

REAL ESTATE LAW UPDATE

September 2010

Land Contracts and the Split of Equitable and Legal Title: Avoiding Traps for the Unwary

By Steven K. Stawski, Attorney

Clients in the real estate marketplace — bankers, brokers, agents, mortgage lenders, title agents, insurers, sellers, buyers, and associated service providers — are observing an increased dependence on land contracts. While land contracts offer an alternative form of financing in a tightening lending market, the simultaneous split of equitable and legal title to the same real property presents potential pitfalls for all industry stakeholders.

Land Contract Basics

Land contracts offer an alternative means to finance real property transactions. A land contract is a seller financing tool that is linked to a promise to eventually convey legal title to the real property.

In a traditional mortgage-financed transaction, a buyer obtains the funds by executing a promissory note with an accompanying mortgage to secure the debt. The seller receives a one-time payment at closing and the lending institution receives the incremental, interest bearing payments. Legal title is conveyed at closing.

In land contract terminology, the seller is the vendor and the buyer is the vendee. The vendee agrees to make incremental, interest-bearing payments over a defined period of time to the vendor. Land contract vendees typically take possession of the property and receive equitable

title, which is essentially a right to receive a future conveyance. Land contract vendors retain legal title and do not convey the land until the vendee has fully paid and performed the obligations under the contract, at which time a deed is given.

This split of equitable title and legal title and the significant delay between the date of execution of the land contract and the eventual conveyance of legal title—ten to thirty years is not uncommon—provides fertile ground for potential problems. Unintended consequences to all stakeholders may arise when two different parties split rights to the same real property.

Vendor Issues

The division in rights between the vendor and vendee can produce unintended consequences. For example, while a land contract may place the obligation to pay taxes on the vendee, a vendor may bear the consequence of the vendee's failure to pay. In a recent case, a vendor discovered that its property had been sold through tax foreclosure after the vendee failed to keep the taxes current.

Upon a vendee default, a vendor's remedies include forfeiture and judicial foreclosure, but not foreclosure by advertisement (which is only available for land contract mortgages). Vendors and other persons in the position of a land contract owner, by assignment or otherwise, should recognize the differences between forfeiture and

foreclosure, and should be aware that the absence of certain contract clauses, or the remedy chosen following a default, could preclude a vendor from accelerating the balance of the debt or prevent a deficiency judgment against the vendee.

Vendors who initiate summary proceedings and obtain a judgment of possession risk a whipsaw effect if a vendee pays the amount of the judgment immediately before the expiration of the redemption period.

Clients and counsel alike should anticipate such issues during the drafting and negotiation stages, and after a default, and select available remedies accordingly.

Vendee Issues

Unsuspecting vendees, after making many years of payments, may also be surprised to learn at the closing of legal title that the owner has conveyed away important rights to the property. For example, a vendee was surprised to discover upon the eventual conveyance of legal title that the owner had conveyed mineral rights to a third party while the land contract was in effect.

Vendees can protect their interests by recording a memorandum of land contract, which gives notice to subsequent purchasers, lenders, and others who are assessing the state of title.

Vendees should also be aware of statutory limitations on the amount of interest that can legally be charged by a vendor.

Banking and Title Issues

The split of legal and equitable title produces an industry-wide effect because the interests of vendors and vendees can be leveraged for purposes of outside lending.

Bankers, brokers, mortgage lenders, owners, title agents, and insurers may be surprised to discover that the interests in real property that guarantors

have placed as security for payment of other notes and financing instruments may have already been conveyed via a land contract.

This result can occur through the actions of vendors and vendees because each retains a statutory right to mortgage its interest in the land contract as security for another debt or obligation. In other words, a land contract vendee could discover that that the property it expects to receive in the future is subject to a mortgage placed by the owner after the date of the land contract. Similarly, a vendee may cloud a vendor's legal title by mortgaging the vendee's interest.

Commercial borrowers seeking to sell property on land contract are limited to a relatively small number of annual land contract sales before they fall within the licensing requirements of the Mortgage Brokers, Lenders and Services Licensing Act.

