

OWNING REAL ESTATE IN A LAND TRUST FOR A LIMITED LIABILITY COMPANY

by Douglas J. Sanderson

I. Introduction

Since at least early 1991, when the Virginia General Assembly enacted the Limited Liability Company Act (the "Act")¹, real estate professionals eagerly have anticipated the opportunity to use limited liability companies ("LLC"s). Authors of numerous magazine and newspaper articles have analyzed the substantial benefits and modest disadvantages of conducting business as a Virginia LLC, virtually all of them concluding that the LLC is an outstanding new option for real estate ownership.² The advantages became even more pronounced following the issuance by the Internal Revenue Service of the favorable ruling that Virginia LLCs will be treated as partnerships for federal income tax purposes.³ The advantages are not enough, however, to support an unequivocal endorsement of the LLC as the entity of choice for a real estate enterprise that plans frequent transactions. The Virginia land trust⁴ remains a worthy alternative, either on its own or, in many circumstances, in combination with an LLC.

Cautionary signals appeared at an early stage concerning title issues affecting real estate owned by LLC's.⁵ In practice, title insurance companies have added requirements in their commitments that encumber considerably the ease of administration that the General Assembly and other LLC proponents undoubtedly foresaw. The use of Virginia land trusts can eliminate all or most of these title concerns, however, without significantly limiting the flexibility of the members of LLC's.

II. Advantages and Disadvantages of the LLC

What could be better for holding an investment or operating a business than having the flexibility and tax advantages of a general partnership combined with the limited liability of a corporation? In most instances, nothing. This is not to assert that no circumstances exist in which an LLC might not or could not be the best choice of entity for a real estate enterprise. A prime example of such a circumstance is an enterprise that conducts business in more than one state, where some of the states do not recognize the LLC form of entity. Uncertainties regarding

¹Presently codified in Va. Code Secs. 13.1-1000 to 1069 (Cum. Supp. 1993).

²See, e.g., Joseph H. Carrington and Louis J. Rogers, "The Virginia Limited Liability Company: A New Entity for Real Estate Ownership," The Fee Simple: The Newsletter of the Virginia State Bar Real Property Section, Vol. XII, No. 2, page 54 (May, 1992).

³Rev. Rul. 93-5, Bulletin No. 1993-3 (Jan. 19, 1993).

⁴See Va. Code Sec. 55-17.1 (Repl. Vol. 1993).

⁵See, e.g., Douglass W. Dewing, "Title Insurance Concerns Regarding The Limited Liability Company," Virginia Bar Association Journal, Volume XVIII, Number 4, Page 8 (Fall, 1992).

both liability and state tax issues arise in this scenario, although these uncertainties may abate as an increasing number of states and the District of Columbia consider and pass LLC legislation.

For new enterprises and relatively small-to-moderate size existing enterprises, however, the LLC presents the opportunity to present as innovative a management structure -- or as traditional a management structure, whether operating more like a corporation, limited partnership or general partnership -- as the owners can conceive and want. It can be owned by any mix of owners, from individuals and partnerships through trusts to corporations, and even including other LLC's. It offers the advantage of increased privacy from public disclosure, by comparison to partnerships, because nowhere in public records must the names of any "members" of LLC's be disclosed⁶ (subject, presumably, to the disclosure requirements of any particular statutes or ordinances that may apply to elective activities that an LLC might pursue, e.g. rezoning requirements). Please see the articles such as Carrington and Rogers (cited in footnote 2) for more detailed discussions of the nature and advantages of LLC's.

The disadvantages of LLC's for an active real estate enterprise -- and potentially for any active business -- arise from some of the same features that make LLC's so appealing. The informality and privacy permitted for LLC's and for their operating agreements, if any⁷, allow a virtually infinite number of options regarding operating structures, authority to bind the company, and transferability of interests.

The existence of such a range of options makes it literally impossible for an outsider to determine who owns or operates the company at any particular point in time without an insider's supplying the information or without a review of the current operating agreement, if one exists. While the Act "vests" management of an LLC in its members, it also "permits" any action "permitted to be taken" to be taken by the vote of the owners of the majority in membership interests, all subject, though, to any existing operating agreement.⁸ However, nothing in the Act entitles a third party to rely upon the commitment or representation of a member as binding the

⁶Query, however: does an LLC need to file a fictitious name certificate? As required by Va. Code Sec. 59.1-69 (Repl. Vol. 1992), any "person, partnership or corporation" that transacts business under an "assumed name" must file such a certificate with the circuit court for the jurisdiction where it is located. Does the association of individuals as an LLC that will transact business come within the statute? To be safe, one might suggest that it does, but the express language of the statute nowhere mentions LLC's, and thus is unclear. A good argument can be made that the statute should be construed such that it requires the filing of a fictitious name certificate only if the LLC itself transacts business under a different name than the one under which it was organized. Furthermore, it is suggested that an LLC that merely owns real estate, and does not engage in an activity that constitutes "transacting business", clearly should not be required to file a fictitious name certificate. These uncertainties probably result from oversights by, and should be corrected by, the General Assembly.

