MICHIGAN REAL PROPERTY REVIEW

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The Section encourages interested members of the Bar to contribute articles and other publishable material relating to real property law and of interest to the profession. Manuscripts are reviewed by attorneys experienced in the subject matter covered by each article.

Readers are invited to submit articles, comments and correspondence to George J. Siedel, Editor, University of Michigan Business School, 701 Tappan Street, Ann Arbor, Michigan 48109-1234 (gsiedel@umich.edu). The publication of articles and the editing thereof are at the discretion of the Editor. A cumulative index of articles is printed annually in the Winter issue of the *Review* and is available on the Section website:

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CHAIRPERSON'S REPORT

by *Vicki R. Harding*

As incoming Chair, many people have asked me what I hope to accomplish during my term. Several former chairpersons have commented on how quickly the year seems to pass by. Keeping that in mind, together with my very rewarding experiences with the Section over the last fifteen years, my message to you is simple: get involved, stay involved.

The strength of the Section is its committees. They offer an opportunity to exchange ideas with others who have unique expertise in a number of areas of real estate law. They offer an opportunity to publish articles. They offer an opportunity to make a difference in legislation affecting the real estate system in the state of Michigan.

One of the key issues that we need to grapple with is how to facilitate meaningful involvement given both the competition for people's time and the ever-increasing impact of technology on our daily lives. As part of an effort to focus on these issues, a strategic planning committee has been appointed to examine these issues and update the recommendations from the 21st Century Committee.

One area that we will be examining is the alternatives to in-person meetings. For example, one of the committees has made very effective use of a listserv in developing the committee's position on legislation affecting their specialty area. Other committees have used telephone conference calls to permit participation by members in different parts of the state. As video conferencing becomes more affordable and more commonplace, participation in council and committee meetings by video conference may become a feasible alternative.

In each case, the goal is to obtain the benefits – i.e., interaction with other members of the real estate law community – while reducing the cost – i.e., the investment of time required to participate. Similarly, various forms of "remote" participation may encourage involvement by people in more diverse geographic areas. Typically the majority of people participating in Section activities are located in the Detroit metropolitan area, with some participation from people from Lansing and Grand Rapids. I would like to see an even broader participation from these, as well as other, areas of the state.

We are also exploring other new approaches, particularly in the area of continuing legal education. If the Section's 2002 Summer Conference, which was held at the Grand Hotel, Mackinac Island, is any indication,

we are going in the right direction. The Summer Conference was a tremendous success, due in large part to the tremendous efforts of Brian Henry, Chairperson of the Section's 2002 Summer Conference, Pat Karbowski, CLE Chairperson, and Arlene Rubenstein, the Section Administrator. This Conference continued to develop the alternate program formats. Specifically, we continued our breakfast roundtables on Thursday and Friday mornings, and held workshops on Friday morning. Both of these alternate formats are designed to encourage interactive education. Thanks for this continuing development should also go to Bob Berlow, who has long championed pursuing new directions in CLE format, with an emphasis on this approach.

In continuing to develop this approach, the Section will be using the breakfast roundtable/workshop format for two of our traditional CLE offerings this upcoming year. The first session, which is on leasing, will be held in October and was fully subscribed by mid-September. The second session will be held in March 2003, and will address land use and eminent domain issues.

The Section's Pro Bono Committee continued to make a contribution by preparing another brochure on the topic of predatory lending. The Pro Bono Committee has prepared a series of pamphlets designed to explain various real estate topics.

A bylaw amendment proposal has been submitted for a section vote at the annual meeting in Grand Rapids on September 26, 2002. If approved, this would specifically authorize remote participation in Council meetings at the Chairperson's discretion. Again, the underlying objective is to accommodate creative ways to expand participation in the Section. Traditionally, the Council meets at 9:30 a.m. on Saturday mornings. Although there have been various council members from Grand Rapids and Lansing on the council and as council officers, requiring in-person attendance imposes a potentially significant burden the further people need to travel.

USE OF SPECIAL PURPOSE ENTITIES IN REAL ESTATE FINANCING TRANSACTIONS

by *John C. Murray**

Introduction

In recent years, many commercial mortgage lenders (especially in connection with multi-state, securitized, and structured-financing transactions) have required that the borrower be constituted as an independent bankruptcy-remote special purpose entity ("SPE"), which is unlikely either to become the subject of a bankruptcy or to be substantively consolidated if a bankruptcy of a related person or entity occurs. The SPE is often an intermediate holding company, which is separate from the borrowing entity that obtains the first-mortgage loan. The originating person or entity that initially seeks the loan (the "Originator") transfers the property that is the security for the debt to an SPE in a "true sale" transaction. This assures that the bankruptcy of the originator has little impact on the financing transaction. Separating the assets from the Originator allows easier access to the capital markets and more favorable pricing of the loan, because the financing is based on the quality of the assets transferred to the SPE and not the Originator's credit. To demonstrate the separate nature of the entities, a "non-consolidation" opinion is required along with assurance that the general partner (or member, if the Originator is a limited liability company) of the originator is not liable for the debt.

