

An electronic newsletter for real estate professionals



From the desk of:



The Real e-ditor
By: Steven D. Sallen

“The actual enumeration shall be made within three years after the first meeting of the Congress of the United States, and within every subsequent term of 10 years, in such manner as they shall by Law direct.”

U.S. Constitution, Article I, Section 2



2010 is another Census year. The United States Census counts every resident of the U.S. and is required by the Constitution to take place every 10 years. Data collected by the Census helps determine, among other things, the number of House of Representatives seats in each state, the allocation of over \$400 billion in federal funds for hospitals, senior centers, schools, public works projects and services.

Participation is not only important, it's mandatory.

Since we here in Michigan will soon be re-counted, I was curious to know how the 2000* Census numbers compared, by percent and the like, to the entire United States tally. Here is how Michigan compared in the last Census:

	MI 2000	US 2000	MI 2010
Persons under 5 years old	6.3%	6.9%	?
Persons 65 years old and over	13.0%	12.8%	?
Female persons	50.8%	50.7%	?
Foreign born persons	5.3%	11.1%	?
High school graduates	83.4%	80.4%	?
Mean travel time to work (minutes)	24.1	25.5	?
Homeownership rate	73.8%	66.2%	?
Median value owner-occupied housing	\$115,600	\$119,600	?
Persons per household	2.56	2.59	?
Median household income	\$48,606	\$52,029	?
Persons per square mile	175.0	79.6	?

All down the line, Michigan seemed fairly close to the U.S. median, although home values and household income lagged a bit. However, I strongly suspect we may not look so good in 2010, when compared to national averages. We will fill in that last column, with the 2010 Census information, when it is available. Stay tuned!!

**Some of these numbers were adjusted as of 2008.*

Steve Sallen

SAFE HARBOR FOR FAILED SECTION 1031 EXCHANGES

BY: WILLIAM E. SIGLER



The IRS recently issued Revenue Procedure 2010-14, which provides a safe harbor method of reporting gain or loss for certain taxpayers who initiate deferred like-kind exchanges under Section 1031 of the Internal Revenue Code, but fail to complete the exchange because a qualified intermediary defaults on its obligation to acquire and transfer replacement property to the taxpayer.

Section 1031 provides that capital gain or loss is deferred when business or investment real estate is exchanged rather than sold. The exchange does not have to be simultaneous. In fact, in most cases it is not. Typically, the property the taxpayer desires to exchange is conveyed before the replacement property is acquired, although it is also possible to acquire the replacement property first, and then sell the exchange property. In either case, there are strict rules and timelines that must be followed.

In the usual transaction, the taxpayer enters into an agreement to sell the property to be relinquished. The contract is assigned to an intermediary, which is often a title insurance company or other company specializing in like-kind exchanges. The intermediary completes the sale and collects the proceeds. The taxpayer then has 45 days to identify replacement property, and 180 days to close on the purchase of the replacement property. At closing, the intermediary pays the purchase price to the seller, and the seller conveys title to the taxpayer.

As a reflection on the state of the economy, and particularly the commercial real estate market, many taxpayers have

been unable to complete like-kind exchanges because the intermediary they used (and their exchange proceeds!) has gone into bankruptcy or receivership. Ordinarily, this would result in the taxpayer having to recognize any gain or loss on the sale of the relinquished property, even though the proceeds of sale may be tied up for months in the intermediary's bankruptcy proceedings. Revenue Procedure 2010-14 provides relief in this situation.

“Under Revenue Procedure 2010-14, the taxpayer is not required to report gain from the failed exchange until a payment is received.”

Under Revenue Procedure 2010-14, the taxpayer is not required to report gain from the failed exchange until a payment is received. At that time, the portion of any payment attributable to the relinquished property that is recognized as gain is determined by multiplying the payment by a fraction, the numerator of which is the taxpayer's gross profit and the denominator of which is the selling price. In certain circumstances, a taxpayer may be able to claim a loss deduction.

This relief is available to taxpayers who have a like-kind exchange that fails after December 31, 2008, due to the intermediary's default. A taxpayer who is already in this position can file an amended return.

This is a prevalent problem, and Revenue Procedure 2010-14 is not exhaustive. The IRS has requested comments by April 12, 2010, on issues requiring additional guidance. Feel free to call us at any time for further developments.

NON-RECOURSE LOANS REQUIRE CAUTION IN FORECLOSURE CIRCUMSTANCES

BY: STEVEN D. SALLEN



Most non-recourse loans were never really, fully, non-recourse. Even in non-recourse deals, one or more of the principals of the borrower typically executed personal guarantees of the so-called “bad boy” carveouts. These carveout guarantees would provide for springing recourse (i.e., the entire loan balance would become fully recourse to the guarantors) upon the happening of certain events, such as: missing the very first payment, filing of a petition in bankruptcy, or breaching the due-on-sale provisions of the mortgage. These are fairly bright-line events that most borrowers have control over and can avoid. For example, don’t file for bankruptcy!

