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From the Desk of

The Real e-ditor
Steven D. Sallen

Much ink has been spilt in the past several weeks, concerning the Michigan legislature's supersonic passage of P.A. 67 of 2012. First introduced as Senate Bill 992 on February 29, 2012, Public Act 67 (P.A. 67) was signed into law by Governor Snyder just four weeks later, to the day. This new law is intended to remedy the effect of a small handful of wrongly decided cases which could leave Michigan unique among the fifty states (and not in a good way!) for its treatment of Commercial Mortgage-Backed Securities (CMBS) loans; exposing the personal guarantors of the so-called "bad-boy carveout" provisions, to personal liability for the entire debt or deficiency amount after foreclosure. You could almost hear a collective and audible sigh of relief from Michigan's real estate community when this law was passed. But, as they say…"*it ain't over 'til it's over!*"

The case that has garnered most of the notoriety is the *Cherryland Mall* case, discussed on these pages in our January Real e-State Newsletter. Various industry trade groups weighed-in with *amicus* briefs during the Court of Appeals' proceedings. Their arguments included that, if the case was not reversed, Michigan would be an outlier in the country; the one and only state where uniform contract language was being interpreted, so as to create full recourse liability, in what were uniformly understood and intended, by both the borrowers *and* lenders (at the time of their making), to be non-recourse loans. Nevertheless, to the shock and collective dismay of the real estate community in Michigan, the Court of Appeals affirmed the trial court decision.

Now, *Cherryland* has moved on in the process, and is pending in the Michigan Supreme Court. So why, you may ask, isn't that case simply dismissed, now that P.A. 67 is law? The plaintiff's counsel in that case, through various public statements, has indicated the plaintiff's intention to challenge P.A. 67 on Constitutional grounds. The plaintiff will argue that P.A. 67's retroactive application to loans already on the books, and even decisions already rendered in the courts of Michigan, is unconstitutional. So for now, the *Cherryland* decision remains the law in Michigan and P.A. 67 stands in diametric opposition to it. A standoff between two of the three branches of government.

Apparently, the Constitutional issue will be raised, but where? Since P.A. 67 did not exist and was not addressed during the Court of Appeal proceedings, we wonder whether the Supreme Court will even allow the defendant in *Cherryland* to invoke it. If so, perhaps, game over.

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Court of Appeals Expands Rights of Construction Lien Claimants

By: Kasturi Bagchi

In a recent case,[1] the Michigan Court of Appeals concluded that test wells installed during a buyer's due diligence constituted "first actual physical improvements" under the Michigan Construction Lien Act (the "Act"), and the plaintiff's construction lien was held to have priority over a mortgage recorded prior to such lien.

The Act provides that a construction lien has priority over all other interests recorded after the first actual physical improvement.[2] The first actual physical improvement is statutorily defined as:

> an actual physical change in, or alteration of, real property as a result of labor provided, pursuant to a contract … which is readily visible and of a kind that would alert a person upon reasonable inspection of the existence of an improvement. Actual physical improvement does not include that labor which is provided in preparation for that change or alteration, such as surveying, soil boring and testing, architectural or engineering planning, or the preparation of other plans or drawings of any kind or nature. Actual physical improvement does not include supplies delivered to or stored at the real property.[3]

In the *Mackenzie* case, before purchasing 93 acres in Raisin Township (the "Property"), the prospective buyer ("Buyer") engaged a contractor ("Contractor") to perform well testing. When the Contractor finished the work by the end of August 2006, eight wells were drilled and located on eight lots over the Property. The PVC pipes of these wells extended about five feet above ground. On September 29, 2006, the Buyer purchased the Property and simultaneously granted a mortgage in favor of United Bank which was recorded on December 11, 2006.

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Updated Title Company Underwriting Standards May Influence Transactions

By: Danielle M. Spehar

Many participants in the commercial real estate market are beginning to discover that title company underwriting decisions may more specifically impact their transactions and their ability to obtain title insurance and/or to eliminate certain exceptions to title. Some of the changes in underwriting appear to have originated from the underwriters' risk assessment in less traditional transactions, while others appear to be the result of a proliferation of title claims during the real estate market crash.

One example is the inability to obtain tax deed title insurance without first bringing a quiet title action. Certain title underwriters have determined that they simply will not insure title acquired through a tax foreclosure without the grantee initiating a quiet title action and obtaining a judgment in their favor prior to issuance of a title insurance policy. Other underwriters have determined that they will rely on private professional certification services which eliminate the quiet title action in lieu of the company's review process. The certification process is normally completed within 45 to 60 days and the service will cost $750.00 to $1,500.00 on average, plus certain hard costs depending on the property value. Once the tax foreclosure is certified, certain title insurers who otherwise will not insure tax deeds, will issue title insurance without a quiet title action. In the event of a failure in the tax sale process, such that the property cannot be certified, owners may still pursue a quiet title action having incurred only the hard costs of a review fee and title search fee.

