APPELATE COURT APPLIES NO NONSENSE APPROACH IN FORECLOSURE PROCEEDINGS  
BY: KASTURI BAGCHI

On May 15, 2007, the Detroit News reported that there was one foreclosure filing for every 614 Michigan households during the month of April, thereby awarding Michigan with the dubious distinction of being the state with the tenth highest foreclosure rate in the nation. The good news is that the April foreclosure rate was much lower than in January, creating a sense that the worst may be over. What’s the bad news? On the same day that this Detroit News article was published, the Michigan Court of Appeals revealed its no nonsense approach to handling foreclosure proceedings in Sweet Air Investment, Inc. v. Kenney, No. 265691 (May 15, 2007), which may be a source of concern to Michigan mortgagors.

In Sweet Air, the mortgagor purchased 66 continuous acres consisting of three different tax parcels. The property was improved by an 8,000 square foot main house, 5 outbuildings, dog kennels, and a caretaker’s home. The mortgagor resided at the main house, located at 300 Marr Lake Road (the “Main Parcel”) and used the property to raise show dogs. The caretakers resided at the caretaker’s home, located at 750 Marr Lake Road (the “Caretaker Parcel”), which was connected to the Main Parcel only by a bridge. When the mortgagor defaulted on a loan secured by all 66 acres, the lender instituted foreclosure proceedings and received a sheriff’s deed at the sale. The lender then quitclaimed all 66 acres to Sweet Air Investments which then sought possession of the property and commenced eviction proceedings.

The mortgagor sought protection under MCL 600.3224 arguing that the Main Parcel and the Caretaker Parcel were distinct parcels separately occupied by the mortgagor and the lender. However, the Michigan Court of Appeals rejected this argument, holding that the parcels were part of a single 66 acre parcel, and that the mortgagor was liable for the entire 66 acres.

In spite of the public policy goal of insuring redemption rights, the ruling in Sweet Air suggests a literal approach in applying the law as well as a reluctance to favor mortgagors who have waited too long to object to foreclosure proceedings.

AVOIDING AN UNINTENDED RELEASE OF A PERSONAL GUARANTOR IN A COMMERCIAL LEASE  
BY: DANIELLE M. SPEHAR

Getting the principal of a commercial tenant to sign a personal guaranty for a lease is like pulling teeth. Because the negotiation process can be difficult, many landlords rely on a standard guarantee clause that often states the guarantor remains liable despite any modifications, extensions, or renewals of the lease, to avoid asking the principal to execute a new guaranty when the existing lease expires and a new lease is signed. Unfortunately, this may not be a sound business practice. Without the guarantor’s consent to become liable under the new lease, you may end up inadvertently releasing the guarantor from further liability under the guaranty.

In a recent Ohio Court of Appeals case, Samsel Rope & Marine Supply Co. v. Gray, a landlord learned this lesson the hard way. The facts of the Samsel case were quite typical. The tenant’s principal signed a personal guaranty of the tenant’s obligations under a 1985 lease. The guarantor died in 1994 and the tenant’s assets were assigned to a new principal. The lease was scheduled to expire by its terms on August 31, 1995, but provided the tenant with an extension option.

But wait, we here in Michigan have been sweating out a weak economy for years. Could it be that the rest of the country is just now catching up to Michigan? Does that mean that maybe, just maybe, we’ll lead the way out of the weakness first? Coincidentally, GM reported an unexpected rise in stock prices and an otherwise promising summer now looks worrisome. Lenders are rethinking in our entire area.

Steven D. Sallen  
Editor-in-Chief
The marketplace has dictated that some apartment buildings are more profitable if converted to condominiums. Apartment building owners face a dilemma – if they sell their building intact to a condominium converter, they will pay capital gain tax (15-25%), but will not share in the profits from individual condominium sales. If they do the conversion themselves, maximizing their economic profit, then the conventional wisdom is that they will pay tax at ordinary income rates (up to 35%) on individual unit sales. This increased tax load could outweigh the additional profits of conducting the conversion.

This article briefly explores three methods of enabling an apartment owner to reap condominium conversion profits without losing capital gains tax rates.

In tax terms, “dealer” means a taxpayer who holds property primarily for sale to customers in the ordinary course of a trade or business. Dealers in real estate pay ordinary income tax because their real estate sales are like an auto dealer’s car sales, just profits in the everyday operation of a business. However, rental properties are deemed to be held for use in the rental business, not held for sale. Since rental properties are held for a business/investment use, their sale produces capital gain. Typically, the sale of rental properties produces a substantial amount of capital gain because, even if economically the sale is a break-even, the taxpayer’s basis in the property is low due to years of depreciation deductions which reduce the cost basis for tax purposes.

Example: assume Fred buys an apartment building for $2 million. He owns it for 10 years and deducts $800,000 in depreciation, leaving him with $1.2 million of basis left. If the building were sold for $2.7 million, Fred would have $1.5 million in capital gain ($700,000 economic gain taxed at 15% and $800,000 recovery of past depreciation taxed at 25%). This translates to $305,000 in tax. Assume instead Fred converts the building and enters the everyday business of selling condominiums as inventory, ultimately selling them all (net of costs) for $3 million, an extra $300,000. Fred now has $1.8 million of ordinary income taxable at 35%, resulting in tax of $620,000. Thus, Fred actually loses $15,000 on the conversion – though he gets an extra $300,000 in profits, his tax bill goes up by $315,000.