Lender and Rating-Agency Requirements

To comply with the requirements of lenders and credit-rating agencies, an SPE generally will have the following

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characteristics and covenants as part of its organizational documents (articles and bylaws, if a corporation; partnership agreement, if a partnership; or operating agreement if a limited liability company ("LLC")):

- Prohibition against any business activity other than operation of the property and against owning any other property.
- Prohibition against any merger with another entity or acquisition of any subsidiary.
- Prohibition of any other debt (secured or unsecured) other than the subject loan, except for ordinary trade debt (fully subordinate financing *may* be permitted if the credit rating is not impaired).
- Separate SPE books and records, stationery, bank accounts, tax returns, and office space.
- Prohibition against contracts with affiliates, unless arms-length.
- Prohibition against commingling of assets with affiliates.
- Prohibition against the guarantee of (or the pledge of assets to secure) the debt of an affiliate.
- "Independent director" approval of major decisions such as a bankruptcy filing, a change in the SPE organizational or governing documents, and transactions with affiliates.
- Disclosure, of any transfer of the assets from the borrowing entity to a new SPE, to the transferor's other creditors.
- A "lockbox" arrangement to monitor cash disbursements.[1]

As mentioned above, most forms of structured financing customarily utilize an SPE so that legal ownership of assets can be structurally isolated, creating a financing vehicle that is legally independent of and removed from the bankruptcy risks of the original borrowing entity. The SPE must be structured as an entity with no assets or operations other than the real-estate project providing the security for the loan. This is because of the negative experiences of lenders in recent years involving bankruptcy filings by and against borrowers. Real estate lenders have learned that if a borrowing entity with very few creditors is created, such as a bankruptcy-remote SPE, it will be much more difficult for the borrower to file, or have filed against it, a bankruptcy proceeding or avoid early dismissal of the case.[2] As noted above, the purpose this bankruptcy-remote structure is to make it difficult for the SPE borrower to file bankruptcy. However, bankruptcy "remote" does not mean bankruptcy "proof" and, as one author has stated, "the nature of securitized loans is such that a bankruptcy court may be the only venue where meaningful relief can be obtained."[3] Structural isolation of the SPE also creates access to increased investment and pricing advantages available through securitization and use of the capital markets.[4]

"Independent" Directors, Officers, or Members

A desirable alternative for a lender seeking to protect its interests without (hopefully) opening itself up to unwanted liability may be to require that one or more of the directors, general partners, or members (in the case of an LLC borrower) of the SPE be "independent," i.e., a reputable individual or entity with no prior or current affiliation or relationship with either the lender or the borrower. However, several courts have held that as an entity approaches insolvency, i.e., becomes unable to pay its debts as they become due in the ordinary course of business, the directors, partners, or members owe a fiduciary duty to all the creditors of the company. For example, in a New York bankruptcy court decision, *In re Kingston Square Associates*,[5] the court stated that, "it is universally agreed that when a corporation approaches insolvency or actually becomes insolvent, directors' fiduciary duties expand to include general creditors. Nearly all states' law is in accord."[6]

The use of "bankruptcy remote provisions" in SPE loan documents, especially those that require approval of certain entity actions by an independent director who is in actuality under the influence of a major secured lender, may later be determined by a bankruptcy court to run afoul of the Bankruptcy Code's prohibition of provisions preventing an entity from commencing a bankruptcy reorganization. In the *Kingston Square* case, *supra*, the debtor was unable to obtain its board of directors' permission to file a voluntary bankruptcy proceeding because of the refusal of the "independent director" to authorize such a filing. The debtor then orchestrated an involuntary filing by certain unsecured creditors (with the help of the debtor's limited partners). The bankruptcy court found that such actions were not taken in bad faith and that the debtor reasonably believed that the best course of action for the entity was to file bankruptcy. The court therefore refused to grant the secured creditor's motion to dismiss the involuntary filing. The court also appointed a Chapter 11 trustee, and held that the debtor's board of directors had violated their fiduciary duties owed to the debtor, its limited partners and

its unsecured creditors and interest holders, in favor of the interests of the mortgage lender. The court declined, however, to specifically nullify the debtor corporation's bylaw provision containing the bankruptcy-proof provisions as against public policy.[7]

Trusts as SPEs: Bankruptcy Issues

A. Bankruptcy Code Treatment of Trusts.

An SPE created in the form of a trust could under certain circumstances be a bankruptcy-proof entity – as opposed to a bankruptcy-remote entity – because the trust itself may be prevented from filing a voluntary bankruptcy petition and creditors (including trust investors) may be prevented from filing an involuntary bankruptcy petition against the trust, unless the trust is characterized as a business trust. As a general matter, trusts are not eligible for relief under the Bankruptcy Code.[8]

The definition of "corporation" in §101(9)(A) of the Bankruptcy Code includes an "association having a power or privilege that a private corporation, but not an individual or a partnership, possesses," and a "partnership association organized under a law that makes only the capital subscribed responsible for the debts of such association." Although the definition of a corporation includes a "business trust," the Bankruptcy Code does not further define a business trust. Furthermore, under § 303(a) of the Bankruptcy Code, only a person may be an involuntary debtor under Chapter 7 or 11. Under § 303(d), "a general partner in a partnership debtor that did not join in the [filing of an involuntary bankruptcy petition] may file an answer to a petition under this section," and therefore can challenge the petition and seek to have it denied. Under §303(b), only the creditors of a corporation may file an involuntary petition against the corporation.