⁷Operating agreements are not mandatory, nor need they even be in writing. Va. Code Sec. 13.1-1023 (Repl. Vol. 1993). After articles of organization have been filed with the State Corporation Commission, the members of the LLC may elect to administer and operate their company solely on the basis of the Act.

⁸Va. Code Sec. 13.1-1022 (Repl. Vol. 1993).

LLC, such as, for example, the entitlement that a third party would have to rely on a partner's authority to bind a partnership, nor is there a position analogous to the "secretary" of a corporation, who by law⁹ is responsible for keeping and authenticating corporate records. Thus, not only is the concept of apparent authority absent, or at best ambiguous, in the context of LLC's, but in the absence of a "reliable" operating agreement an outsider can only rely on authority that derives from an action of, or at least is confirmed as being the action of the majority in interests by, all the members of the LLC. Furthermore, there exists no way to determine if all the membership interests have participated, if and as required by the Act, without "reliable" (whatever that may mean) documentation or information from members.¹⁰

In addition, the Act requires that an LLC be dissolved and wound up upon, inter alia, the death or withdrawal of a member, unless the remaining members consent unanimously to continue the business of the LLC.¹¹ What the remaining members must do, such as filing any documentation, new articles, etc., if they elect to continue is unclear. The answers to technical but potentially problematical issues such as whether the "continued" LLC is the same entity or a new entity, and therefore whether the continued LLC must take specific action to assume the contracts of its "predecessor", also are unclear.

These corporate issues, even if the members of the LLC attempt to resolve them to the extent possible in a written operating agreement, cause serious title issues. How, for example, can a prospective recipient of title to real estate owned by an LLC be certain that the company has authorized the transfer of title, and done so on the terms and conditions stated, and that the person(s) signing and proffering the executed deed are authorized to do so?

The response of title insurance companies to these concerns, while perhaps more cautious than necessary, illustrates the problems that are inherent in the operation of an active real estate enterprise as an LLC. A set of requirements for a conveyance of real estate from an LLC could include not only all the types of requirements that are common to transfers from other types of corporations (e.g., articles of organization, operating agreement, certificate of good standing, and corporate resolution), but also others, particularly if the operating agreement is oral or incomplete (e.g., "current" (as determined by the title insurer) membership roster, authorizations, various resolutions, individual indemnity bonds to the title insurer, and unanimous consents of members). These requirements result in a substantial reduction, if not virtual elimination, of at least three major advantages of LLC's that the General Assembly probably intended: privacy of ownership, ease of administration, and, due to any bond requirements, limited liability. They also cause operational difficulties because of the need to procure numerous signatures for each

⁹Va. Code Sec. 13.1-693 (Repl. Vol. 1993).

¹⁰Legislation could allay substantially these concerns, but has not done so to date. For example, legislation could vest presumptive or apparent authority in a "manager," or other word or phrase of choice, and could entitle any person to rely on the completeness and accuracy of any roster of members that is presented by such a manager, or, if no person were serving as a manager, by any member, as being current (what is "current" also could be defined by statute).

¹¹Va. Code Sec. 13.1-1046 (Repl. Vol. 1993).

transaction.¹² Please see articles such as Dewing (cited in footnote 5) for a detailed discussion of title insurance concerns regarding LLC's.

III. The Land Trust

a. Structure of the Land Trust

The proper use of a Virginia land trust can provide a solution to many of the problems of how to operate an active (or inactive) real estate enterprise as an LLC. A Virginia land trust is a trust which contains two key elements: a deed in trust, which is recorded, and a trust agreement executed by all the beneficiaries and by the trustee.¹³ Note, furthermore, that the beneficiary(s) need not be one or more individuals; other entities such as partnerships and corporations can also be, and have been, beneficiaries of land trusts.

Under Va. Code Sec. 55-17.1 (Cum. Supp. 1993), a land trustee may take title to real estate without specifying the identities of any trust beneficiaries, and this does not invalidate or defeat the trust. More significantly, the statute provides that "no person dealing with such a trustee shall be required to make further inquiry as to the right of such trustee to act nor shall he be required to inquire as to the disposition of any proceeds." Thus the land trust statute makes the trustee of a land trust the full title owner of the real estate, and allows the beneficiaries to protect their privacy.

