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Partition Methods and Madness

I am a bit wary when I hear "all you have to do is…" in almost any context. But that idea is characteristic of a valuation method based on the legal right of a tenant-in-common to bring an action to partition real property. Not literally madness of course, but I do think a more complete recognition of the facts and circumstances surrounding a hypothesized legal action would help this very useful method make much more sense to users of these multidisciplinary valuation reports.

Partition is an absolute right that derives from English common law and is fairly uniform across state and national jurisdictions. Exercising the right to partition involves suing one's co-owners to cause either equitable division of the property, or if that is not practical, force a court-ordered sale and distribution of the proceeds. The outcome can be no big deal or disaster, depending on the circumstances.

This article is not a legal treatise. It is specifically about placing a value on the right to partition. As for any valuation method, the analysis ultimately concerns a market participant's process for arriving at price based on future expectations; in this instance, what might happen if he or she needed to exercise their right to sue their partners in order to exit their ownership position.

Cost-to-Partition

Valuation usage of partition began with what was termed "cost-to-partition." This method's premise is that the economic effects of a co-owner bringing a partition action should be limited solely to actual hard costs incurred. It then simply deducts those costs from the pro rata value of the interest to determine the interest's fair market value. Not surprisingly, this “method” failed because, as we shall see below, out-of-pocket costs are hardly the only economic effect of a partition action. So much for that.

Partition Time and Cost (Present Value of Future Benefits)

As for nearly all market value analyses, our methodology must take into account potential future costs and benefits, whether explicitly or implicitly. Methodology may vary depending on the nature of the available data and the market’s decision-making process, but underlying all methods are future expectations (of costs and benefits) coupled with an assessment of risk over time. In the case of partition, present value analysis (the income approach) is the exactly appropriate model for analyzing a partition right. I coined the term “Partition Time and Cost” many years ago as a more appropriately descriptive label for present value application. Costs may or may not be significant, but time (along with risk and benefits) is always important.

The valuation process is the same as for any fractional interest in real estate: estimate how long it will take for the interest-holder to obtain its pro rata share of the whole property, then discount that future payout back to the present using a risk-adjusted yield rate.

Keep in mind that we are building a valuation model that mirrors the expected decision-making process of a typical market participant. How much would a (hypothetical) buyer of the subject interest be willing to pay for it, based on the expected time, cost and risk associated with bringing a partition action, should they ever want to exit the deal? It is important to note that this method is only useful as a pricing model if the interest holder (either the hypothetical seller or buyer) would actually be willing to sue their co-owners. If the facts and circumstances suggest otherwise, then this method would be given little weight or be dismissed altogether.

Timeline

Estimating the overall time for analysis, beginning with the date of value, is the first step. It would be pretty weird for a new interest holder (our hypothetical buyer) to take possession of an interest and then file a lawsuit the next day; a lawsuit would not be the best outcome anyway. It is more likely that the process would begin when the interest holder realizes that he or she really doesn’t want to be a co-owner anymore, and approaches the other co-owners to arrange a buyout. But if they don’t agree, then the lawsuit might have to proceed.

(Do realize that the subject interest holder and his or her replacement might be hypothetical but the others owners are real—they come with the deal. *You can ask them what they would do*. Just sayin’.)

Since partition is an absolute right, many jurisdictions ‘fast track’ the process. Of course, ‘fast’ is a relative term for any court proceeding. Two years is a possible ‘fast track’ result, but timing can be strongly affected by the chance of appeals and countersuits as well as property complexity and the likelihood of physical division.

Growth

During this 'forced hold' period, market conditions will most likely change, and how values are expected to change is a big deal. The market's expectation for the forecast period is definitely needed. An increasing market can very much reduce the discount with a greater terminal value, while a flat or declining market can increase the discount by a lot. Also be sure to deduct the seller's share of transaction costs from proceeds of sale.

Risk

Now we are getting to the critical part. Present value is determined by applying a yield rate or rates to expected cash flows. Positive cash flows from the property and net sale proceeds at the end of the period are discounted to their present values using a risk-adjusted rate. It is this yield rate that allows market participants to compare the investment you are analyzing to their other options, which makes that a good way to conceptualize yield rates.

Let's consider a basic investment selection example: Say you had two investment opportunities available. In one, you would own an entire $1 million property, but in the second, you would own 25% of a $4 million property. Naturally, you would be able to exit the 100% holding whenever you wished, but your exit from the 25% interest could involve suing your new co-owners. In order to be neutral between the two choices, and using a partition model to determine pricing, you would need to use risk-adjusted yield rates to determine which is the better investment. Do you think the one involving a lawsuit (certain because of the premise of the model) would be a bit riskier than the one that does not? What? You wouldn't want it at all?[1]

The first scenario in the above example would use a yield rate determined from the market for whole-property transactions, probably in the range of 8% to 12% depending on property type. The yield rate in the second scenario should therefore be greater not only because of the lawsuit, but also due to loss of control of the property during the period and other considerations typically present for fractional interest circumstances. A 15% to 18% yield rate would not be unreasonable. Of course, you will still want to consider out-of-pocket costs, but they carry minimal risk of their own—being pretty much certain—so you can discount them to present value using a borrowing rate rather than the real estate-related yield rate.

Realizing all of this has led me into the land of astonishment when reading any of a number of tax court memoranda that report the case's partition analysis used a yield rate of…10%? Really? The court does only have what experts bring in to work with, but in *Case of Ludwick* [2], Judge Halpern actually tried to find out if 10% was correct, and one expert suggested the yield rate should be 30%. No evidence supporting the higher rate was offered, though, and ended up using 10% for his own valuation. Other cases also use 10%, implying that *the lawsuit option is no worse than any direct real estate investment*. This makes no sense whatever. Valuers should be doing a lot better.

The facts and circumstances of a case matter, and the valuer needs to address them carefully. But realize that, even if all seems easy and the likelihood of conflict minimal, it doesn't mean that the reality of actually being sued might change attitudes a bit. If countersuits or appeals might be possible, then consider that too. Upending a long-standing real estate ownership arrangement might not always turn out the way one expects. The future is unknown, and *stuff happens*.

Conclusions

Partition is an important right attributable to fractional interests in real estate, and must be considered as part of the valuation unless it is waived or otherwise unavailable. The valuation process that relies on that right is necessarily the appraiser's interpretation of how market participants would price that right, *based on the specific facts and circumstances of the case*. Present value of future earnings is a familiar valuation technique that I have renamed "partition time and cost" in order to make a clear distinction between a method that addresses risk and time, and the original "cost-to-partition" that addressed neither.

Bringing a partition action against one's co-owners might be no big deal. But it could also turn into a real can of worms. It might not be feasible based on either costs or declining market conditions, as either can produce very high discounts. If the others' interest in holding onto the property isn't strong, then an action might not even be necessary. Given that the future is unknown, how would an informed market participant price their partition right? A persuasive answer to this question, closely tied to the facts and circumstances, will be an important contribution to a credible and useful opinion of value.

Endnotes

[1] The certainty of a lawsuit would arguably reduce the size of the potential market, but there do exist real estate market players who deliberately buy into legally difficult situations. If you think they would want something (a low entry price and nice eventual gain) if they can solve the legal problem, I think you'd be right.

[2] *Case of Ludwick*, T.C. Memo. 2010-104

[3] Author's Comment: A case study that includes the partition time and cost method is included in *Valuing Fractional Interest in Real Estate 2.0*, which you can find at www.primusivs.com. An online partition analysis feature is also included as part of PrimusPVX® fractional interest valuation software, at www.primuspvx.com.