B. Case Law.

Bankruptcy cases have defined what constitutes a business trust. Bankruptcy courts customarily consider the following factors, among others, in determining whether or not a trust is a business trust eligible for filing under the Bankruptcy Code: whether the trust conducts business; whether its purpose is to generate profits; whether it has the attributes of a corporation; and whether the beneficial interests in the trust are transferable.[9]

In *Shawmut Bank Connecticut v. First Fidelity Bank (In re* Secured Equip. Trust of Eastern Air Lines, Inc.),[10] the Second Circuit Court of Appeals held that a trust created to facilitate aircraft financing for Eastern Airlines did not qualify as a business trust under § 101(9)(A)(v) of the Bankruptcy Code and, therefore, could not be a debtor. The trust had entered into a "Secured Equipment Indenture and Lease Agreement" with Eastern Airlines as the lessee. The trust then sold $500 million in trust certificates to investors, and used the proceeds to purchase a portion of Eastern Airlines' fleet of aircraft. The aircraft were then leased back to Eastern Airlines in exchange for rental payments equaling the amount of the principal, premium, and interest on the certificates. Under the lease agreement, Eastern Airlines was entitled to a return of any rental payments exceeding the amounts owed the certificate holders under the trust indenture. The lease agreement also stated that, upon full payment of the lease obligations, title to the leased aircraft would be reconveyed to Eastern Airlines. The court found "no dispute that [the lease transaction] was a secured financing."[11] After Eastern Airlines filed a Chapter 11 bankruptcy petition, holders of a portion of the trust certificates filed an involuntary Chapter 11 petition against the trust. The court, noting that it was deciding an issue of first impression, held that the trust was not a business trust within the meaning of the Bankruptcy Code because it was not created to generate a profit or transact business, but rather existed solely to preserve and protect the security interest of the certificate holders in the assets of the trust (*i.e.*, the aircraft collateral) and to facilitate the secured financing transaction sought by Eastern Airlines. In a strong dissent, Judge Kearse, believing that the trust qualified as a business trust under New York law, argued that the certificate holders "expected to earn a profitable return on their investment," and that "this trust is not a typical trust for the simple preservation of assets," and should, therefore, be deemed a business trust within the meaning of § 101(9)(A)(v) of the Bankruptcy Code.[12]

In *In re Sung Soo Rim Irrevocable Intervivos Trust*,[13] the bankruptcy court held that the voluntary Chapter 11 bankruptcy petition filed by the trust, the only asset of which was a multi-unit retail project that was transferred to the trust shortly before an imminent foreclosure of the project, must be dismissed because (1) the trust did not qualify as a business trust under California law, (2) it did not conduct any business as that term is commonly understood, (3) it was controlled exclusively by the trustee, and (4) it had been created solely for the benefit of family members. Judge Fenning explicitly rejected the reasoning of the Second Circuit from *Shawmut*, *supra*.[14]

In *In re Gonic Realty*,[15] the bankruptcy court held that a trust could be a debtor under Chapter 11. The court found that the trust in question undertook many operations relating to the property that constituted business activity,

and that the trust was, therefore, engaged in more than just the ownership of real estate. As a result, this case appears to be distinguishable from Illinois and Florida cases (cited and discussed in C. below) that have held that a true passive land trust is not a business trust eligible for relief under the Bankruptcy Code.[16]

Because of the availability of income tax deductions for investors and the simplicity of documentation in Massachusetts, the use of a nominee trust is common in connection with the ownership, development, and financing of commercial real estate. In *In re Medallion Realty Trust*,[17] the Massachusetts bankruptcy court, after observing that "the decisions are sharply, and perhaps hopelessly divided on the issue of the meaning of a 'business trust,'"[18] held that the trust in question was created for the purpose of transacting business and was, therefore, eligible for Chapter 11 relief. The court found that the traditional Massachusetts business trust (under which the trust's day-to-day operations are run by directors elected by the certificate holder), as well as a nominee trust (under which the beneficiaries are investors in a business enterprise), are both eligible for treatment as a business trust under the Bankruptcy Code.[19]

In an attempt to "convince" a court that an SPE trust created to facilitate the financing of real estate is not a business trust eligible for filing under the Bankruptcy Code (especially in connection with synthetic-lease financing; see discussion below), some attorneys have added language (in "all caps") similar to the following in the financing documents executed by the trust:

> THE TRUST IS NOT A BUSINESS TRUST. THE SOLE PURPOSE OF THE TRUST IS AS SET FORTH IN SECTION _____. THE TRUSTEE MAY NOT TRANSACT BUSINESS OF ANY KIND WITH RESPECT TO THE TRUST ESTATE, NOR WILL THIS TRUST AGREEMENT BE DEEMED TO BE, OR CREATE OR EVIDENCE THE EXISTENCE OF A CORPORATION *DE FACTO* OR *DE JURE*, OR A MASSACHUSETTS BUSINESS TRUST, OR ANY OTHER TYPE OF BUSINESS TRUST, ASSOCIATION OR JOINT VENTURE BETWEEN OR AMONG THE TRUSTEE, THE CERTIFICATE HOLDERS, THE AGENT AND THE NOTE HOLDERS.

Whether the use of this language, in and of itself, will be sufficient to persuade a bankruptcy court to rule that the trust is in fact not a business trust remains to be seen.

C. Land Trusts.

The primary purpose of a land trust is to hold title to real property, not to operate a business or commercial activity for profit. As a result, a land trust does not conduct a business activity capable of being reorganized under Chapter 11 of the Bankruptcy Code. Florida, Hawaii, Illinois, Indiana, North Dakota, and Virginia have statutes that permit land trusts, while states such as California and Kansas have permitted the creation of land trusts through court decisions. The majority of states do not permit the recognition and use of land trusts.

