How do I start a real estate company with a friend? Who makes decisions for my LLC?

Some people wanting to start a real estate company will form an LLC and think they are good to go. While this is part of the process, there is a lot more that you need to do to start your real estate company. This article mainly explores some of the more important portions of your LLC's operating agreement, but it is part of a series of articles by us on how to start a real estate company.

The operating agreement is the governing document that contains information on how your LLC will be owned and governed. If you are the sole owner of an LLC, that operating agreement is likely short and simple, but the more people you involve, the more complicated it can become. Talking through these considerations with the other members up front can save a lot of headaches later on. You should consult with your attorney about these provisions and how they apply to your individual situation, so you can help put together an operating agreement that better suits the needs of your company.

Member-managed vs. manager-managed

Member-managed

When it comes to who has authority to make decisions for your LLC, you need to consider whether your LLC will be "member-managed" or "manager-managed." A lot of this depends on how the day to day operations are handled and what specific acts do you are comfortable with certain members taking.

If you plan to simply own an entity 50/50 with another person, the most common set up is member-managed. This means both members will have the ability to carry out certain actions unilaterally. The members also can designate what actions they will both need to approve before taken.

Manager-managed

Sometimes there is a situation where one co-owner might be living in a rental property owned by the LLC and such person is more likely to be the point of contact and handling day to day situations with the other tenants. The operating agreement can designate this member as the manager, making the LLC and manager-managed. But it is still more common that both members manage the company. Think of it more as what powers you don't want a specific person to have, rather than what powers you want a specific person to have. Even if one member is more likely to exercise certain powers, that doesn't mean that the other members should not have the same powers.

The more common scenario for using a manager-managed LLC is when there are some smaller minority interests involved, like when there are 3, 4, or even 5 or more members in a company. Let's say there are two 45% members and one 10% member. It might make sense to make both the 45% members "managers" with specific powers that you don't want the 10% member to have.

Keep in mind, if you are 50/50 at the start, there might come a time when you have another minority shareholder. If that happens, you can amend the operating agreement to better reflect the new ownership structure. That can reflect a switch from member-managed to manager-managed.

This situation also comes up when the original members eventually want to buy another property. If you plan to bring additional members in to help purchase the new property, it is certainly a good idea to have a new operating agreement to reflect the new ownership structure and decide how decisions will be made with respect to the new property.

Note that even if the new property's ownership structure is the same, you should still consider owning it in a new LLC for liability limitation reasons.

Membership unit distribution

We have discussed in another article why you should use an LLC to own your rental real estate, but, to reiterate, you can get really creative when it comes to how membership units will be distributed and what rights those specific units will have. Let's say you and your friend want to both contribute the same money up front and both have a 50/50 split when it comes to profits. In this case, you will probably have one class of membership units that will represent both the voting and the financial rights. It is not uncommon, however, that one of the members contributes all or a larger portion of the capital to purchase a certain property. If that is the case, the members might want the voting rights to be equal, but when it comes to the financial success of the company, want the membership units to reflect the unequal contribution of capital. To accomplish this, the LLC can have two classes of membership units- one class would be voting units and the other financial units. The additional class of units can have preferred returns so that the member that contributed more capital will get a certain amount of the profits until he or she has recouped the investment. Thereafter, profits and losses will be split according to respective ownership percentages thereafter.

Member compensation

It is also common for an LLC taxed as a partnership to have guaranteed payments. Members are owners of the company, not employees, but this is still a way to compensate a member for specific skills that member has or work that a specific member will perform. From the earlier example, let's say the live-in member will receive $10,000 as compensation for services to the LLC since such member is the main point of contact and deals with the tenants and their issues more frequently, but the ownership is still 50/50. If the profit is $100,000 the live-in member would get the first $10,000 as a guaranteed payment, and then each member gets $45,000, splitting the remaining $90,000 of profit.

Finally, you want to discuss how disputes will be handled in your LLC. If you are 50/50 owners, it is likely that at some point you will not see eye to eye and will need to have a mechanism in place for the decision to be made. We will cover these provisions in more detail in a future article.

As always, each situation is unique, so reach out to an attorney at CPM to discuss your circumstances and the course of action that makes the most sense for you and the real estate you own or plan to own.