gets all the cash available for distributions first and until she has "recouped" her $20,000 investment, and then any distribution after that is 50/50 to each of them.

This is very common when one person is the money and the other is the work. If the flip project only nets $30,000 in profit and they split that 50/50, Mary would have put in $20,000 and only gotten back $15,000 in profit. She lost $5,000 while John made $15,000. That wouldn't be fair. So, in the example in above paragraph, Mary would actually get $25,000 (her $20,000 investment first plus half of the remaining profit, or $5,000) and John would get $5,000.

Again, there are an infinite number of ways to do special distributions. It's all negotiable!

What about future contributions? This is a scenario where the partnership needs more money somewhere down the road—like a rehab going over budget!! Will all partners contribute according to their interest? What happens if one of the partners cannot contribute according to his percentage ownership? Will a partner make a "loan" to the partnership (or to the partner that doesn't have the cash)? Will ownership percentages have to change?

2. Special Allocations

We just described situations that created special distributions of cash. Likewise, you can allocate tax gains and tax losses differently than you allocate distributions.

For example, it is common for a partnership to "run in the red" its first year. That is, it doesn't make any money and there is a tax loss for the year (you spent money on a flip project and haven't sold it yet!). Remember, that you will need to "clean" the books at the end of each year! You can't wait until the end of the partnership to do your taxes.

Would it be fair in a 50/50 partnership where one person put up all of the cash but only gets half of the tax deduction? Normally, those who put up money want to claim that contribution as a tax deduction until profits come back in. In this case, your agreement would read something like, John is to receive all tax loss allocations up to the amount of his capital account, then any tax losses shall be allocated according to percentage interests.

It is very common to do a "special allocation" of tax losses for that reason. Also, tax losses don't' have to be the same as tax gains! But rarely are tax gains specially allocated.

So you see, tax gains, tax losses and distributions can all be allocated among the partners differently from each other and differently than the partners' interests. This can get complicated very quickly. In complex partnering situations, you should discuss ALL TAX RAMIFICATIONS with your tax advisor!

3. Salaries

Remember that distributions define how profits are given out to the partners. This "profit" is all income minus expenses. However, you can add in salaries for a given partner. This salary then becomes an expense of the partnership, which is taken out before profits are split up among the partners.

This is often done where one partner is doing a larger portion of the work or providing services that would otherwise cost the company money (like accounting services), and therefore deserves more in return than just her profit share by her percentage ownership. It's a way of getting one partner a bigger return without having to change up percentage ownership.

4. Management

This is probably the most problematic issue in partnering. More disputes occur over decision making and managing the project than just about anything else.

Who will be the primary decision maker?
What happens if there is a disagreement?
What decisions will require all partners to agree on (or in some percentage)?

The more decision makers there are, the more problems are likely to arise. Rarely do we recommend multiple managers. The type of structure you choose, will also be a factor.

What we are discussing here is the "authority" to bind the partnership. As we explained above, for ease of management, normally one (or just a few) of the partners have any managerial responsibility. They are the ones with the legal authority to sign (and commit) the partnership. This means they have the authority to buy and sell real estate, sign loan and closing documents, sign contractor agreements and etc.

In an LLC, a manager will run the day-to-day operations while the members are only called in to make the defined "bigger" decisions. Choosing the manger is very important! The members also have authority to fire and hire new managers.

A LP works the same as an LLC except the "manager" is called the general partner. The limited partners (like the members) are mostly passive except for bigger decisions.

Likewise, in an AHT, the trustee acts as the "manager," while the beneficiaries are the "members."

Remember, in a JVA, there isn't a business entity with "managers" and "members." It's just a contract with two or more parties (partners). So, typically, each partner is responsible for their share of the work, however that is defined in the JVA. Each oversees his own duties. But again, you can write your JVA anyway you want.

Fifty-fifty partnerships can be the most problematic. Rarely do we recommend that two partners enter into a 50/50 agreement. There is just a lot of potential conflicts that can arise.

You need to think about voting percentages. Typically, unless otherwise defined in the agreement, all partners have a vote strength equal to their partnership interest. If there are 4 members, each with 25% interest and you define a "majority" to pass anything, then it will take THREE members to approve something. Remember, two of the members only equal 50%, which is NOT a majority! You will need to play

around with numbers depending on how many partners there are and what their anticipated interests will be.

As you're beginning to see, there is a split between partners who "run" the business and those that are "passive" equity holders. Keep this in mind!

5. The Buy-Sell Agreement

Typically, because of asset protection and control issues, most partnership agreements heavily restrict the addition of new partners. Most people do not want to suddenly find themselves working with someone they don't know, or worse, don't like.

Most partnerships will prohibit one partner from unilaterally (by himself) selling his membership to another person. When it is allowed, there are rules about the exchange. The most common is the "right of first refusal." This means that before a partner sells his ownership to a third party, she must first offer it to the company and other partners (usually at the "market" value). Only if the current partners take a pass, then is she allowed to sell to someone else. That new partner must then become a signatory to the governing partnership agreement, provide tax information and possibly jump through other hoops dictated in the agreement.

