

KEEPING REAL ESTATE IN THE FAMILY: THINGS TO CONSIDER FOR A FAMILY REAL ESTATE LLC

One of the best approaches for continuing family ownership of real estate is to create a limited liability company (LLC) to own the real estate. The benefit of using an LLC is that you can establish rules for the management and transfer of the real estate. If the people own the real estate directly, no centralized management exists and serious problems can occur that jeopardize the continuing family ownership. For example, if an owner gets divorced, the owner's divorcing spouse could stake a claim on the real estate. Or, if one owner wants the real estate sold rather than kept in the family, that owner has the right to start an action in court and force the sale of the real estate. While disputes can still arise that land the owners in court even if you have an LLC, with an LLC in place the court interprets the LLC agreement instead of responding to the whims of one particular owner.

With a properly organized LLC, an operating agreement exists that spells out the ground rules. Decisions can be made by majority vote or, for major decisions (such as the sale of the real estate or major capital investment in the real estate), the operating agreement could require a 90 or 100% vote. The operating agreement is quite a flexible document that can take into account many different subjects. The following are some issues that you should consider when thinking about your LLC operating agreement:

A. WHAT IS THE CURRENT SITUATION?

1. Who owns the real estate?
2. What is the legal description and property tax identification number?
3. How much is the real estate worth?
4. What kind of real estate is it (hunting land, farm land, cabin, lake home, etc.)?

5. Has the current owner made significant gifts (more than \$14,000) to any person in the past?
6. What is the total value of the current owner's estate?
7. Is the real estate mortgaged? If so, what are the terms?
8. Are there any potential legal problems associated with the land (boundary disputes, neighboring development, septic systems, water usage, zoning, etc.)?
9. What are the current property taxes, insurance, and annual maintenance expenses?
 - Will transferring the real estate to an LLC change the property tax treatment?
10. Are there other related expenses (such as slip fees, condo association dues, shared expenses with neighbors for things like access road maintenance, etc.)?

B. WHO PARTICIPATES IN THE LLC?

1. Will parents gift children the LLC interests?
 - Will the children own the interests equally?
 - Can the children afford to take care of the property?
 - Do some children want/not want the property?
 - Will some children use the property more than others? If so, how is that difference in use going to be accounted for?

- Do any of the children have financial, legal, or psychological problems that would disrupt cohesive ownership?
- Do the children get along?

2. What happens when a member dies?

- Does that member's children inherit that member's interest or does a spouse? What happens when the spouse dies?
- Does the LLC have to buy the interest back?
- Does the interest have to get bought-out by the other members?
- What role do spouses have?
- How is the value decided?

3. Will members be allowed to withdraw?

- If they can withdraw, what value will they receive, if any?
- How will that value be determined (e.g., 80% of tax value paid out over 10 years at 2% interest)?

4. Can a member sell their interest?

- To another family member?
- To an outsider?
- Should family members have the right to buy the interest first (first right of refusal)?

5. What happens if a member gets divorced?

- Do they lose their interest?

- Do the other family members have to buy their interest out or can they have the first right to buy the interest?
 - How is it decided who has the right to buy the interest?
6. What happens if a member is subject to bankruptcy/judgments?
 - Do they lose their interest?
 - Do the other family members have to buy their interest out or can they have the first right to buy the interest?
 - How is it decided who has the right to buy the interest?
 7. Can members vote to expel people from the group?
 8. Are there events that should trigger an involuntary buy-out (such as bankruptcy, insolvency, etc.)?
 9. How should a member's interest be valued? Should there be any difference in value depending on why a member's interest is being sold (*e.g.*, death, divorce, desire to be bought out, etc.)?
 10. How should a member's interest be paid for when there is a buy-out (*e.g.*, cash immediately or a percentage as a down payment and "X" years to pay balance and at what interest rate, if any)?

C. HOW IS THE LLC AND REAL ESTATE MANAGED AND USED?

1. Is governance to be by majority rule or some other percentage?
2. What items should be put to a vote of the group and what can be delegated to a manager, such as selling the property, amending the controlling documents, or obtaining a mortgage?

3. Who gets to vote?
4. If appointing a manager:
 - Who should serve as manager?
 - Should there be a manager from each family unit?
 - How should a manager be decided upon?
 - Does the manager speak for the “group” relative to outsiders in business matters such as billpaying, ordering work done, resolving disputes, etc.? If not, who does?
 - How long will the manager act?
 - How is a successor chosen?
 - What type and frequency of reporting/accounting to the group is expected of the manager?
 - In what circumstances would the manager be expected to step down?
 - Does a manager have authority over physical maintenance of the property? If not, who does?
 - Does a manager have authority to paying utilities, taxes, insurance, and costs of maintenance? If not, who does?
 - Should, and how should, the manager be compensated?
5. How would “non-routine” decisions be made on maintenance (replace roof, resurface the access road, replace the dock, etc.) and improvements (adding air conditioning, winterizing, or expansion of existing structures)?

6. Should a schedule be established to determine the use (applicable to hunting land, lake cabins, etc.)?
- How? Drawing straws, rotation, authority of the manager, bid, lottery, etc.?
 - Can people assign their use time to other family members?
 - What will the basic time slots be? (Many choose weekly, e.g., from Wednesday to Wednesday.)
 - Will there be different procedures for scheduling use of the cabin on holidays (e.g., Memorial Day, July 4th, Labor Day, and, with increasing use of cabins year-round, winter holidays) and/or any other dates of importance to the family?
 - What method will be used to assign the weeks? (Many use a lottery, often at an annual meeting in late winter or early spring, with a different family taking the first pick each year. This can be difficult if the involved persons cannot easily get together or figure out their family schedules well in advance. Out-of-state participants may be able to participate in such meetings by conference call. Others use a first-come first-served approach. In any case, clear procedures for participating in the assignment process are desirable.)
 - Can two family units trade weeks if their situations change?
 - Can a family unit sell its week to another family unit?
 - Can a family unit that does not use their week rent it out to non-family members?
 - Can two family units intentionally book the same week together if they wish?
 - Will there be a prohibition on booking consecutive weeks? (Some groups allow two consecutive weeks, but no more.)
 - Is a family unit's scheduled use exclusive, or can other members of other family units also use the property if space is available?