Title companies may be challenged with a closing on a land contract that has been assigned where the original owner is now deceased and is unavailable to convey legal title upon the purchaser's final payment.

Protective Measures

These and other risks are minimized through use of a purchase agreement, protective contract clauses, updated title work, the recording acts, the placement of the instrument of conveyance in escrow and other measures. Each land contract, and its relative benefits and risks, should be evaluated individually.

Steve is a member of the Real Property Section of the State Bar of Michigan, the Michigan Land Title Association, and the Commercial Alliance of Realtors. Representative clients include banks, mortgage lenders, insurers, health care organizations, architectural and engineering firms, developers, and contractors. For more information, please contact him at 616.458.4394 or sstawski@shrr.com.

Elimination of the Homeowner Construction Lien Recovery Fund

On August 23, 2010, Governor Granholm signed into law Public Act 147 of 2010 which amends the Electrical Administrative Act, the Forbes Mechanical Contractors Act, the State Plumbing Act and the Occupational Code.

The law ultimately eliminates the Homeowner Construction Lien Recovery Fund. It reduces the contractor license fees by \$10 per year, retains the method for a homeowner to prevent a construction lien from attaching by filing an affidavit with the circuit court, and eliminates the felony penalty for submitting false information in order to receive payment from the Fund, given that the Fund is no longer in existence.

The Fund was originally established for the purpose of protecting homeowners from paying

for a construction project twice, should the contractor fail to pay its suppliers or subcontractors. However, the Fund has been insolvent since October 2009.

Even though the Fund has been eliminated, homeowners will remain protected from construction liens for home improvements or other home construction projects when they have already paid the contractors or builder. All that is required of the homeowner is the filing of an affidavit and evidence of the payment with the circuit court.

The new law was given immediate effect.

Lindsay Weber contributed to this article and can be reached directly at 231.486.4547 or lweber@shrr.com.

Acquiring Distressed Assets

By Jonathan J. Siebers, Attorney

Distressed assets come in many shapes and sizes, and the reasons why assets are distressed vary significantly as well. With respect to investment property, the asset may be distressed because the tenants within the property are suffering or because the property is simply being mismanaged. With respect to owner-occupied property, the property may be distressed because the owner's business is suffering or because the value of the asset has declined to such an extent that it no longer makes financial sense to make mortgage payments.

Whatever the reason for the distress, many distressed assets are coming on the market.

Though good deals can be had, purchasers need to be extra cautious when they consider acquiring a distressed asset because, no matter how great a discount the purchaser believes it is getting, savings can quickly turn into a drain on resources.

In light of the foregoing, following are five tips for anyone considering the acquisition of distressed commercial real estate:

1. Identify the Necessary Parties Early On

Most transactions relating to distressed real estate involve more than just the buyer, seller and buyer's lender. These days, the purchaser must

often negotiate with the seller's lender (if there is a short sale or if the lender is in possession of the property); with a receiver appointed by the court to protect the asset pending a sale, with a bankruptcy trustee if the owner of the asset is in bankruptcy, and with existing tenants in the event that issues exist between the owner and its tenants. The earlier the purchaser can identify each of the parties who will be involved, the earlier it can anticipate what each party will require to close the deal, and whether the deal remains worth doing.

2. Review Leases and Management Contracts Carefully

This step is absolutely critical when buying property subject to existing leases. The property may be distressed because the lease rates are well below market value. Alternatively, problems with the project may make it difficult to attract and retain quality tenants. If the leases or the tenants are problematic, the purchaser will want to know whether it will be stuck with those bad leases or if such leases can be terminated. At the same time, the purchaser will want to know what good leases will remain and what good tenants will have termination rights. If the property manager shares in the responsibility for the distressed nature of the asset, the purchaser will want to know whether it can change management companies.