Several Illinois cases have analyzed the applicability of the Bankruptcy Code to land trusts, and have held that a land trust may not be a debtor under the Bankruptcy Code.[20] Bankruptcy courts in Florida also have held that a land trust may not be a debtor under the Bankruptcy Code.[21] The Florida cases used reasoning similar to the Illinois bankruptcy courts, generally finding that where the trust was created solely to preserve and protect the trust assets for the beneficiary and not to actively manage a going-concern business, it would not be deemed to be a business trust eligible for protection under the Bankruptcy Code.[22]

LLCs as SPEs: Bankruptcy Issues

Because LLCs are still relatively new state-law creations, the treatment of these entities in bankruptcy is uncertain, i.e., whether they will be treated as partnerships or corporations for bankruptcy purposes.[23] This uncertainty is especially troublesome with respect to single-member LLCs. This is because, if an LLC is treated as a partnership, it could dissolve upon the bankruptcy of its sole member and its assets would be distributed to creditors and the bankrupt member. If, on the other hand, the LLC were treated as a corporation, it would not dissolve upon the bankruptcy of the last remaining member, although the member's ownership interest could be transferred. Some commentators believe that, at least under the under the Delaware Limited Liability Act,[24] an LLC should be treated as a corporation because the LLC operating agreement is similar to a certificate of incorporation and a member's interest is analogous to a share of stock in a corporation.[25]

There are no specific provisions in the Bankruptcy Code or Bankruptcy Rules that deal with LLCs, and the application of bankruptcy law and specific Bankruptcy Code provisions is uncertain. The Bankruptcy Code does not include an LLC within the definition of a debtor that is eligible for relief. However, it is likely that a bankruptcy court would conclude that an LLC would qualify as a debtor under the Bankruptcy Code.[26] Case law is just beginning to develop in this area. Does an LLC qualify as a "corporation" (which includes an "association having a power or privilege that a private corporation, but not an individual or a partnership, possesses" and a "partnership

association organized under a law that makes only the capital subscribed responsible for the debts of such association") as defined in sec. 101(9) of the Bankruptcy Code, or does it qualify as a "person" (which includes an "individual, partnership and corporation") as defined in sec. 101(41) of the Bankruptcy Code? As noted above, the Bankruptcy Code currently does not recognize an LLC as a distinct or separately defined entity. However, a bankruptcy court may well find that an LLC has significant similarities to both partnership and corporate entities to qualify as a "person" entitled to protection under the Bankruptcy Code.[27]

With respect to bankruptcy issues affecting LLCs, it is uncertain whether, in the absence of clear-cut case law, the Bankruptcy Code eventually will be amended to specifically define and deal with LLCs. At a 1997 meeting of the National Bankruptcy Review Commission, which considered proposed amendments to the Code, the Small Business, Partnership and Single Asset Real Estate Working Group submitted a Memorandum suggesting that the Bankruptcy Code be amended to provide for similar treatment of partners and LLC members under the Bankruptcy Code, the exclusion of partnership and LLC agreements from the executory contract provisions of § 365 of the Bankruptcy Code, and the unenforceability of *ipso facto* clauses. The Memorandum did not suggest altering the overall treatment of debtor LLCs in bankruptcy, but only provided for specific treatment of the LLC relationship for LLC member or LLC manager debtors. The Memorandum stated that LLC members are similar to general partners in member-managed LLCs and similar to limited partners or shareholders in manager-managed LLCs.[28] No further action has been taken on this proposal and a legislative solution does not appear imminent, as the proposed revisions to the Bankruptcy Code being considered by Congress as of the date of this article do not include any provisions addressing LLC issues.

SPEs: Loan Refinancing and Workout Issues

Some lenders may *require* that the borrower form (or reorganize or convert to) an SPE in connection with a loan workout (or at the inception of the loan where required by rating agencies in connection with securitized financing transactions), in order to create a bankruptcy-remote entity. For example, in *Exton Plaza Associates v. Commonwealth of Pennsylvania*,[29] a refinancing lender required that the shopping center owned by the borrower, a general partnership, be transferred to a "single purpose and bankruptcy remote entity" as a condition to obtaining the loan. The general partnership converted itself into a limited partnership of the same name, with each of the two general partners owning a 49.5 percent interest as limited partners in the new limited partnership. A new LLC, of which each of the original partners owned a 50 percent interest, was created to own a one-percent interest as the general partner of the new limited partnership. (The refinancing lender's loan commitment prohibited either of the individual general partners from serving as general partner in the new entity). The deed from the general partnership to the limited partnership recited a consideration of $1.00 and claimed a full exemption from payment of the Pennsylvania transfer tax, stating on the deed that "Principals of grantor and grantee are one and the same." The Commonwealth Court of Pennsylvania upheld the claim of exemption, finding that the deed in this case did not meet the statutory definition of "document" because it did not convey an interest to someone other than the grantor, i.e., it was merely a "name change" and "did not effect a meaningful transfer of title."[30] The court reasoned that the general partnership had merely "converted" to the limited partnership, transferring a 1 percent interest to an LLC as the general partner. The court stated that, "the shopping center was essentially 'contributed' to the Limited Partnership, and the principals' property rights in the shopping center were essentially unchanged."[31]

When an existing borrowing entity (other than an LLC) with significant debt seeks a workout with its mortgage lender, it may voluntarily, or at the specific request of the lender, be reorganized as or converted to an SPE, with the mortgage lender (or employees, officers, or representatives of the lender) becoming a director, partner, or member (with a limited right to vote) of the SPE for the purpose of blocking any future attempt by the SPE to voluntarily file for bankruptcy. For example, the operating agreement of an LLC borrower would require unanimous consent by all members for a bankruptcy filing. Theoretically, the lender should be able to exercise its right to vote to block a bankruptcy filing because an LLC shields all members from personal liability, regardless of participation in management. This also may provide a significant business advantage to a lender who seeks management input in return for partial debt forgiveness or deferral. This is because an LLC permits participation by members in management in a manner different from their participation in earnings and, to the extent that existing debt remains after the restructure or else is deferred through, e.g., a loan modification, an LLC's non-taxability at the entity level may lessen the likelihood that the entity debt will be reclassified as equity.[32]

