

BROKERAGE FIRM ORGANIZATIONAL ISSUES

I. INTRODUCTION

This article will attempt to clear up what appears to be widespread confusion as to the ability of licensees to operate within a corporate structure.

II. DISCUSSION

A. The Company within the Company

This portion of the article was included in last year's legal update. It is essentially being reprinted and included in this year's legal update based on the volume of calls that the MAR Legal Hotline continues to receive on this subject, *i.e.*, the establishment of corporations and limited liability companies by salespersons or associate brokers.

It is generally believed that salespersons can obtain real tax benefits by forming their own corporate entity to receive income from their real estate activities. It is widely believed that the Internal Revenue Service is less likely to question business expenses that are deducted from the operation of a corporate entity, as opposed to business deductions claimed on an individual salesperson's tax return. Whether these tax benefits really exist is beside the point. The belief that the benefits do exist is causing many salespersons to establish a corporate entity. However, unless certain steps are taken, these salespersons and their brokers may find themselves in violation of various provisions of the Michigan Real Estate License Law and the Internal Revenue Code.

Typically, a salesperson will visit with a lawyer who will file articles of organization with the State of Michigan to establish a limited liability company in which the salesperson is the sole member (the "LLC"). The salesperson will then ask her broker to pay

all future commissions owed to her to her LLC. The broker then begins paying the salesperson through checks made payable to the LLC. The LLC, in turn, pays the salesperson. Is this arrangement legally permissible? The answer is absolutely not, for at least two reasons.

First, real estate brokers are prohibited under the Real Estate License Law from paying a fee, commission or other valuable consideration to an unlicensed person or entity. In the arrangement discussed above, the real estate broker is paying commissions to the LLC. The LLC is not licensed. Thus, such payments by the real estate broker violate the Real Estate License Law. MCL 339.2512(h).

Second, the LLC is, in essence, turning around and paying commissions received from the real estate broker to the salesperson. The Real Estate License Law specifically prohibits a real estate salesperson from accepting a commission or valuable consideration for licensed activity from anyone other than the broker with whom the salesperson is affiliated. MCL 339.2510.

One frequently suggested solution to comply with the law is to have the LLC be directly licensed with the real estate broker and receive payment of commissions based upon the efforts of the salesperson affiliated with or employed by the LLC. Unfortunately, this solution is not technically possible. Rule 339.22201 provides that associate broker and salesperson licenses may only be issued to individuals. There is, however, another arrangement which is legally permissible assuming a few mandatory steps are carried out by the salesperson.

First, the salesperson would cause the organization of the LLC. Then the salesperson would file an application with the Department of Labor & Economic Growth ("DLEG") to obtain a real estate broker's license for the LLC.

Second, in order for the LLC to obtain a broker's license, the salesperson would have to file an application to obtain an associate broker's license with the LLC. This, of course, assumes that the salesperson can meet the requisite qualifications for an associate broker's license as set forth in the Real Estate License Law.

Third, the salesperson would also have to apply and become an associate broker with the real estate brokerage firm with whom she is presently affiliated. In the end, the former salesperson would be an associate broker both for the real estate brokerage firm where she has worked and for her newly formed LLC. She cannot remain as a salesperson with her present real estate brokerage firm, as a salesperson can only receive commissions from her broker. As a salesperson with the real estate brokerage firm, she could not receive commissions from the LLC.

Finally, as an associate broker of the real estate brokerage firm, the licensee would carry out her business as an identified agent of the real estate brokerage firm. The licensee's LLC is simply assigned the right to receive the licensee's commissions from the real estate brokerage firm. In other words, the associate broker does NOT conduct business in the name of her LLC, but in her individual name as an associate broker with the real estate brokerage firm. The real estate brokerage firm can now lawfully pay commissions to the LLC.

It should be understood that the former salesperson (now associate broker), by acting as an identified agent of the real estate brokerage firm, will not have the protection of

the "corporate shield" which would normally be available to a person operating through a limited liability company. This would be the case, as the public would not even be aware of the existence of the LLC. However, if at all times the former salesperson (now associate broker) carries out her business as an associate broker of the real estate brokerage firm, she should be covered by that firm's errors and omissions insurer. For what it is worth, DLEG has advised that it considers the arrangement described above to be permissible under Michigan law. If a REALTOR® is considering some form of arrangement that differs from the arrangement described above, he or she should seek legal advice prior to doing so.