3. Review the Title Work and Zoning Carefully

The real estate may be distressed because of the way it is being used, because of restrictions on the property or because of the way the property has been developed. If the purchaser intends to completely redevelop the property, it must first determine whether the intended redevelopment is allowed under zoning and under any covenants, conditions, restrictions or easements that are binding on the property. If the property is not properly zoned for the intended reuse or redevelopment, the purchaser will need to build into the purchase agreement sufficient time to explore a rezoning or a special use permit. If the

property is subject to restrictive covenants that prohibit the intended reuse or redevelopment, the purchaser will need to determine what consents are needed to amend the restrictive covenants and whether those necessary consents are likely to be obtained.

Additionally, many times the owner of the distressed property will have outstanding taxes that must be paid to prevent tax forfeiture or foreclosure. Any title analysis should confirm the full amount of the outstanding taxes, and the purchaser must ensure that those taxes are paid at or before closing. If the IRS or Michigan Department of Treasury have liens on the property for unpaid taxes, the purchaser must follow the proper procedures for getting those liens removed. The last thing the purchaser wants is to acquire the property and then lose it through a foreclosure by the taxing authority.

4. Conduct Thorough Inspections of the Improvements

In many instances, routine maintenance has long been neglected on distressed assets. As a result, much of the distressed real estate on the market will require significant work to bring the property back into shape. The purchaser should determine what maintenance and repairs must be made and whether the cost of the maintenance and repairs will be born by the purchaser or can be passed along to the tenants. If the repairs are significant and are the responsibility of the purchaser, the purchaser should determine whether it will have sufficient funds to make the necessary repairs or whether it will have to finance the cost of the repairs. In the latter situation, the purchaser should line up the financing for the repairs prior to closing on the acquisition of the distressed property.

5. Perform Environmental Due Diligence

If the price seems too good to be true, it may be. No purchaser wants to find that the property they

acquired for a song is actually a money pit due to contamination issues. The purchaser should get a Phase I. If the property is a “facility,” the purchaser may want to document the pre-existing contamination, and avoid liability for such contamination, through preparation of a BEA that is disclosed to the MDNRE.

Conclusion

At first glance, many properties on the market these days appear to be a great deal. However, as the layers are peeled away, the purchaser may discover that the great deal is not such a good deal after all. The initial investment may be small, but that investment can pale in comparison to the cost of significant capital improvements that must be

made to the property, the liability for contamination, or the continuing drain that results from bad leases for which the purchaser will be responsible. In short, to avoid getting stuck in a bad deal, every purchaser should do its homework carefully. While due diligence is important in any real estate transaction, it is even more critical when acquiring distressed commercial real estate.

Jon has represented developers, lenders, health care facilities, physician groups, minority investors, landlords, tenants, retailers, restaurants and other businesses with their commercial real estate needs. In addition, he represents lenders and borrowers in mortgage-based loan transactions and work-outs. He can be reached directly at 616.458.5298 or jsiebers@shrr.com.

Recent Amendments to the Real Estate Transfer Tax Act Bring Both Good News and Bad News

By Robert W. Parker, Attorney

In early 2009, the Governor signed into law some significant changes to Michigan’s State Real Estate Transfer Tax Act. Previously, in 1994, the Michigan Legislature elected to impose a state tax on real estate transfer in addition to the tax which had historically been imposed by counties. Since that time, uncertainty has existed as to whether or not the real estate transfer tax applied to the transfer of an interest in a corporation or limited liability company. With the recent amendments to the Act, there is both bad news and good news for these types of transfers.

The bad news is that, under certain circumstances, the Act now clearly applies to transfer of entity interests. The tax is imposed upon a *transfer* which is broadly defined to include “the conveyance of title to or other transfer of a present

interest or beneficial interest or any other interest in real property by any method, including the interest in real property acquired through the acquisition of a controlling interest in any entity with an interest in the property.” Thus, without a doubt, conveyance of an LLC membership interest can trigger a state transfer tax under the Act.

