ST. LOUIS TRUST
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Considerations for Shared Ownership of Family Property

The Problem

Looking back, Sam, Jane and Nick's childhood seemed almost perfect. They grew up in a loving extended family, played sports year-round and traveled. A highlight for the three siblings was their summers spent at Manor Grove, their family estate on the Outer Banks bought by their grandparents in the early 1900's. When their grandparents died, the estate passed to their father, James, and his sister, Clara. As the years rolled by, Manor Grove remained important to the family as James, Clara and their children spent weeks together there. As Sam, Jane, Nick and their cousins married and had children, sharing the property became more of a problem. Family disputes among James and Clara over use and upkeep of Manor Grove became regular occurrences. The disputes spread to the rest of the family, as Sam, Jane and Nick began to see their cousins less often. A few years ago, after an especially nasty dispute over the need for and funding of various capital improvements, James bought Clara and her family out of Manor Grove, and they ceased all communication.

When James died last year, ownership of Manor Grove passed to Sam, Jane and Nick. While the siblings remain close and are juggling shared ownership and the enjoyment of Manor Grove, they can feel the toll the property is taking on their relationships. For example, Jane had new curtains ordered and installed in the house, but her brothers balked about sharing the $40,000 expense. Further, Sam and his family live on the west coast, so they spend the least amount of time at Manor Grove. Due to this, he chafes at having to pay one-third of all expenses. Yet, above all, the three siblings want to preserve their relationships and do not want this special property to create problems among the next generation. The above fact pattern is a common one. Shared family properties can enhance family relationships, but over time as families grow, those same properties that engendered closeness can create dispute and discord.

This paper addresses issues that arise from shared ownership of a property.[*] It will begin with (1) a short primer on the forms of ownership of real estate, move into (2) a primer on LLC structure, discuss (3) various governance issues and possible ways to address them, provide (4) a checklist of items to decide when creating an LLC, and conclude with (5) a discussion of the complexities specific to family ownership of real estate. This paper will not touch on the estate planning and tax challenges of passing property down through generations. While a very important topic for valuable shared property, estate planning is a complex topic that is outside the scope of this paper.

1. Forms of Ownership

Real Estate can be owned in a number of forms:

Sole Ownership **–** First and simplest is outright ownership by a single person. This is referred to as sole ownership. James' ownership of Manor Grove after he bought out Clara's share of the property is an example. Problems with sole ownership occur at death of the owner. First, sole ownership property typically passes through probate which can be time-consuming and expensive. Second, unless the property is being conveyed to only one person, the succeeding ownership will be joint ownership; issues with joint ownership are discussed next.

Joint Ownership **–** Joint ownership is outright ownership by one or more persons (or entities). There are two main types: (1) tenants in common and (2) joint ownership with right of survivorship. With tenants in common, each owner holds an undivided fractional interest of the entire property. For example: after James' death, Sam, Jane and Nick own Manor Grove as tenants in common. Each of them is allowed to transfer, gift or bequest their respective 1/3 shares as they see fit. Thus, Sam could gift his share to his children, and Jane and Nick would then jointly own the property with their niece and nephew.

Tenants in common require that all property decisions be decided unanimously. The requirement of unanimity applies to both small decisions, such as the hiring of landscapers, and large decisions, such as whether major capital improvements will be made, or the property will be sold. As the number of co-tenants increases, the difficulty of decision-making also increases. To remedy a co-tenant disagreement, one or more of the tenants could bring a partition action – a court proceeding to force the division of the property among the owners. As most properties cannot be physically divided, partition usually means sale of the property. In that event, one or more family members can purchase the property from public auction. This option typically results in strained familial relationships.

Joint tenancy with right of survivorship is very similar to tenants in common, except upon the death of a co-tenant, the decedent's rights in the property disappear. This form of ownership is typically reserved for ownership between spouses and occasionally between a parent and a child.

Trust Ownership **–** Ownership of property in trust can alleviate many issues found in sole ownership and joint ownership of property. Use of a trust can help avoid probate and use of a professional or independent trustee can mitigate some of the disagreements arising from of sharing property. However, use of a trust does not completely solve the problems of sole or joint ownership as trusts typically split at some point among beneficiaries, and those resulting trusts assume ownership as tenants in common. Additionally, a trust document is not conducive to providing evolving governance provisions.