However, becoming a member of a borrowing LLC may be contrary to the lender's current institutional lending policies and may also expose the lender to unwanted lender

liability, equitable subordination, bankruptcy, public-policy, conflict-of-interest, and fiduciary risks associated with possessing or exercising significant management and control rights in the borrower. The lender also risks having a bankruptcy court find that it is an "insider" of the borrower, which would extend (under § 547 (b)(4) of the Bankruptcy Code) the bankruptcy preference period applicable to payments made by the borrower to the lender from ninety days to one year. Equity participation in the borrowing entity also could expose the lender to a possible claim by other creditors of the LLC that the lender-member's lien should be equitably subordinated, or even avoided, under §§ 101(31)(c), 547(b)(4) and (5); and 510(c) of the Bankruptcy Code. Furthermore, as a matter of general equity and/or public policy, a bankruptcy court may prohibit the use of a structure that effectively prohibits or severely inhibits the filing of a bankruptcy petition by an LLC.[33]

Use of a Single-Member LLC

Since 1998, single-member LLCs have become very popular in securitized and structured-financing transactions because of their tax advantages, flexibility and low transaction costs. Many states have amended their LLC statutes to specifically permit the formation of single-member LLCs. If a domestic LLC with a single individual owner is disregarded as an entity separate from its owner, its individual owner is subject to federal income tax as if the company's business was operated as a sole proprietorship. The IRS "check the box" regulations[34] eliminated the four-factor test previously used to determine whether an entity should be considered a partnership or a corporation for tax purposes. The new rules provide that any eligible entity may elect to be classified as either a partnership or an association (i.e., a corporation).

However, an eligible entity with only a single member or owner that is not required to be classified as a corporation may only elect to be classified as an association or to have the business entity disregarded as an entity separate from its owner, in which case the entity would be treated for federal tax purposes as if it were a sole proprietorship, branch, or division of the organization's owner. The regulations permit a single-owner unincorporated business entity to be disregarded as a separate entity from its owner and allow an individual or corporation to obtain the limited-liability advantage of a corporation, along with the single-level "pass through" tax advantage of a partnership, by forming a single-member LLC.

The single-member LLC must decide whether to utilize a written operating agreement. Most state LLC statutes provide that in the absence of a written operating agreement, the statutory "default" provisions will apply. For example, the Delaware Limited Liability Company Act provides that a single-member LLC may have an LLC agreement even with only one member (which agreement need not be in writing), and further provides that an LLC's operating agreement is not unenforceable solely because there is only one party to the agreement.[35] Although logically it may seem anomalous to have an agreement with yourself, the existence of a written agreement would be important for creditors of the LLC and other parties who contract with the LLC (for purposes of authorization and the obligation of the sole member to contribute capital), as well as for those who may succeed to the interest of the single member - who would rely on the terms of the LLC agreement in determining their rights and duties.

The Michigan Limited Liability Company Act ("MCLLA") contains a provision that permits a written operating agreement only if the LLC has more than one member.[36] However, amendments to the MCLLA have been introduced that would eliminate the requirement of two or more members and would also provide that an operating agreement entered into by an LLC having only one member would not be unenforceable by reason of there being only one member who is a party to the agreement. It is the author's understanding that there is no opposition to these proposed amendments and that the amendments could become effective sometime in the fourth quarter of 2002.

The single-member LLC operating agreement should specifically provide for the continued existence of the LLC upon the sole member's dissolution or the termination of its membership in the LLC. The operating agreement should also condition the sole member's right to withdraw on the existence of a succeeding member (sometimes referred to as a "springing" member) who would be capable of continuing the operations and existence of the LLC. Typical "bankruptcy remote" provisions, which are promulgated by rating agencies and appear in almost all LLC formative documents involving securitized loan transactions, would also be applicable with respect to single-member LLCs. Legal opinions as to the bankruptcy remoteness of the borrowing entity (and perhaps its principals) are also usually required by the rating agencies, such as Moody's, Duff & Phelps, and Standard & Poor's, in connection with securitized financing transactions to provide support for a high rating. This is especially so in connection with a single-member LLC, where the bankruptcy treatment of such a vehicle is less clear. The enforceability of choice-of-law provisions in LLC documents is also extremely important, because the ability of a single-member LLC to continue in existence after the departure

of the sole member is often dependent on state law that enables the single-member LLC to continue in existence.

It has been suggested that the single-member LLC operating agreement provide (where permitted) that a board of managers, containing at least two "independent" members, would govern certain management and operating decisions. The operating agreement would provide that no bankruptcy filing or related action could occur without the unanimous consent of all the board members.[37]

Another proposed method of enhancing the bankruptcy-remoteness of a single-member LLC is to structure the entity so that the sole member is itself a single-purpose bankruptcy-remote entity. Unlike an individual, who can (and eventually will) die, the sole member of a single-member LLC that is itself structured as a single-asset bankruptcy-remote entity will have a perpetual existence. However, borrowers may resist the imposition of such a requirement because they lose some of the flexibility and cost-saving advantages, including direct personal ownership, of single-member LLCs.

Guarantees Involving SPEs

A. Cross-Collateralization and Creditors' Rights Issues.

To pledge one's assets as security for the obligation of another, through cross-collateralization of debt obligations of SPEs that are "sister" entities, is to become a guarantor regardless of whether any document evidencing an actual guaranty obligation is executed. Cross-collateralization is a very common structuring technique in securitized loan transactions today. As noted earlier, the lender commonly requires that an SPE be created, to which certain assets of a parent entity will be conveyed that are intended to act as security for the loan.