What these underwriting decisions mean to owners or buyers in cases of transactions involving a tax deed, is that it is important to select the title company carefully to insure that all options are available, and that the certification process can be coordinated as early as possible to assure, before closing, the availability of title insurance.

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Raining on FEMA's Parade: Amending Flood Zone Property Maps to Remove Your Property From A Special Flood Hazard Area

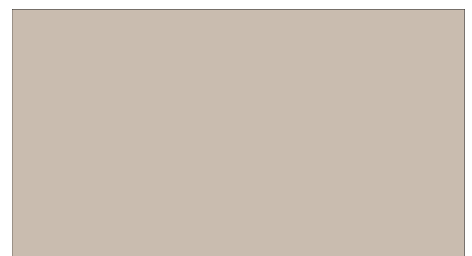
By: Richard F. Roth And Daniel U. Warsh

Most consumers today are familiar with a cartoon lizard who, in a charming Australian accent, reminds us that a mere fifteen minutes of our time can translate into a fifteen percent or more savings on our car insurance. What the gecko does not tell us, however, is that that fifteen minutes could be used to save one hundred percent on flood insurance.

If you or your clients own or manage property located in a designated Special Flood Hazard Area ("SFHA"), it may be possible to have that property removed from the SFHA through a Federal Emergency Management Agency ("FEMA") map amendment. If the amendment petition is granted, the property will be exempted from otherwise applicable development restrictions as well as mandatory (and costly) flood insurance requirements. This ultimately translates into more money in the property owner's pocket, whether the property is being sold or developed. Although the process cannot be completed in fifteen minutes, the process may take as little as three or four months, provided that the proper topographical and engineering maps are readily available. Recently, our office successfully amended a flood zone map in less than four months.

The SFHA is that area which, according to FEMA, has a one percent or greater chance of flooding in any given year. Property located in a SFHA, at its lowest point, lies below the Base Flood Elevation ("BFE"). FEMA estimates that a structure located within a SFHA has a roughly 26 percent chance of flooding over the course of a traditional 30 year residential mortgage term, or once every one hundred years. Often times, only a part of a given parcel is located in a SFHA, and the balance of the parcel is actually above the BFE. The higher elevation portion of property (which may be the developed or developable portion) may not be required to carry flood insurance or be subject to development regulations.

FEMA maintains the National Flood Insurance Program ("NFIP") which is responsible for handling various matters related to floods and flood insurance, including establishing flood zone maps and setting insurance requirements within them. These maps often remain unchanged for decades at a time, and are sometimes based on outdated or inaccurate elevation data. This is just starting to change, as technology allows for the drafting of more advanced elevation maps, and municipalities all over the country are slowly adopting and commissioning revisions to local maps. Given the fiscal climate in many municipalities, however, this process is an arduous one, and property owners would be ill-



advised to passively wait for their local governments to take action.

Because of the general nature of the FEMA Flood Insurance Rate Map ("FIRM") drafting process, it is also possible that a property may be misclassified or assigned a higher level of risk than is appropriate. Further compounding the problem is that property owners typically have no notice of, nor little say concerning, a classification or reclassification of their property by FEMA. Regardless of how a property comes to be located within a SFHA, it is the classification itself which should be of utmost concern for the property owner, because such classification directly affects the owner's bottom line.

Numerous studies have shown that properties located within the SFHA may be more costly to own than their comparable non-flood area counterparts, even if there has never been a flood on the parcel. In response to federal mandates, floodplain development restrictions have been established in many communities to minimize loss of life and damage to property within flood zones. Consequently, property deemed to be within a SFHA may be significantly devalued because of these stifling development restrictions. Certain land uses may be expressly prohibited on property located in an SFHA, even if those uses would otherwise be acceptable. Additionally, the NFIP mandates that if a property is sited in a SFHA and is in any way associated with federal dollars (including receiving funds from a federally-backed mortgage lender), the borrower must maintain flood insurance coverage, which can cost thousands of dollars per year.

If FEMA grants a property owner's appeal, the federal flood insurance purchase requirement, as a condition of receiving federal funds (including those from a federally-backed mortgage lender), is eliminated. However, it is important to note that mortgage lenders retain the prerogative to require flood insurance as a condition of providing financing, regardless of the property's SFHA classification. FEMA recommends that flood insurance always be purchased, even if a given property is located outside of an SFHA. Finally, notwithstanding FEMA's removal of a given property from the SFHA, that does not mean the property is safe from all flooding; it only means that the risk of flooding is not as high as within the SFHA. Events greater than the one percent annual chance event can and do occur, so it is important for property owners to carefully weigh the decision to carry flood insurance.