The Virginia Supreme Court has confirmed that the statute means what it appears to mean. In Air Power, Inc. v. Thompson¹⁴, for example, the Court confirmed that, unlike a security deed of trust, the trustee in a land trust receives and holds both the legal and the equitable title to the real estate.

In establishing a land trust, the parties first probably will execute a trust agreement limiting and carefully defining the rights of the beneficiaries.¹⁵ While the beneficiaries retain certain rights to direct the actions of the trustee, the agreement also should recite, as the land

¹²The administrative difficulties could not be addressed effectively by advance authorizations executed by the members; current rosters, attested to by current members, might still be needed at each future transaction, and the withdrawal of a member probably would invalidate any such prior authorizations due to the dissolution provisions of the Act, thereby for either reason eliminating the efficacy of the advance authorizations.

¹³For an excellent description and analysis of the Virginia land trust, see Peter A. Arntson, "The Virginia Land Trust -- An Overlooked Title Holding Device for Investment, Business and Estate Planning Purposes," *Washington and Lee Law Review*, Volume XXX, Number 1, Page 73 (Spring, 1973).

¹⁴244 Va. 534, 422 S.E.2d 768 (1992).

¹⁵See Arntson article, supra, for more detailed explanations.

trust statute provides, that the beneficiaries' interests are personal property, and contain no element of legal or equitable title in the trust estate.

The land trustee then receives title to the trust real estate by the deed in trust. This deed not only conveys title but also grants the trustee substantial powers to improve, manage, rent, contract, sell, mortgage, encumber, convey, pledge and otherwise deal with the real estate. It also provides, *inter alia*, that no person dealing with the trustee with respect to the property is required to inquire into the trustee's authority to act. An example of general trust powers that are virtually identical to powers that have been used in recorded deeds appears as Appendix A.

b. Use of Land Trust

The land trust protects the beneficial, indirect owners of real estate from public view and permits the transfers of interests in the trust with corresponding privacy. Another major advantage to the use of the land trust is the simplicity with which the trustee can act on behalf of the beneficiaries: if the trustee is empowered properly in the recorded deed in trust, any third party that intends to transact business with the trust is permitted by statute to do so by dealing solely with the trustee, without seeking further assurances from any beneficiary(s). The land trust thus has been an excellent vehicle for estate planning as well as for investment partnerships, whether general or limited, and operating groups,¹⁶ and it can function equally well with an LLC as its beneficiary.

To establish a land trust for an LLC as the beneficiary, all that is necessary, in addition to the deed in trust to the designated land trustee or trustees, is an LLC operating agreement that is coordinated with -- or even is a part of or included within -- the land trust agreement. Although the Act does not require a written operating agreement¹⁷, and although the Statute of Frauds may but probably does not require the operating agreement to be in writing¹⁸, a written agreement is strongly recommended.

In order to avoid any potential argument that a statutory termination of the LLC, such as occurs upon a withdrawal of any member thereof, or any other change in status whatsoever of the LLC, adversely affects the status of the trust, care should be taken to avoid permitting the LLC to be a party to the deed in trust, even as a grantor, if possible. Of course, if the choice of entity determination is made prior to the principals' acquisition of title, then there is no need for the LLC even to be mentioned in the chain of title of record, and title can be taken directly by the land trustee.

Furthermore, title insurance companies generally have no special additional requirements for assuring or verifying the authority or power of a land trustee to convey title to, encumber, or otherwise deal with real property. Thus choosing to establish a land trust to hold title for an LLC

¹⁶See Arntson article, *supra*.

¹⁷Va. Code Sec. 13.1-1023(B) (Repl. Vol. 1993).

¹⁸Va. Code Sec. 11-2 (Repl. Vol. 1993). Also, an interest in an LLC is personal property, and is not made into a real property interest by virtue of the type of business in which the LLC is involved. Va. Code Sec. 13.1-1038 (Repl. Vol. 1993).

avoids entirely the major operational problem, of establishing authority, in procuring title insurance for the real estate transactions of an LLC¹⁹.

IV. Conclusion

Therefore the establishment and use of a land trust is an excellent and innovative solution in the many situations in which the entity of choice may be an LLC but the operational constraints of conducting real estate transactions through an LLC may be too daunting. The flexibility and privacy permitted by the use of an LLC as the entity of choice are preserved, while in addition the use of the land trust as the record title owner simplifies the requirements that third parties, and title insurers in particular, likely will impose in the course of transactions affecting real estate owned by the LLC through its land trust.

¹⁹However, title insurers reserve the right to inquire into details of the land trust if they encounter reasons to question its existence or operation. Note that the land trust statute provides that "no person...shall be required to make further inquiry" (Va. Code Sec. 55-17.1 (emphasis added)) into the authority of the trustee, but it does not prohibit such inquiry.