You will need to decide what you want to do in these situations. You can prevent any transfers at all; or you can allow completely free transfers. You can also put just about any condition on the transfer. You can predetermine how "market" value is to be handled as well.

These "buy out" terms, like the right of first refusal, can be included in the governing document or as a stand alone document that is legally included in the governing agreement.

At Breglio Law, we keep this "Buy-Sell" agreement as a separate document. That way it can be added to any kind of partnership arrangement.

6. Key Man Insurance

Most Buy-Sell agreements contain a clause about a life insurance policy called "key man" insurance. Simply, the company buys life insurance on the partners, especially ones that are "key" to the running of the company. If a partner dies, the life insurance kicks in and "cashes out" that partner's estate! That means his spouse gets cash in an

amount equal to that partner's ownership. Because the surviving spouse gets cash for the membership, the remaining members get that dead partner's interest. So, for example, there are two partners and one dies. His spouse gets cash and the surviving partners now owns the entire company. He doesn't have to worry about working with the surviving spouse at all!

This insurance policy amount is based on the value of any given partner's interest. It should be reassessed each year (because the partnership's value will change over time) and adjusted for changes.

This is one way to deal with the death of a partner. But there is another.

7. The Transfer on Death Agreement

Like they say, there are two guarantees in life: death and taxes. All investors think about saving taxes. But something a lot of investors do not spend much time thinking about is death. But you should!

What happens if one of your partners dies? What if this is the partner that was "running" the partnership? Do you want your partner's spouse suddenly voting in partnership matters? We mentioned that the partnership could buy life insurance.

Another common way to handle death is the Transfer on Death Agreement. This is a corporate document (attached to whatever partnership structure you choose) and used when a HUMAN BEING is the partner (remember, entities don't die!). It states that when a given partner dies, her interest will automatically transfer to someone/something else. Basically, it looks like this:

Hi, I'm Jeff. And I own 50% of this LLC. When I die, I want my membership interest to go to ___________________.

This agreement is very often used even for single member or LLCs/partnerships with husbands, wives or family members (non-partnering situations). Typically, people will put in the name of their family trust on that blank line. This is a way of avoiding probate in the case of death. We always recommend this!!

But it can also be used in partnerships. And you can fill in the blank however you want. You can leave your interest to your partner, another entity, another investor, to a charity, or to whoever you want.

Of course, you should discuss this with your partners so that they know who they will be partnered with in the event of your death

Part 3: Common Pitfalls

Before we discuss particulars, remember what we said above. The two biggest problems that arise are Money and Management. Keep these two things in mind as you read.

1. Death of a Partner

Above, we already discussed the Buy-Sell Agreement, Key Man Insurance, and the Transfer on Death Agreement. These are the most common way of dealing with a partner's death.

Holding title to property as "joint tenants" can also solve the problem of death because the survivor automatically gets the property. But there should always be some form of partnership "agreement" used in conjunction with holding title as joint tenants.

EVERYONE SHOULD HAVE A FAMILY LIVING TRUST! This is true for single people and those just building their assets as well! Too many investors put off creating their family trust for a variety of reasons. Remember, probate is just as expensive—and possibly much more expensive—than creating a family trust! And a family trust is private, and you decide how your assets are allocated! If you haven't created a family trust, please give us a call!

The family trusts we create can name a "trust advisor."

When the managing partner dies, this can cause a lot of problems. If you have a partnership where one person is running the show, you should discuss the possibility of their death in ADVANCE and make a decision about how you are going to handle that. You should have other people that you can contact to jump in. You can even name this person in your family trust. They are called a "trust advisor" and can help the family of the deceased partner run the partnership by making business and real estate decisions that will benefit the partnership.

2. Bankruptcy of a Partner

Bankruptcy can really throw a wrench into your partnership. One of the reasons we like LLCs (and even LPs) is an asset protection tool called charging order protection. Please see our LLC Guidebook and Advanced Asset Protection Guidebook for more information.

A properly created multi-member LLC and LP will protect the assets inside that partnership from the creditors of the partner going bankrupt. It can't protect the debtor's share of partnership distributions. Those will still go to the creditors. But the bankruptcy court cannot force a liquidation of partnership assets to satisfy the debt! This protects the innocent partner from losing anything. The other partners are protected!

You can also add layers to your structure. For example, two LLCs (each with multi-members, like a husband and wife) can then create their own new LLC partnership. The bankruptcy court would have to get through the "top" layer LLC before it even gets to the partnership LLC.

Note. The bankruptcy court can "unwind" transactions (like sticking an asset in a partnership LLC) if it thinks it was done for fraudulent reasons, to avoid liability or to hide it from creditors! The longer the asset is in the LLC the stronger it is.

3. Lawsuits/Judgments Against a Partner

These act the same as a bankruptcy. You want a structure with a solid charging order protection (like a good LLC or LP). While the AHT can also provide this protection, we still recommend tried and true business entities.