In many commercial transactions, it is not uncommon to create as many bankruptcy-remote entities as there are real property assets or, in multi-state transactions, to form as many bankruptcy-remote borrowing entities as there are states. Each newly created entity typically will be an SPE that is wholly owned by the parent entity (although not always on a direct basis; the entity formed to hold title to the real property asset may be owned by another entity or entities, often itself or themselves a bankruptcy-remote SPE or SPEs, which entity or entities may in turn be wholly owned by the ultimate parent).

The ultimate purpose of the loan may be simply to refinance existing secured debt. If the loan were made to the parent, which pledged its own assets as security for the loan, and the proceeds were used to pay off the parent's existing secured debt, there would likely be no creditors' rights issue and the title insurer could be expected to insure the transaction without a creditors' rights exclusion or exception. However, because the lender (or the rating agency that will be rating the transaction if it is to be securitized) desires to isolate the assets that will be the security from the parent's general business operations (and other creditors), a bankruptcy-remote SPE will be the preferred form of borrowing entity.

There are at least two transfers in these transactions that must be analyzed, from the title insurer's standpoint, for creditors' rights issues. The first is the transfer of title from the parent to the newly created entity or entities of the assets that will be the security for the loan. The second is the mortgaging of those assets by the newly formed entity or entities. The actual borrower may be the parent (in which event the transaction in effect becomes an "upstream" guarantee), but it is usually the bankruptcy-remote SPE itself. A separate loan might be made to each SPE, secured by the asset or assets of that particular SPE received from the parent. If the structure stopped there, and assuming that the loan being refinanced became the obligation of the SPE at the time title to the asset (or assets) was conveyed by the parent to the SPE – and also assuming that the parent received "reasonably equivalent value" for its transfer to the SPE – the loan transaction involving the existing secured debt might not involve a creditors' rights issue (except possibly an intentional fraudulent transfer). However, rarely is this type of loan transaction structured as a series of truly "stand alone" loans to each separate SPE. Instead, each SPE pledges its asset or assets as security for its own promissory note *and* for the promissory notes executed by each of the other "sister" SPEs. There may in fact be a formal guarantee by each SPE of the indebtedness of each of these other SPEs (which in turn may be secured by a subordinate mortgage on each of the other properties mortgaged by the respective SPEs). This results in cross-collateralization, as each asset stands as collateral for the "global" loan (being the sum of all of the separate loans made to each SPE), although each individual SPE has only benefited from a portion of the loan proceeds.

The common theme in these types of transactions is that someone other than the entity whose assets stand as security for the loan is benefiting from the loan proceeds and – at least to the extent of the benefit flowing to the parent, subsidiary or sister entities – the transferring entity is not receiving reasonably equivalent value. Therefore, based on § 548 of the Bankruptcy Code (or state fraudulent conveyance or fraudulent transfer statutes), a challenge

can be made by the creditors (or bankruptcy trustee) of the parent, who could attack the transfer to the SPE as one (1) made to "hinder, delay or defraud" the parent's existing or future creditors, or (2) that rendered the parent insolvent, or (3) that left the parent with insufficient capital to carry on its business, or (4) that occurred when the parent was unable to pay its debts as they became due. The transfer of assets by a parent to a subsidiary also could constitute a preference, under § 547 of the Bankruptcy Code, if the parent had guaranteed the subsidiary's indebtedness and is subsequently released from the guaranty obligation when the subsidiary uses the proceeds of the new secured loan to satisfy an existing obligation of the subsidiary that the parent had guaranteed.

For some time, borrowers (and title companies) have struggled to come up with a method of minimizing the risks of fraudulent conveyances in mortgage loans to SPEs involving cross-collateralization provisions and cross-guarantees (especially in connection with multi-property, multi-borrower, securitized, and multi-state transactions), while still providing lenders the protection that they are seeking. Proposed solutions, which have been used with varying degrees of acceptance and success, include the following:

- A "net worth" guarantee, under which the guarantor guarantees all or a portion of another SPE borrower's indebtedness or the aggregate indebtedness of numerous separate SPE borrowing entities, but in an amount not greater than, e.g., 95 percent of its own net worth on an ongoing basis (in order to avoid rendering the guarantor insolvent);

- Statements or provisions in the guaranty agreements, and any mortgages securing such guaranty obligations, to the effect that it is the parties' intention that the obligations of each SPE guarantor shall not constitute a fraudulent transfer or conveyance under the Bankruptcy Code or any applicable state statute;

- A separate affidavit and certificate as to the organizational and financial status of the SPE guarantor(s) and the debts and liabilities of the guarantor(s);

- A "contribution agreement" among all the SPE borrowers-guarantors providing that in the event that any individual borrower-guarantor guaranteeing the indebtedness of other borrowers-guarantors is required to, and actually does, make a payment on such guaranty for the benefit of another borrower-guarantor, it will thereupon have a right of indemnification against the defaulting borrower-guarantor for the amount (which may be an allocated portion of the aggregate debt) paid by the non-defaulting borrower-guarantor; and

- An indemnification agreement from the common principal or parent of each SPE borrowing entity to the title insurance company (which indemnity may or may not be secured by additional collateral such as a cash deposit, certificate of deposit or letter of credit), indemnifying the title company for any claims successfully asserted against it as the result of the failure of the lender to realize on its security because a fraudulent transfer has been deemed to have occurred as a result of the transaction.