Entity Ownership **–** Usually, the best solution is for shared property to be placed into an entity such as a Limited Liability Company (LLC), corporation or partnership. An LLC is often the best entity to use for property ownership. Therefore, this paper will focus on that form of legal ownership.

LLCs are similar to partnerships in that they are pass-through entities for tax purposes, meaning that LLCs pay no entity-level tax. A key aspect of LLCs is that the ownership and day-to-day management can be separated. The LLC operating agreement can provide detailed provisions related to decision-making.

2. LLCs: Structure and Key Concepts

An LLC is a legal entity similar to a corporation. While a corporation's main governing document is its bylaws, an LLC's governing document is called an Operating Agreement. The owners of an LLC are called "members" – analogous to a corporation's "shareholders." While corporations are managed by "officers" such as a president, vice president, treasurer, etc., LLCs are managed by "managers." Corporations are required to have a board of directors while most LLCs merely have members and managers and no board of directors. Thus, the members tend to function both as shareholders and as the board.

A member's ownership interest is usually expressed as a fraction based on his/her/its capital contributions to the LLC as a fraction of the total LLC value. A member's interest will rise or fall if non-pro rata contributions or distributions are made to the LLC. For example, if Tim owns 25% of an LLC worth $1 million and another member contributes $250,000 to the LLC without Tim also making a contribution, he will now own about 20% of the LLC. The dollar value of his interest will be the same ($250,000), but he will own a smaller percentage of a more valuable LLC.

As mentioned above, typically one or more "managers" is given authority over various aspects of the daily operations of the LLC while the "members" – who are the owners – have the power to weigh in on various decisions. The common distinctions between managers and members are listed below:

Managers

The Operating Agreement designates one or more managers to manage the day-to-day affairs of the property owned by the LLC. Typically, managers have the power to:

- Pay bills in the ordinary course of business (often up to a certain dollar amount)
- Hire and fire contractors, such as landscapers, handymen, housekeepers and the like
- Arrange for normal maintenance and upkeep (often up to a certain dollar amount)
- Handle scheduling and usage of the property by members and other family members according to procedures/rules approved by the members

Members

Members are the owners of the LLC. The members retain ultimate power over the LLC, including the power to remove and replace the manager(s) and to appoint successor managers. The Operating Agreement lays out what decisions require a simple majority, a supermajority or unanimity. Decisions requiring the approval of the members usually include:

- Amending the Operating Agreement
- Electing a new manager or naming a successor manager
- Removing a manager
- Selling property or assets over a certain dollar value
- Purchasing property or assets over a certain dollar value
- Approving annual budget
- Approving capital expenditures over a certain dollar value
- Approving maintenance and upkeep or any other expenses over a certain dollar value
- Borrowing money
- Requiring additional member contributions
- Approving new members and approving transfers of interests (other than those expressly permitted in Operating Agreement)
- Dissolving and terminating the LLC
- Approving/ratifying procedures for scheduling of property usage and rules for usage of property
- Approving any lease agreements or other business agreements relating to the property

Transfers of Interests

Crucial provisions of the Operating Agreement concern the transfer and redemption of membership interests. Typically, the agreements provide for (a) permissible transfers which do not require approval or give rise to purchase rights in the other members or LLC and (b) all other transfers which give rise to various purchase rights in the other members or LLC.

Permitted Transfers – Operating Agreements typically allow a member to make transfers for estate planning purposes without need for approval from the other members. For example, transfers to a trust for the primary benefit of the member's spouse and descendants might be a permitted transfer which does not give rise to a purchase right for the other members or LLC.

Other Transfers – Transfers other than permitted transfers usually give rise to some sort of option for the remaining members or the LLC to purchase the interest that is being transferred. This purchase right is often structured as a first right of refusal or right of first offer.

For example, assume that Sam, Jane and Nick own Manor Grove as 1/3 owners in an LLC. Sam decides to sell his 1/3 interest to a third party. If the LLC provides for a right of first refusal, either Jane or Nick (or maybe the LLC itself) could buy Sam's interest at the price and terms equivalent to the terms agreed to between Sam and the third party. A right of first offer is similar, but before exploring the sale to a third party, Sam must first offer to sell his interest to Jane, Nick and the LLC. If they refuse to exercise their right, Sam is free to sell the interest for an amount equal to or greater than the offer to the members/LLC.

Valuation

The Operating Agreement often provides different values for purchase rights depending on different circumstances. For example, a right to purchase upon a transfer pursuant to divorce or bankruptcy may be at a discount to the interest's market value.