But there is a separate group of carveouts providing for personal liability up to the extent of “damages” suffered by a lender for certain other borrower acts or failures. A typical (but by no means, exhaustive) list of such carveout liabilities includes:

- Fraud or intentional misrepresentation by a borrower in connection with the loan;
- Damage on account of the gross negligence or willful misconduct of borrower;
- The removal or disposal of any portion of the property;
- Misappropriation or conversion of rents received by borrower after the occurrence of an event of default;
- Misappropriation or conversion of tenant security deposits or rents collected in advance, except to the extent they may have been applied in accordance with the terms of any lease;
- Misappropriation or conversion of the proceeds of insurance or award given in condemnation;

- Personal property removed from the property by or on behalf of borrower and not replaced with personal property of similar utility and value;
- Any fees or commissions paid by borrower to a related party;
- Failure to pay charges for labor or materials resulting in filing of a construction lien against the mortgaged property;
- Borrower’s breach of environmental representations, warranties or covenants; and
- Attorneys’ fees and court costs of enforcing carveout liabilities.

“... pre-foreclosure planning is essential for borrowers and their principals, to avoid personal liability for things they may have long since forgotten about or overlooked.”

Most borrowers paid these provisions little mind when entering into mortgage loans, believing themselves to be fully insulated from personal liability by the general non-recourse nature of the loan, their lack of malicious intent, and by significant equity in the collateral, which equity was expected to grow as the loan was paid down and the property appreciated over time. However, with the real estate market now on its head, failing to understand the impact of, and to plan in the face of these carveout provisions upon occurrence of a loan default, could have serious financial repercussions to the carveout guarantors, thereby adding further economic injury.

As lenders cope with mounting foreclosures, and mortgage balances exceed property values, they are looking for any way they can to minimize their losses, even in non-recourse loan situations. Notwithstanding

the moniker “bad-boy” carveouts, malicious intent is not a requisite to liability under one or more of the carveouts. Consequently, pre-foreclosure planning is essential for borrowers and their principals, to avoid personal liability for things they may have long since forgotten about or overlooked.

A prime example is security deposits. Most borrowers would agree that upon foreclosure they must and will turnover any security deposits held on account of tenant leases. However, most landlords “hold” security deposits by means of a liability kept on the journal books of the property; they don’t actually maintain a separate security deposit account, except in the multi-family housing/apartments sector where state laws may mandate holding security deposits in a segregated account. Chances are that in most commercial leasing situations, security deposit monies were used to pay for brokerage commissions, tenant improvements and other expenses incurred concurrently with new lease signings. Now, flash forward several years to today, when property owners must set aside those security deposit dollars in order to pay them to their foreclosing mortgagee, or risk personal liability up to the amount of aggregate security deposits. A foreclosing mortgagee may take the position that setting aside those dollars, especially after (or, perhaps, even in preparation for) a loan default is actually a misappropriation of rental income. This puts the borrower in a Catch-22 position, where the lender may claim personal recourse against the borrower either for failing to turnover security deposits, or for misapplying rentals.

Another situation. At the time of foreclosure, the lender undertakes to perform environmental due diligence in the form of a phase 1 environmental site assessment, or even soil or groundwater testing, or some limited remedial activities, especially for industrial properties. Many lenders are taking the position that their investigational expenses are personal recourse obligations to the carveout guarantors. However, the guarantors probably intended to guaranty against “problems” not mere investigational activities preceding foreclosure!

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INCREASING VACANCY RATES LEAD TO RISK OF BEING UNDER INSURED

BY: KASTURI BAGCHI

Once a transaction closes, property owners and their lenders tend to file away their insurance certificates and overlook insurance coverage issues unless premiums have jumped, a payment has been missed, or a covered event has occurred. This tendency is even greater in a real estate market where vacancy rates are increasing and properties are vacant, thus compelling owners or foreclosing lenders to focus energies on marketing and cutting operating expenses (such as insurance premiums). But from the insurance industry perspective, vacancy is a basis for policy cancellation or reduction of coverage. The rationale is that vacancy presents an increase in hazard, which in turn increases the probability of a loss. For example, when a property is vacant, no one is there to keep an eye on maintenance or keep away the scavengers and vandals.

So the question that naturally arises is, when is a property deemed vacant by the insurer? During an interview with Brian Pilarski of Brown & Brown Detroit, we discussed the definition of *vacancy* as provided by the "Insurance Services Offices (ISO) ... the leading source of property and liability risk information and...underwriting information to insurance companies." The ISO has deemed vacancy to have occurred if, for sixty consecutive days or more, less than 31% of the total square footage has been leased to third parties to conduct customary operations or used by the building owner to conduct customary operations. Therefore, you could have a 10,000 square foot retail center, or medical office building, that is at least one-quarter occupied and be deemed "vacant" under ISO standards. But what if you own a building originally occupied entirely by retail stores and then you lease up the vacancies with medical offices? Would an insurer view that switch from retail to medical office as not within the scope of "customary operations," and use it as basis for

policy cancellation or coverage reduction? Pilarski cautions that the ISO has not defined "customary operations"; however, some factors that may come into play include whether the new operation is a permitted use under the applicable zoning ordinance, and if any real rents are being paid. Clearly, an insurer's definition of vacancy differs from a layman's definition.