Notwithstanding their increasing use and the benefits provided by such documents, net worth guarantees may have the following disadvantages:

- The transaction may still be deemed a fraudulent transfer because it fails one of the tests, other than insolvency, under § 548 of the Code (i.e., the guarantee causes the guarantor to fail either the capitalization test or the cash flow test);

- The difficulty of determining and verifying the actual net worth of the guarantor (or multiple guarantors) at any given point in time;

- The potential inability to collect the full amount of the guarantee because of the guaranty agreement's limitation to a specified amount of the guarantor's net worth and the possible miscalculation or misrepresentation of such net worth; and

- The lack of reported court decisions determining the validity and enforceability of net value guarantees.

Based on case law over the past several years, lenders and title insurers may in fact be safer (or just as safe) taking a full, unrestricted guarantee from each of the borrowing entities. For example, in *In re Xonics Photochemical, Inc.*,[38] the Seventh Circuit Court of Appeals held that the amount of a subsidiary's liability on an upstream limited guarantee must be discounted by the probability that the contingency (i.e., payment on the guaranty) will actually occur. As a result of this ruling, the possibility that a court will find that a guarantor's payment obligations on an aggregate indebtedness will render the guarantor insolvent has been lessened, because the contingent obligation must be discounted. Also, a "full value" guarantee, when used in the proper circumstances, may eliminate or reduce the

risks of litigation, collection and uncertainty of enforceability that are inherent in net worth guarantees. Furthermore, the contingent nature of a particular guarantor's liability may need to be further adjusted based on the guarantor's rights (commonly contained in commercial loan guarantees) of subrogation, indemnification, and reimbursement against the defaulting guarantor(s) or the primary obligor.[39]

B. New FASB Standards for Disclosure and Recognition of Guarantee Obligations.

On May 22, 2002, the Financial Accounting Standards Board ("FASB"), which is the designated organization in the private sector for establishing financial accounting and reporting standards, issued an Exposure Draft of a proposed interpretation of existing accounting rules regarding guarantees ("Interpretation").[40] The Interpretation would, according to the FASB, "clarify and expand on existing disclosure requirements for guarantees, including loan guarantees. It also would require that at the time a company issues a guarantee, the company must recognize a liability for the fair value, or market value, of its obligations under that guarantee."[41] The Interpretation would apply to (among other guarantee contracts) "[a] guarantee of the collection of the scheduled contractual cash flows from individual financial assets held by a special-purpose entity (SPE)."[42] The Interpretation, in explaining its intention to apply to guarantees that arise in connection with various types of commercial transactions and business relationships, states that, "[f]or example, guarantees can arise from transactions or other arrangements with SPEs, joint ventures, equity method investors, franchisees, employees and members of the entity's board of directors, other related parties, and customers."[43] Appendix A to the *Interpretation* states that the FASB's "decision to undertake a project on guarantees was made in conjunction with its discussion of interpretive guidance related to identifying and accounting for SPEs. Guarantees are common in situations involving SPEs and in other commercial arrangements."[44]

The Interpretation provides that the liability of the guarantor under the guarantee must be initially reported (and recognized) at the fair value of the guarantee. Unfortunately the Interpretation does not define "fair value," and does not address or provide any guidance on measurement of the guarantor's liability either at the inception of the guarantor's liability or subsequently over the remaining term of the guarantee.[45] The guarantor would have to make a (most likely subjective) determination of the fair value of the obligation to comply with the Interpretation.[46]

The FASB takes the position that the guarantor must disclose the following information in its financial statements (even if the likelihood of the guarantor making payments under the guarantee is remote):

- The nature of the guarantee, including how it arose and the events that would require performance by the guarantor.
- The maximum potential amount of future payments (undiscounted and not reduced by any amounts that are subject to recovery under recourse or collateralization provisions in the guarantee).
- The current carrying amount of the liability, if any, for the guarantor's obligations under the guarantee.
- The nature and extent of any recourse provisions providing for recovery by the guarantor against third parties or available collateral with respect to all or a portion of the amounts paid out under the guarantee.

According to the Interpretation, the issuance of a guarantee obligates the guarantor in two respects: (1) the guarantor undertakes an obligation to stand ready to perform over the term of the guarantee in the event any of the triggering events occurs (the "noncontingent element") and (2) the guarantor undertakes a contingent obligation to make future payments if the triggering events occur (the contingent element"). In addition to the disclosure requirements set forth above, the Interpretation would require the guarantor to recognize, at the inception of the guarantee, the fair value of all of its obligations under the guarantee, i.e., the entire guarantee encompassing both the contingent and noncontingent elements. The Interpretation acknowledges that an entity may have insufficient data to readily determine the fair market value of a previously issued guarantee as of the date it was issued, and provides that in such a case the guarantor may report a liability due to its obligation to stand ready to perform based on the fair value of the entire guarantee on the date of initial application of the Interpretation.[47]

The Use of SPEs in Synthetic Leasing Transactions

In many synthetic-lease financing transactions, an SPE (usually a pass-through entity such as a business trust, special-purpose corporation, limited partnership, or LLC) is formed. The SPE then takes title to the property, either directly or by assignment of the purchase contract, constructs the building, and leases the property to the lessee-corporate user or its subsidiary. A synthetic lease of real estate using

an SPE commonly requires rental payments from the lessee equal to the sum of the interest on the SPE's debt plus a return on the SPE's equity investment, with no amortization of the debt's principal or return of its equity during the term of the lease. The SPE, acting as lessor, obtains financing for the transaction with a small equity investment in the project (usually three percent) and debt financing for the balance. The debt financing generally is in the form of commercial paper or commercial bank debt, often in combination with mortgage financing.