- Should outsiders be allowed to use the real estate and if so, on what basis?
 - During a specific family's time to use the property, do they have exclusive use of the property, are there to be any restrictions on guests, and under what circumstances can others just "drop in?"
 - Provisions regarding whether outside parties may use the property and if so, under what conditions?
7. Under what circumstances would the property be sold, and how should that group decision be made?
8. How should maintenance and repairs be handled?
- Are there going to be work days at which everyone must attend?
 - Are people who do not attend to be assessed fines?
 - How does sweat equity count as compared to dollars spent?
 - How and by whom is it to be decided when furnishings, appliances, etc. need to be replaced?
 - Will a log be kept of tasks each family has done?
 - Will major jobs (like house painting or re-roofing) be compensated?
 - If the family is not doing the work, what is the procedure for hiring such work out?
 - Who oversees routine maintenance (e.g., mowing, leaf raking, minor tree trimming and picking up fallen limbs and twigs, raking the beach)?
 - Does routine maintenance have to be completed each time the cabin is used?
9. If the property is large enough, can family members build their own homes on the property?

10. How is personal property treated (especially boats, ATVs, etc.)?

- How much personal property goes with the cabin (boats, motors, furniture, dishes, linens, etc.)?
- How would it be maintained and, as necessary, replaced?
- Can individual families keep their own things on-site?
- Will they be owned collectively?
- Will such items be individually owned? If so, may the owner restrict others' use of the items?
- Is use limited to persons with driver's licenses and insurance coverage?
- Will guests be allowed to drive?
- Will there be a minimum age for family members?
- What will be the agreement on repairs, winterizing, storage, replenishing the gasoline, and whether the boat can be towed to another lake?
- Should the budget include an extra amount for eventual replacement of such items?
- Will individually owned boats be kept on individually owned boat lifts? Is there enough dock space and lake frontage to do this?
- May families store other large personal property items on the real estate (such as trailers, campers, RVs, snowmobiles, etc.)?

11. What are the general cabin/home rules?

- Is there a maximum number of persons who can be at the property?
- May minors use the property, or be left at the property, without adult supervision?
- What responsibilities do members have to clean up after themselves and to prepare the property for the next user group (replenishing firewood, cleaning out the fridge, washing bedding/linens, replenishing condiments or other nonperishables, basic food items)?
- Are there restrictions on noise, parking, smoking, drinking, use of drugs, pets, campfires, or parties?
- What happens if there is an immediate maintenance or repair issue (for example, addressing septic system needs, dealing with storm damage or broken windows, and the like)?

D. HOW ARE THE FINANCES AND EXPENSES HANDLED?

1. Will the current owners leave liquid assets to fund expenses of the cabin, or will the successor owners be called upon to share expenses?
2. How is the LLC's money handled?
 - Will a treasurer or bookkeeper be appointed?
 - Will this position be paid?
 - Who will be signatories on the LLC's account(s)?
 - Should a reserve be built up? If so, should the reserve be invested or at least segregated from the operations account?
 - Will any money be left at the cabin for use (e.g., in case emergency repairs are needed)?
3. How are costs divided?

- Who will assess expected costs of the LLC?
 - How will the costs be allocated among the members? (One method is to total up the expenses, add a “cushion” or amount for a reserve, and divide the total by days used to decide daily rent and impose assessments if there is a shortfall during the season. Another method might be to divide the overall predicted cost of having the cabin, e.g. taxes, insurance, and maintenance expenses, among the owners, presumably proportionate to their ownership interest.)
 - Is there a desire to build up a fund for future repairs, maintenance, and improvements that should be factored in?
 - How are payments characterized--as rent, membership dues, usage fees, or otherwise?
 - What happens if a family member does not provide his or her share?
 - Can a capital call be made in case of a shortfall of funds?
4. How will capital improvements be decided upon (e.g., replacing a roof, replacing, or upgrading a dock or boat lift, upgrading, or replacing a septic system, and the like)?
- What is the procedure for proposing, considering, and approving such improvements?
 - What is the procedure for planning and funding such improvements?
 - How rustic or modern do the members want the any cabin to be? (Improvements such as installing indoor plumbing, electricity, heating, or air conditioning, installing a telephone, buying a television and/or stereo system, providing internet access, paving a driveway, adding a garage or other outbuilding, and landscaping can all be contentious.)

E. HOW ARE DISPUTES HANDLED?

1. Should an intra-family system, or an alternative dispute resolution process, be set up to address disputes about any management or use issue that arises?
2. If so, what kind of process would work best? Among other considerations, should a non-family member lead the process and should the process be mandatory?
3. Should the process be adjudicative (e.g., arbitration where the arbiter's decision is final) or conciliatory (e.g., mediation)?
4. What should the consequence be if a party to a dispute does not participate in good faith?
5. If the process is not adjudicative, at what point should the dispute resolution process end and the parties be free to pursue other recourse?
6. Should a prevailing party have the right to seek his/her reasonable attorney's fees?
7. Should members agree to give up or limit the right to a jury trial?

Attorney AmyAnn W. Mursu
Lakeview Trust & Estate Law, PLLC
231 MN HWY 78
Unit B
Ottertail, MN 56571