**TAX STRATEGY AND CONDO CONVERSIONS**

**BY: MICHAEL K. HAUSER**

**PRE-CONVERSION SALE TO 50%-OWNED ENTITY.** The easiest method to allow capital gain on the conversion involves selling the building to a 50%-owned entity. In the example above, Fred would sell the building for $2.7 million (its value as a rental building) to Fred-Joe Corp., an entity half-owned by his partner Joe. This new corporation would do the conversion and collect the $300,000 in net conversion profits (taxable at 35%), but Fred’s sale would produce $1.5 million of capital gain taxable at 15-25%. Joe and Fred would have to be even-steven shareholders in all respects. Joe must own 50% because a sale of depreciable property between “related entities” produces ordinary income under Section 1239 of the tax code. An aggressive seller could attempt to capture additional conversion profits by taking a high-interest note back from the purchasing entity or by taking a contingent interest “kicker” or participation right in the purchaser’s later sale proceeds. The 50%-line could get tested, and possibly crossed, if the seller’s “kicker” is considered a disguised form of equity in the new corporation.

**ORDERLY LIQUIDATION.** Though the conventional wisdom is that converting an apartment building into condominiums will bar capital gain, actual cases on the subject are mixed. There are cases, most notably Gangi, holding that the conversion of apartments into condominiums can be classified as merely the “orderly liquidation” of an investment, with the conversion activities too insubstantial to amount to the everyday “trade or business” of selling condominiums.

Relying on this method is generally frowned upon by practitioners due to its uncertainty, as compared to the pre-conversion sale. However, in the Parkside case (571 F2d 1092 (9th Cir. 1977)), the roles were reversed and the IRS argued for the “orderly liquidation” theory since capital asset status was preferable to the IRS for other reasons. The fact that some cases approve of this method, coupled with the fact that even the IRS sometimes argues for this method, indicates that it has some validity in the right circumstances, especially where the pre-conversion sale is not practical. The liquidation strategy can best be employed where (1) the evidence indicates that the taxpayer had a strong rental intent but made the conversion based on unforeseen circumstances which were out of the ordinary course of business; (2) the conversion-related physical renovation work is minimal; (3) the building has relatively few units, and (4) the sales, brokerage and advertising efforts are not excessive or prolonged.

In conclusion, careful advance planning can avoid the heavy tax burden of recognizing all ordinary income on the sale of a depreciated apartment building as condominiums. The pre-conversion sale is generally the preferred method, with 50%-common ownership generally considered safe and above-50% considered aggressive but justifiable. In some cases, the liquidation theory may be adequately supported by the facts.

**NOTE:** For additional reading on this topic, please e-mail our office to request a copy of additional articles authored by Michael K. Hauser entitled “Avoiding ‘Dealer’ Status to Obtain Capital Gains” and “Dealer Status and the Condominium Conversion” which appeared in *Real Estate Taxation*, a WG&L journal.
The trial court ruled in favor of the mortgagor and set aside the foreclosure sale. It found that the mortgaged property was made up of two distinct parcels that were occupied separately and the lender should have sold them separately. However, the Court of Appeals reversed the ruling of the trial court because the statute "require[s] the sale of individual parcels or property covered under a single mortgage only when those parcels are in fact physically separated and not interconnected or integrated in their use or occupancy." In this instance the properties were "physically connected and... accessible to each other by a bridge". The court emphasized that in cases where sales were set aside pursuant to MCL 600.3224, the parcels making up the mortgaged property were separated by a mile or were not continuous. The court also found it noteworthy that the Main Parcel and the Caretaker Parcel were purchased and mortgaged as one property. Furthermore, "the caretakers occupy the caretaker's home for the purpose of maintaining the dog kennels and the entire property. This factor makes the Caretaker Parcel an integral part of the Main Parcel and to the functioning of the entire property's current primary use, which is to raise show dogs." Finally, the court noted that forcing separate sales would land lock the Caretaker Parcel from the highway and impair the value of the property as a whole.

The mortgagor also attempted to have the foreclosure set aside for lack of adequate notice but this also was rejected by the Court. Even if the lender did actually fail to provide notice as required by statute, the foreclosure sale would not be set aside because there was no prejudice to the mortgagor. The mortgagor never timely challenged the validity of the foreclosure sale, nor did they make any "effort to redeem or take any action until well after the redemption period had" expired. In fact, the mortgagor did not take any action until eviction proceedings had commenced.

In spite of the public policy goal of insuring redemption rights, the ruling in Sweet Air suggests a literal approach in applying the standards of MCL 600.3224 as well as a reluctance to favor mortgagors who have waited too long to object to foreclosure proceedings. Michigan mortgagors should be aware of this and promptly seek legal counsel if they receive notice of foreclosure from their lender.

Guaranty (Continued from Page 1)

In September 1994, the landlord and tenant signed a new agreement by which they agreed to be bound by the terms of the original lease for an extended term ending in 2004.

In 2002, the tenant defaulted. The landlord sued the tenant and obtained a judgment for $513,000. The landlord then sued the guarantor’s estate claiming it was liable for those tenant’s obligations under a new lease. In these situations, it is advisable to address the issue head-on as opposed to relying on the language of a guaranty only to be disappointed when trying to enforce the guarantor’s obligations after a default of a new lease by the tenant.