Navigating the FEMA administrative procedures for amending SFHA maps can be a daunting task, and is one that is best pursued with competent legal guidance. But, it is important to know that FEMA maps can be amended.

By: Steven D. Sallen

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If not, however, the defendant will have to continue trying to overturn *Cherryland* on its merits (or lack thereof). If the Supreme Court does overturn *Cherryland* on its merits, then P.A. 67 may be rendered moot; especially if the Supreme Court renders a well-reasoned decision that prevents similar cases from ever being brought again in Michigan.

But if the Supreme Court refuses to dismiss the case on the basis of P.A. 67, and if *Cherryland* again shocks us with an unexpected decision, then presumably the plaintiff will attempt to execute on its judgment against the guarantor for the loan deficiency. We would then expect the defendant to invoke P.A. 67 to stop execution on the judgment. That could be the beginning of a lengthy court battle over the Constitutionality of P.A. 67. Such a battle might begin at the trial court level, and then work its way through the Court of Appeals and, perhaps again, to the Supreme Court. If that scenario plays itself out, we could still be more than a year from knowing whether CMBS lenders can do unto you, what they did to the principals of *Cherryland Mall.*

Temporary Regulations on Deduction v. Capitalization of Tangible Property

By: William E. Sigler

The IRS issued temporary regulations in late 2011 regarding the treatment of expenditures incurred in selling, acquiring, producing or improving tangible assets. The temporary regulations are generally effective for tax years beginning on or after January 1, 2012. The regulations provide guidance as to whether costs related to tangible property are currently deductible repairs, or capital improvements that are deducted over a period of years. The

regulations provide that a unit of property is improved if the amount paid or activities performed after the property is placed in service by the taxpayer results in a betterment of the unit of property, restores the unit of property, or adapts the unit to a new or different use. The temporary regulations treat the unit of property for a building as the building and its structural components (walls, partitions, floors, windows and doors, etc.). However, in determining whether an amount paid is for an improvement to a building, the temporary regulations require the taxpayer to consider the effect of the expenditure on certain specifically defined components of the building, instead of the building and its structural components as a whole.

As a result, a taxpayer will be required to capitalize a cost that results in an improvement to the building structure (building and its structural components) or any of the specifically enumerated building systems:

- HVAC system;
- plumbing system;
- electrical system;
- all escalators;
- all elevators;
- fire protection and alarm systems;
- security systems; and
- gas distribution systems.

The temporary regulations do not change the rules for depreciable lives, bonus depreciation, or the availability of cost segregation studies to take advantage of shorter depreciable lives, if it is determined that the expenditure must be capitalized. Prior to 2012, taxpayers were required to capitalize and depreciate the cost to replace a structural component of a building, and to continue to recover the cost of the original structural component. For example, if a taxpayer capitalized the cost of replacing an entire roof the taxpayer would have to continue depreciating the removed roof, and at the same time, capitalize and depreciate the replacement roof over the same recovery period as the building. The temporary regulations revise the definition of disposition, so that a taxpayer may treat the retirement of a structural component of a building as a disposition of property. Most taxpayers will need to change their method of accounting to comply with the new regulations. The IRS indicated that they would issue revenue procedures that provide transition rules for taxpayers changing their method of accounting, and they subsequently issued Rev. Proc. 2012-19 and Rev. Proc. 2012-20. The regulations require that taxpayers make Code Section 481(a) adjustments to prevent duplicated or omitted tax benefits. Taxpayers will, in effect, have to apply the new rules to costs incurred prior to the effective date of the regulations. As a result, some taxpayers may have to capitalize amounts they previously deducted, and recognize income based on the difference in treatment. Conversely, other taxpayers may be able to deduct amounts previously capitalized, and take a deduction for the difference.

Updated Title Company Underwriting Standards May Influence Transactions

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Another example of underwriting considerations impacting transactions is a determination by several of title insurance companies that they will no longer remove exceptions for construction liens recorded against a property in the circumstance of a foreclosure by advertisement of a mortgage against the property. The basis for this decision is that in the context of foreclosures by advertisement, there is no determination of priority of liens. Conversely, underwriters will insure title and delete exceptions for subordinate liens in cases of judicial foreclosure, where the court makes a determination of priority.

There may be many practical reasons, however, why mortgage lienholders do not wish to incur the time and expense associated with judicial foreclosure. What this means to us is that although subordinate liens are often extinguished by foreclosure of the first priority mortgage (*i.e.*, where there are no proceeds of foreclosure sale left over to pay junior lienholders), title insurance may not be available to insure against junior liens recorded against the property unless there is a judicial foreclosure. Consequently, if a junior lien claimant brings an action after closing, the new owner will bear the expense of defending against the junior lienholder's tardy enforcement efforts.