Once an insurance adjuster deems that a property is vacant, what are the ramifications? Under ISO standard provisions, no coverage is provided for theft, attempted theft, vandalism, water damage, sprinkler leakage or glass breakage, and a 15% deduction is taken from awards for any other casualty claim. While ISO provisions are the most common, Pilarski points out that it is not adopted by all carriers and, consequently, it is critical to review vacancy provisions with your insurance advisor to determine if other carriers have more lenient, or stricter, vacancy exclusions.



So what can an owner or foreclosing lender do to mitigate this loss or reduction in coverage? Pilarski indicates that mitigation options vary carrier by carrier:

By adding the "Vacancy Permit Endorsement," some insurance companies will allow you to continue to maintain full coverage if they are notified within the 60 day window required in the ISO policy. Other insurance companies do not want the exposure of a "vacant building" at all.

For those insurers willing to issue a Vacancy Permit Endorsement, an additional premium is required and often conditions are imposed, such as the maintenance of a security system or periodic inspections.

Because of the variations in coverage and exclusions within the insurance industry, it is important to review your insurance policies to see how they fit with your ever changing business, and, unfortunately, ever increasing vacancy rates. In the context of the vacancy provision in particular, there is some flexibility if you take the time to shop around and investigate. But don't wait until after you suffer a loss!

"The ISO has deemed vacancy to have occurred if, for sixty consecutive days or more, less than 31% of the total square footage has been leased to third parties ..."

NO RELIEF IN SIGHT FOR CLAIMANTS OF THE HOMEOWNER CONSTRUCTION LIEN RECOVERY FUND

BY: DANIELLE M. SPEHAR

In mid-October 2009, the Homeowner Construction Lien Recovery Fund (the "Fund") became insolvent. The Fund was established under the Construction Lien Act to provide a means of redress in the event that all debts owed on a home building or remodeling project are not paid by the licensed contractor. The Fund was created to protect both the homeowners who have contracted with a licensed builder or remodeler for construction or improvements on a home, and the subcontractors, suppliers and laborers who have provided materials or labor on the job. Simply stated, the Fund has no mechanism for securing sufficient funds to allow it to continue to defend the several hundreds of lien claims and lawsuits that are currently pending against it. As of March 4, 2010, the balance of the Fund is fully encumbered.

Realizing that an adequate source of funding could not be found, the Fund filed a Motion For Interpleader with the Macomb County Circuit Court in October 2009 in what was stated as an effort

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Many property owner/borrowers have, in recent years, made lease termination deals where national tenants have bought their way out of leases for underperforming locations. If these transactions were not approved by the lender, there may be non-recourse exposure for misapplication of pre-paid rentals long since accounted for and forgotten.

Or, consider the property owner who tried to make an out-parcel to his shopping mall more leaseable. After reconfiguring a large single tenant building into a multi-tenant facility, the net result was six right-sized tenant spaces ready for lease, but in several thousand square feet fewer gross leaseable (albeit, more desirable, and imminently more leaseable) floor space. On foreclosure, however, the owner must be cognizant that the lender could take the position that the unauthorized building alteration amounted to a "removal" of collateral, thus triggering a non-recourse liability carveout, even though the value of the property was enhanced.

As a matter of procedure, simply giving property back to a lender has become more difficult as well. Many lenders are refusing to settle these non-recourse carveout issues before they receive the property back.

Some lenders are demanding immediate payment of security deposits and other amounts, before final settlement of all issues. So even where a borrower is willing to give a deed in lieu of foreclosure in exchange for a release from liability under the carveout guaranty, lenders are often demanding the property and money back first, and then promising to negotiate a settlement. This order of things is reversed, requiring borrower's to let go of the only leverage they have (control of the property and what little money is in their property management account) before lenders will negotiate a final settlement. What other business relationship requires one party to pay first, and negotiate a release later?

These are trying times for borrowers and lenders. But, even the most heavily negotiated loan documents are generally most favorable to the lenders. Now, lenders are using those favorable loan document rights and powers to exert maximum leverage over financially (and often emotionally) exhausted borrowers and guarantors. So even "non-recourse" borrowers have to re-examine their loan documents when facing the threat of foreclosure.

NO RELIEF IN SIGHT FOR CLAIMANTS OF THE HOMEOWNER CONSTRUCTION LIEN RECOVERY FUND

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to drastically reduce its legal costs while permitting an equitable distribution of funds. On October 19, 2009, all payments from the Fund were placed on hold until the Motion For Interpleader could be considered by the Court. On November 17, 2009, the Court issued an Order and Opinion to deny the Fund's Motion For Interpleader on the basis that the Court did not have jurisdiction to allow provisions for the interpleader as required under the applicable court rule.

At present, the Michigan Department of Energy, Labor & Economic Growth is seeking to repeal the Fund through legislative action. While the statutory provisions for the Fund remain in place, however, the Fund is required by law to continue to collect the Fund revenue through the licensure process in addition to restitution payments to the Fund. Unfortunately, the revenue anticipated from those sources is simply insufficient in the current economic environment to sustain the viability of the Fund.



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