The good news is that the legislature has defined clearly what a controlling interest is that triggers a transfer tax. According to the revised definitional section of the Act, “[c]ontrolling interest’ means more than 80% of the total value of all classes of stock of a corporation; more than 80% of the total interest in capital and profits of a partnership, association, limited liability company, or other unincorporated form of doing business; or more than 80% of the beneficial interest in a trust.” MCL 207.522(a). Accordingly, the question of

whether a transfer of a 51% interest in an LLC constitutes a “transfer” for purposes of the Act has been answered in the negative. Further, the Act states that it applies to contracts for the transfer of a controlling interest “only if the real property owned by that entity comprises 90% or more of the fair market value of the assets of the entity determined in accordance with generally accepted accounting principles.” MCL 207.523(1)(c). Finally, a transfer of a controlling interest is exempt under the Act “if the transfer of the real property would qualify for exemption if the transfer had been accomplished by deed to the real property between the persons that were parties to the transfer of the controlling interest.” MCL 207.526(p)(iv).

The 2009 amendments do not affect the provisions of the Act that address conveyances between a limited liability company and its members or between a partnership and its members. So long as the members of a limited liability company own the affected real estate in the same proportion as they own their membership interests, and so long as the partners own the affected real estate in the same proportion as they own the partnership, such conveyances are exempt from the Act.

Despite the 2009 amendments, the Act is not without its gray areas. The amendments do not specifically address whether an individual’s conveyance of property to an entity as a capital contribution is a taxable transfer or falls without one of the exemptions where the individual receives less than a controlling interest, or where the affected real estate and the entity are not owned by the same people in the same percentages. Further, as described above, the Act contains an exemption for transfers between members and a limited liability company, and between partners and a partnership, where the affected real estate and the entity are owned by the same people in the same percentages, but the Act contains no similar exemption for transfers between shareholders and a corporation.

While these are perilous waters, there are also planning opportunities here, which if done correctly, may result in the avoidance of state transfer tax.

Robert focuses his practice on real estate law and has represented landowners, developers, business owners, lenders, municipalities, and individuals throughout Michigan. He can be reached directly at 231.486.4504 or rparker@shrr.com.

**SMITH HAUGHEY’S REAL ESTATE DEPARTMENT
NEWS & SUCCESS**

Craig Noland is one of 14 Smith Haughey attorneys who have been selected for inclusion in this year’s edition of *Michigan Super Lawyers*. In addition, **Steve Stawski** is one of two Smith Haughey attorneys who has been selected as a “Rising Star.” This publication lists outstanding attorneys who have attained a high degree of peer recognition and professional development.

Selections are made using a combination of peer reviews and third-party research.

Robert Parker and **Andy Blodgett** successfully mediated to a settlement the partition of a 60 acre parcel of property on Lake Michigan with 1/4 mile of frontage.

Ron Schuknecht is one of 15 Smith Haughey attorneys who have been selected for inclusion in this year's edition of *Best Lawyers in America*. This publication is regarded as the definitive guide of legal excellence and inclusion is based on peer-review surveys.

Jon Siebers has closed real estate transactions totalling over \$20 million since May 1, 2010. The transactions include a mix of traditional bank-financed acquisitions and seller-financed acquisitions. Additionally, **Jon** and **Robert Parker** recently represented a group of landowners in negotiating a form wind lease to be used in a 56-turbine wind project.

Jon Siebers and **Steve Stawski** have recently delivered multiple in-house presentations on troubled assets and lender liability to commercial real estate firms.

Steve Stawski obtained summary disposition for a client bank to preserve its mortgage interest in a downtown condominium and for a client township and tax assessor in a slander of title action arising from a land contract. He also recovered property on behalf of a bank client in a condominium site development, successfully represented a real estate appraiser in a state licensing action, and negotiated a re-conveyance of a tax-foreclosed property for a national special servicer to benefit owners who are deployed in the military.

Mark Your Calendar!

Thursday, October 28, 2010

Hagerty Center at Northwestern Michigan College - Traverse City

The real estate, development, and construction industries in Michigan are in the midst of a difficult transition period. To survive, each has had to adapt by embracing non-traditional and emerging tactics to doing business.

Smith Haughey will present a free seminar for real estate, development, and construction professionals where we will discuss the opportunities and risks presented in the current economy, as well as specific tips for protecting your business and keeping an eye toward the future.

Watch your mail for more information to arrive in the coming weeks.

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