One final example of how title underwriting has changed is that many of the largest title insurance companies will no longer issue title insurance policies in connection with a deed-in-lieu of foreclosure that was held in escrow. A deed-in-lieu of foreclosure is often held in escrow, after a borrower defaults and the lender agrees to forbear from enforcing its rights for a period of time while the borrower attempts to secure replacement financing. In exchange for the time, the borrower delivers the deed-in-lieu, to be held in escrow by the lender or its counsel to be released upon a further default.

In the past, lenders who record such deeds held in escrow have been able to obtain an owner's title insurance policy insuring their title. Recently, however, information has been disseminated by many of the large, national title insurance companies that they will no longer insure title obtained under such circumstances. Two of the main reasons for this underwriting decision are that title insurance companies are fearful of being involved in litigation over claims that the deed-in-lieu was improperly or prematurely released from escrow, and that they fear that other creditors may attack the deed-in-lieu if it turns out that the value of the collateral increased from the time that the deed-in-lieu was placed in escrow to the time that it is actually recorded, resulting in the lender receiving a windfall.

These examples suggest that additional consideration must now be given to title matters, earlier in transactions. It is no longer safe to assume that certain title matters can simply be insured over. However, in most cases, if dealt with timely, such matters can be addressed in a satisfactory manner, but in some cases, underwriting may dictate that owners must conduct their own risk analysis to determine how to structure a transaction in light of the fact that certain transactions may not be insured.

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Then on May 21, 2007, the Buyer and a development firm ("Developer") entered into a contract to develop the Property. Developer started construction on May 29, 2007 and completed on November 20, 2007. Developer recorded a claim of lien against the property for $325,008.30 and filed suit against the Buyer. Developer subsequently filed a motion for partial summary judgment on the issue of priority between its lien and United Bank's mortgage. "The trial court found that the mortgage was recorded before the first actual physical improvement because… the Contractor's test wells did not meet the statutory definition of an actual physical improvement." The trial court ruled that the mortgage had priority over the lien for the most part.[4]

The Michigan Court of Appeals, however, rejected the findings of the trial court and concluded that the Contractor's test wells did in fact constitute the first actual physical improvements; therefore, Developer's lien had priority over the previously recorded United Bank mortgage. While recognizing that MCL 570.1103(1) specifically excludes certain due diligence processes as an actual physical improvement, such as surveying, soil boring and testing, the Court repeated its ruling from a prior case,[5] and concluded that the statutory exemption does not apply to due diligence activities such as digging wells that "leave a permanent presence" and are "readily visible and of a kind that would alert a person upon reasonable inspection of the existence of an improvement." The Court also dismissed United Bank's assertion that Developer's lien could not have priority because its work was unrelated to the test drilling done by the drilling contractor. Simply put, the Act does not require the work resulting in the construction lien to bear any relationship with the first actual physical improvement.

As a result of these recent cases, lenders and title companies must be sure that a purchaser has performed no due diligence activities that are "readily visible" or "leave a permanent presence." In particular, lenders should perform a thorough site inspection to verify that no activity has taken place prior to closing. Title companies may also require a disclosure from a purchaser in an affidavit at the time of closing that confirms that no "readily visible" due diligence was conducted. Alternatively, if purchasers have completed due diligence acts that could be deemed an "actual physical improvement", then lenders may require a subordination agreement as a condition precedent to closing the transaction.

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[1]*E.T. Mackenzie Company v. Sutton Place-Raisin Township, L.L. C. and United Bank & Trust.* Unpublished opinion issued November 22, 2011, Docket No. 297864 (2011 WL 6186822).

[2]MCL 570.1119(3)

[3]MCL 570.1103(1)

[4]Notably, the United Bank mortgage was for a construction loan and a portion of the disbursements were not verified by sworn statements and lien waivers.

[5]*Mich Pipe & Valve-Lansing, Inc v. Hebeler Enterprises, Inc*, ____ Mich App____; NW2d__ (Docket No. 294530, issued May 3, 2011).

www.maddinhauser.com
28400 Northwestern Highway
Third Floor, Essex Centre
Southfield, Michigan 48034

Phone: 248-827-1861
Fax: 248-359-6161

The Real e-State Staff:

EDITOR-IN-CHIEF
Steven D. Sallen
ssallen@maddinhauser.com

CONTRIBUTING EDITORS
Danielle M. Spehar
dspehar@maddinhauser.com
Kasturi Bagchi
kbagchi@maddinhauser.com

GUEST WRITERS
Richard F. Roth
rroth@maddinhauser.com
Daniel U. Warsh
dwarsh@maddinhauser.com
William E. Sigler
wsigler@maddinhauser.com

LAYOUT EDITOR
Tracy L. Farley
tfarley@maddinhauser.com

Maddin Hauser Wartell Roth & Heller, P.C.

Members of

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