Disagreements and Deadlocks

If there are an even number of members with equal ownership interests, deadlock may result. It is best to plan ahead for handling deadlock as the judicial solution is often dissolution of the LLC. Potential solutions include:

- Require a supermajority for important decisions (for example requiring a 75% vote would avoid the possibility of deadlock where there are four equal partners)Appoint a neutral party as
- Appoint a neutral party as tiebreaker or give a small amount of equity to a fifth person. It is best to name this person in advance of any deadlock
- Designate one member as the member with tiebreaking authority
- Incorporate a mediation/arbitration requirement in the Operating Agreement in the case of deadlock
- Incorporate provisions in the Operating Agreement that allow a dissenting partner to be bought out on terms agreeable to both sides; it is best to have these provisions in the agreement prior to any dispute

3. Governance Considerations

Governance is an important topic for shared property regardless of the form of legal ownership. Many governance issues are addressed in the Operating Agreement. Having a process for making decisions (some by the managers, some by the members), as well as processes and procedures relating to transfers of interests and deadlocks will alleviate many problems common to shared ownership of property.
There are other governance issues that also should be decided by the family that are addressed outside the operating agreement. These governance issues include:

Care and Maintenance

- Who opens and closes the house at the beginning and end of the season (if there is a season)?
- Will there be compensation for family members who perform work on the property (opening/closing, paying bills, etc.)?
- Who oversees maintenance and takes responsibility for completion of repairs?
- Who will receive mail for the property, and who will pay the bills (among the managers)?

- Who will choose the new paint/wallpaper/furnishings when remodeling is done? What will the process be for gaining buy-in from other family members?

Financial Responsibility

- How will expenses of the property be funded? Pro-rata by ownership? Will amount of usage come into play (should family members pay rent for use of the property)?
- Which manager will handle tracking the expenses and managing the budget?
- Should rental to third parties be allowed?

Ownership Changes

- When and how will the next generation get a vote? What happens if a member of a senior generation dies or otherwise passes a voting interest to a lower generation – will the lower generation's voting rights equal those of their aunts and uncles?
- Do in-laws have a voice/vote in any governance matters? What happens when a family member dies leaving a surviving in-law spouse? Will he or she have a voice?

Usage

- How will usage of the property be determined? Will there be "usage slots" of a standard length of time? Will some slots during peak times of the year be worth more than slots during other times? How will the prime slots be allocated? Who is in charge of the schedule?
- At what point in time is the next generation allowed slots of time?
- What rules, if any, will there be for pets?
- What are the rules about the condition the house is left in for the next user? Should a cleaning crew be used between users of time slots?
- What will be the penalties, if any, for failure to comply with policies, rules and regulations?
- What will the procedure be for handling grievances? [1]

A KEY POINT: While each of these governance points is important and many should be thought about in advance, not all need to be (or should be) addressed in the Operating Agreement. Instead, many of these issues can be decided among the family and adopted by the managers or members as resolutions and documented in a handbook of household procedures and rules.

4. Checklist of LLC Terms

General

- Name of LLC: ____
- Registered agent and address: _______________________________________
- Property to be contributed to LLC:
  1. Real estate ____
  2. Cash for expenses ____

Management

- Who will be the manager(s)? ____
- If more than one manager, are the decisions by the managers made by majority vote or unanimous consent?

  ____
- Certain decisions may require consent of the members in addition to consent of the manager(s). What consent of the members (based on % ownership) should be needed for the following actions:
  1. Amend the operating agreement: _________
  2. Elect new manager(s): _________
  3. Remove manager(s): _________
  4. Sell property/assets over $_________ in value: _________
  5. Purchase property/assets over $_________ in value: _________
  6. Capital improvement expenses: _________
  7. Other expenses in excess of $_________: _________
  8. Borrow money in excess of $_________: _________
  9. Require additional member capital contributions: _________
  10. Add new members (other than permitted transferees): ________
  11. Transfer LLC interest (other than permitted transferees): _________
  12. Dissolve the LLC: _________
- Is anyone other than the manager(s) authorized to write checks and deposit in the account of the LLC? _________
  1. If so, who? ____

Capital Contributions

- If a member fails to make a required capital contribution, what are the options?
  1. Dilute his/her ownership interest: _______
  2. LLC or other member(s) loan money to the non-contributing member, obtain lien on the non-contributing member's LLC ownership and receive interest on the loan at _________% per year: _________
  3. Consider it a default event which gives the LLC and the other members the right to buy

out the non-contributing member's LLC ownership. (If 3 is yes, typically 1 and 2 will be no): ________

