The Long Term Burdens Of Family-Owned Real Estate

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I write about commercial real estate negotiations, deals and legal issues.

Two brothers bought a New York City building together in equal shares, more than 50 years ago. They did well and bought more buildings. They operated the buildings out of their back pockets, informally and successfully. When they couldn't avoid using lawyers, they used the cheapest lawyers they could find, typically with no expertise in real estate or estate planning. Their partnership agreements were a handshake or at most a page or two. The value of their portfolio rose dramatically over time.

The next few chapters in the story are familiar to many commercial real estate lawyers. That includes the author, who has recently handled several disputes, and prevented others, arising from stories just like this one.

Over time, the brothers had kids. The kids had kids. Some family members died. Many of the kids went to law, business or medical school. Some became professors, others artists or farmers. Over time, 20 or more people became co-owners of the various buildings. Some buildings needed more investment over time. The family members preferred to put money in their pockets instead, to the maximum extent possible. They could never agree on a capital expenditure program.

Family-owned real estate isn't what it used to be.
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Some wanted to sell and pocket substantial gains. No one could agree on how to choose a broker. Most knew they would want to take the sales proceeds and buy replacement property to defer income taxes, but in a way that would disentangle the family members. This goal was achievable but complicated, sometimes requiring several transfers over time.

Other family members wanted to obtain mortgages and upgrade the buildings to attract better tenants and higher rents. Once in a while, proposals were floated to demolish some of the buildings and build new ones.

To save money, maintain control and prevent theft, the family never hired outside managers. Instead, a couple of family members took responsibility for some of the buildings, but they also had day jobs. Other family members handled other buildings. The family members also handled leasing.

No one else was ever satisfied with how management and leasing were handled. Financial reports and tax returns were always late. The buildings suffered from an endless series of emergencies – roof leaks, broken boilers, drug dealing, collapsed floors. Insurance inspectors expressed increasing concern about unrepaired hazards. Rents were among the lowest for similar buildings in the neighborhood.

Once in a while, groups of family members offered to buy out others. They could never agree on a number. In the backs of their minds, each group knew that one group or the other would end up regretting the trade so it would further fray whatever family ties and goodwill remained. And no one can sell their position to anyone outside the family.

The group hobbles along, with buildings that are undermanaged, underexploited, deteriorating and sometimes on the verge of litigation. Suspicions, distrust and criticism run high. The various family members all seem to be either too sophisticated or not sophisticated enough to properly handle the family's portfolio.

Blame the forefathers for this all too familiar series of events. They thought they were immortal or that future generations would get along and know how to maximize value in real estate the same way the first generation did. They were wrong. They are often wrong in these situations.

Everyone would have avoided a great deal of grief if the first generation had given more thought to the future. Even if they hadn't, perhaps the second generation could have done some better planning. It could have included some or all of these measures, plus others, such as additional measures to mitigate income and estate taxes:

— A structure for decisionmaking and taking action, such as a board of directors, perhaps with outside professional managers or with each branch of the family having one vote.

— A reasonable process to make major decisions with a majority or supermajority vote.

— Dividing up ownership of the various buildings, rather than having everyone own everything. This could take the form of present transfers. Or it could contemplate a future process with valuations and sequential picking and choosing.

— Breaking up some individual buildings via long-term leases, so that a younger generation with an appetite for repositioning and upgrading could do that, while paying rent to older generations, reflecting the value of the buildings as they were when the lease was signed.

— A requirement to sell the buildings through an orderly marketing program if the family members couldn't agree on how to proceed, with some tax planning to make those sales as painless as possible.

— An ownership structure that allows the easy sale of interests to third parties, in a way that makes those interests palatable but does not complicate internal governance and decisionmaking. It might, for example, allow present or future tax-deferred sales of partial or complete interests to a real estate investment trust.

None of that happened. Sooner or later the situation could blow up. If that happens, it will entail great expense to all, both emotionally and financially.