B. Business Corporation vs Professional Service Corporation

Real estate brokerage firms in Michigan have always been able to choose to operate their business as a corporation formed under the Michigan Business Corporation Act, MCL 450.1101, *et seq* (the "BCA") and its predecessor statutes. Until recently, there was never any question that real estate brokerage firms could lawfully incorporate under the BCA. Unfortunately, this well-established rule was disturbed by the Michigan Court of Appeals in *Miller v Allstate Ins Co* on remand, 275 Mich App 649, 739 NW2d 675 (2007) (the "Miller Decision"), a case which involved physical therapists, but which held far-reaching consequences for other types of licensees, including real estate licensees.

As a result of the Miller Decision, the Department of Labor and Economic Growth ("DLEG") determined that real estate brokers and salespersons could not be properly incorporated under the BCA. The DLEG made the same decision with respect to real estate appraisers. The DLEG took the position that real estate brokers, salespersons, and appraisers must be incorporated under the Professional Services Corporation Act, MCL 450.221, *et seq*

(the "PSCA"). This action by DLEG created great difficulties for both existing and planned real estate brokerage firms.

There are substantial legal differences between a corporation formed under the BCA and a corporation formed under the PSCA. For example, if a REALTOR® wishes to start a real estate brokerage firm and family members wish to invest in the business, the REALTOR® could not incorporate under the PSCA. If a real estate brokerage firm is incorporated under the PSCA, its only investors can be persons licensed under the real estate license law. As another example, in most instances a corporation organized under the BCA provides a corporate shield against personal liability for its shareholders. A corporation organized under the PSCA offers no corporate shield or other protection against personal liability for its shareholders.

MAR, through its legal counsel, advised its members that real estate brokerage firms previously incorporated under the BCA were generally not exposed to liability from third parties. However, many REALTORS® who were investors in existing real estate brokerage firms incorporated under the BCA expressed grave concerns about their ability to sell or bequest their interest in their corporate entities to third parties. MAR then sought legislation to cure the problem.

On July 2, 2008, the Michigan Supreme Court took care of the problem. The Supreme Court vacated the Miller Decision of the Court of Appeals and determined that only the Attorney General has standing under MCL 450.1221 to challenge the lawfulness of the incorporation of any entity in the State of Michigan. *Miller v Allstate Ins Co*, 481 Mich 601, 751 NW2d 463 (2008). In a footnote on page 13 of its decision, the Supreme Court states:

We emphasize that in no way are we passing judgment on the lawfulness of plaintiff's incorporation. Because a court cannot entertain an individual's challenge to corporate status under MCL 450.1221, plaintiff must be presumed lawfully formed until its incorporation has been successfully challenged by the Attorney General.

After the Supreme Court's decision, there is no longer any judicial precedent supporting DLEG's decision preventing real estate brokerage firms from lawfully incorporating under the BCA. Thus, there is no basis for rejecting articles of incorporation filed by entities licensed as real estate brokerage firms. As important, existing real estate brokerage firms are irrefutably presumed to be lawfully organized under the BCA, subject only to a successful challenge by the Attorney General.

Finally, based on the Michigan Supreme Court decision, the DLEG resumed its long-standing practice of requiring only corporations that provide services in a "learned profession" to perform as professional corporations under the PSCA. These "learned professions" generally include doctors, lawyers, and the like. It does not include real estate brokerage firms. Thus, approximately thirteen months of chaos ended with a full lap around the track back to the starting point. Real estate brokerage firms may again choose to incorporate under the BCA or form as a limited liability company under the Michigan Limited Liability Company Act. Any real estate brokerage firm that formed during this period under the PSCA should strongly consider converting to a corporation under the BCA. Incorporating under the BCA provides greater protection from personal liability and permits non-licensees to invest in the real estate brokerage firm.

III. CONCLUSION

In sum, it is possible for salespersons to obtain the perceived benefits of having payments made to their own corporate entity, either as a corporation or a limited liability company. They just need to make sure that all steps outlined above are completed.