Transfers of LLC Interest

- Should there be any restrictions on transferability?
    1. Right of first refusal: ________
    2. Only to permitted transferees: ________
    3. Right of first offer: ________
    4. For non-permitted transferees, approval by ________% of members: ________
- Who are the permitted transferees? ____
- When a member dies or withdraws from the LLC, do the other members or the LLC have the right (but not the obligation) to buy out the deceased/withdrawing person's interest? ________
    1. If so, at what price? ________
- If a member transfers his/her interest in violation of the Operating Agreement, do the other members have the right to buy out the transferred interest? ________
    1. If so, at what price? ________
- Will transferees have:
    1. Full voting rights? ________
    2. Lesser voting rights? ________
    3. Should the members vote on whether to grant them voting rights? ________

5. Complexities of Shared Family Real Estate

All families who own family businesses know that the interrelationship between the family and the business is very complex. The basic objective is for (at least some) family members to invest their time and capital in order to generate financial returns for the broader family. Joint ownership of family recreational property is also complex, particularly because the basic financial structure is the opposite – family members contribute their money in order to enjoy recreational time at the property. This dynamic heightens the need to have a long-term, multi-generational plan for the financial support, governance and usage of the property that takes into account the inevitable changes in family makeup. Family-owned properties can be a great source of joy, memories and togetherness, but they can also be the cause of stress in the family.
The following is a partial list of topics/questions to be considered as a family contemplates joint ownership of recreational property:

Numbers Matter: The Math of the Family Tree

The starting point is usually simple: Mom and Dad own the property. They make all the rules and pay

all the bills.
If the property passes to their three adult children, it becomes more complex because three people (and possibly their spouses) need to agree on everything. If the adult children then, years later, pass the property to their children, then six, nine, twelve or more people (with spouses) must agree on everything.
As the ownership pool expands, owners' personal interests and financial capacity tend to diversify. Decision-making typically becomes more difficult and time-consuming as the pool of decision makers grows.
For these reasons, broad family ownership of recreational properties seldom survives the second generation.

Emotional Attachment

If the parents build a beach house and their children spend summers there with their parents, those children would likely have a strong emotional attachment to the property as adults. In contrast, if the great-grandfather built that beach house and the same children spent two weekends a year there growing up, they would likely not have as strong of an emotional attachment to the house. Emotional attachment, or the lack thereof, usually drives willingness to lend financial support to a shared property.

Differences

People are all different, whether or not they are related to each other. They have diverse likes, needs, abilities, personalities, tolerance levels and so on. Some people like fancy, some like casual. Some people are neat, some messy. Some have more income than they need, others are on a budget. Some like to play golf, some would rather ride horses. Some love the sun, others can't be in direct sunlight. Some choose to have many children and love being with them, some choose to have none. Some love rock 'n roll, others hate loud music. Some always clean out the refrigerator, some never do. Some like to fix things, others don't know how. And so on, and so forth. The challenges in accommodating different tastes, desires, schedules, resources, etc. of the members of a family grows geometrically with the addition of each generation – as does the distance of the relationships. It gets harder.

Leadership

Mom and Dad bought the ranch and made it "perfect" for the family by investing their time and treasure in it. The decision-making process was simple and effective. They decided everything; when, how and how much. Decision-making by a group of siblings is much more difficult. It gets even harder with the addition of cousins. A formal structure for governance becomes a necessity. It can become business-like.

Success

Some families decide that preserving a part of their family's legacy in the form of a piece of real estate is worth the effort, and they devote the time and resources required to make it a positive investment for all family members. Some also have a time frame in their planning, in terms of years or generations, after which they recognize that the dilution of the emotional connection to the property makes the effort required become disproportionate to the value and pleasure derived. They design a plan to dispose of the property, whether to an unrelated person or entity or to one family member who starts the process over again.

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* This paper was written for informational and educational purposes and not for the purpose of providing legal advice. St. Louis Trust & Family Office is not a law firm. You should contact your attorney to obtain advice with respect to any particular issue or problem that is legal in nature.

1 Many of these governance issues were provided from the following article: Huggins, Ken (2003) "Essay – Passing It On: The Inheritance, Ownership and Use of Summer Houses," Marquette Elder's Advisor: Vol. 5: Iss. 1, Article 7.