But in a lawsuit, you must look at who the named defendants are. Only defendants are subject to the suit. So, if the lawsuit is against a partner, it is not against your partnering LLC. But that doesn't mean you are out of the woods.

When you file a lawsuit, the plaintiff can request a **lis pendens.** This is notice of an impending lawsuit. It is NOT a judgment (not yet). But, if the court grants the **lis pendens** it can attach to the property in question and will prevent the sale until the judgment is finalized or some other resolution is reached. The court will make a determination if a property is to be subject to a lis pendens. If the lawsuit is against a partner for something totally unrelated to the partnership, it is highly unlikely a court will grant a **lis pendens** on partnership property.

However, this can cost you in time! Not to mention the expense of defending the partnership if it does.

When a partner is sued and loses, a judgment is entered. That judgment can be recorded with the county recorder where that partner owns real estate. Title companies are required to search for judgments when anyone buys or sells property in their own names. This is not the case when the party to the transaction is an entity. They will only search to see if there are judgments against the entity itself. With an AHT, title companies will search the name of the trustee! That may, but not necessarily, cause a problem.

Again, the best defense here is a great offense! Use a solid LLC or LP, and even add in layers. And you want strong transfer restrictions so that in the event the bad partner's interest is given away in a lawsuit, then they only get cash distributions and no management or control.

4. Partner Divorce

It is totally possible for a partner to lose her interest in a partnership to an ex-spouse during a divorce proceeding! The divorce court can determine that the ex-spouse gets the property even when that ex-spouse was not a partner. Divorce decrees are searched by title companies just like judgments.

Again, when we create partnership agreements, we put in very strict transfer clauses (we mentioned this above a couple of times!). So, in the event an ex-spouse does get the membership interest, all they get is cash distributions (and the K1 for tax purposes). They do NOT get any control over the company. Your documents need to have this language or you will suddenly find yourself working with your partner's ex.

5. Nuclear Blowout

This is the situation where the partners no longer get along and cannot continue working together.

The best advice we can give is summarized as follows:

1. Discuss all the above issues in advance
2. Vet (do background checks) on your partners
3. Don't jump into large deals with people you don't know
4. Make decisions in advance as to what you will do in this case
5. Put all this in writing in really strong documents (and make sure all the documents are SIGNED)
6. Don't deviate from the written documents (doing so can change or even invalidate what you put in writing!)
7. Don't let small issues become big. Fix them IMMEDIATELY
8. Try to resolve the issue with reasonable, frank discussions
9. Involve an intermediary (like another investor) to help solve problem

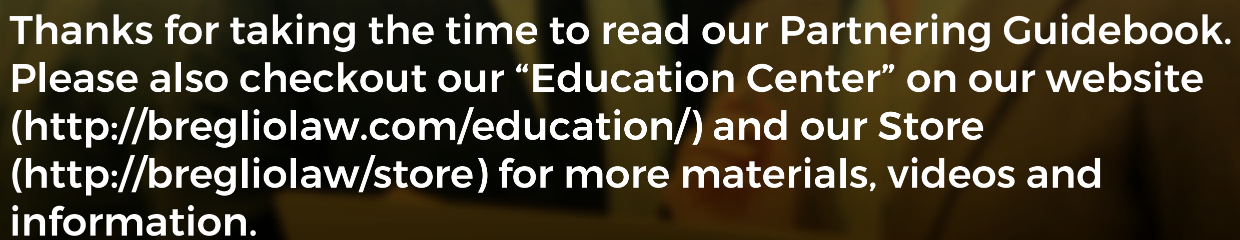
When you just can't reach a resolution, the partnership will be forced to dissolve and wind up. That is what a court will decide. Usually that means liquidating the assets and distributing funds. This is often not in anyone's best interest. So keep this in mind when negotiating with your partner

What about removing a non-performing partner? Let's say there are three or more partners and only one is a problem. The others get along fine and are doing their part. Can you "oust" one of the partners?

Well, this can be tough. Ownership in the partnership (in whatever structure you choose) is a vested right, like owning a home. That home just can't be taken away (due process constitutional rights). Your agreement can include terms that allow for a "forced buy out" of a partner. The remaining partners will have to come up with the cash to buy out the bad partner. But he's at least gone. If there is no language in your documents that allow for this, then you cannot force out a partner from his ownership.

Another solution is making your LLC manager-managed. We always set up LLCs this way and this is one of the reasons why. If the non-performing partner is a manager, the remaining members can remove him as a manager and appoint a new one. It doesn't take away his membership interest. But it does get rid of him from management or acting on behalf of the company.

At the end of the day, an ounce of prevention is worth a pound of cure. It is infinitely cheaper and easier to prevent problems and start correctly, then to try and go back and fix things (or make decisions) once the problems arise.



Thanks for taking the time to read our Partnering Guidebook. Please also checkout our “Education Center” on our website (http://bregliolaw.com/education/) and our Store (http://bregliolaw/store) for more materials, videos and information.

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