On June 28, 2002, the FASB issued an Exposure Draft of its Proposed Interpretation of existing accounting rules[48] with respect to the consolidation of certain SPEs ("SPE Interpretation"). The FASB expects to issue the final SPE Interpretation (after reviewing comments) in the fourth quarter of 2002. The SPE Interpretation would be applied immediately to SPEs created after the issuance date of the final SPE Interpretation. For SPEs created before that date, the provisions would be applied to those SPEs existing as of the beginning of the first fiscal year or interim period beginning after March 15, 2003. The SPE Interpretation represents a significant change in current accounting practice and will have a profound effect on the use of SPEs in off-balance-sheet financing transactions, particularly with respect to synthetic leases. The SPE Interpretation applies to businesses of all types and sizes, both public and private, and virtually every type of financing transaction that utilizes an SPE will need to be reviewed for compliance with the SPE Interpretation.

The SPE Interpretation makes clear that the new rules are not intended to restrict the use of SPEs – which the SPE Interpretation acknowledges serve valid business purposes by isolating assets or activities to protect creditors against bankruptcy risk and/or allocate risks among participants and by facilitating various financing transactions and other arrangements, such as securitization, leasing, hedging, research and development, and reinsurance – but to improve financial reporting by enterprises involved with SPEs and provide more complete and accurate information about the consolidated enterprise. The SPE Interpretation is concerned about accounting for transactions involving SPEs where the SPE is controlled by a business through means other than actual ownership of voting interests, e.g., by use of a loan arrangement, lease, management contract, guarantee, or other credit enhancement. The SPE Interpretation also would require disclosure of information regarding the assets, liabilities, and activities consolidated by enterprises that act as administrators of those SPEs.

The SPE Interpretation requires each such enterprise to determine whether it provides financial support to the SPE through a "variable interest." Variable interests are defined in the SPE Interpretation as "the means through which financial support is provided to an SPE and through which the providers gain or lose from activities and events that change the values of the SPE's assets and liabilities."[49] Variable interests could arise from financial instruments, service contracts, nonvoting ownership interests, or other arrangements, and include loans to the SPE, leases, management contracts, referral agreements, options to acquire assets, purchase contracts, credit enhancements, guarantees of debt or asset values, and derivative instruments.[50]

If it is determined that an SPE is subject to the SPE Interpretation, each party involved with the SPE must determine whether it provides substantial support to the SPE, e.g., by holding a subordinate debt instrument or by providing a guarantee of the value of the SPE's assets or liabilities. If an enterprise holds (1) a majority of the variable interests in the SPE, or (2) a significant variable interest that is significantly more than any other party's variable interest, that enterprise would be the "primary beneficiary" of the SPE.[51] The primary beneficiary would be deemed to be the "parent" of the SPE and would be required to include the assets, liabilities, and results of the SPE in its consolidated financial statements. An SPE can have only one primary beneficiary, which itself must be a substantive operating entity that is not an SPE.

The SPE Interpretation provides that the primary beneficiary is "an enterprise that has a controlling financial interest in an SPE that is established by means other than holdings of voting interests. The primary beneficiary provides significant financial support to an SPE and benefits from its activities by holding a majority of the variable interests in the SPE or a significant portion of the total variable interests that is significantly more than the variable interest held by any other entity."[52] An enterprise involved with an SPE must determine at each reporting date whether it is a primary beneficiary by ascertaining whether it provides significant financial support to the SPE through a variable interest. If it does not, the enterprise is not the primary beneficiary. However, if the enterprise does provide such support, it must then determine whether any other party or parties also provide support to the SPE through variable interests. If other entities also provide financial support, the enterprise is the primary beneficiary if it provides a majority of the financial support or a significant portion of the total financial support that is significantly more than any other party, as noted above.[53] An enterprise that has a variable interest in an SPE also must treat other variable interests in that SPE held by its related parties as its own interests for the purpose of determining whether it is the primary

beneficiary.[54] If it is not apparent which party's activities are most closely associated with the SPE's activities, the party with the largest variable interest is the primary beneficiary.[55]

With respect to arrangements whereby contractual or other legal provisions or agreements substantially restrict an enterprise's rights and obligations to specifically identified assets of an SPE ("silos") and the interests of the creditors of the SPE apply equally to all of the SPE's assets, the SPE Interpretation provides that the enterprise must treat those assets and the portions of the SPE's liabilities attributable to those assets as a separate SPE.[56]

The SPE Interpretation would require primary beneficiaries to consolidate SPEs if the SPEs do not effectively "disperse" risks among the parties involved with the SPEs. SPEs that effectively disperse risks would not be required to be consolidated unless a single party holds an interest (or combination of interests) that effectively recombines risks that were previously dispersed. The Summary of the SPE Interpretation, which prefaces the new rules, states that, "SPEs used for leasing may not be as effective at dispersing risk as qualifying SPEs."[57] Currently, a lender to an SPE lessor is not required to consolidate the SPE unless it holds a majority voting interest in the SPE. However, the SPE Interpretation "would require consolidation of an SPE that leases to a single lessee by either the lessee or the lender unless the equity investor has decision-making authority and the investment meets specified conditions for sufficiency, which may require an investment significantly greater than 3 percent [as required under current practice] of assets. If an enterprise that leases from an SPE that is subject to this proposed Interpretation provides a guarantee of the value of the property at the end of the lease [such as a residual value guarantee in a synthetic lease] or otherwise accepts risk of loss from changes in value of the property, the lessee would probably consolidate the SPE lessor. If the lessee does not provide such a guarantee, the lender to the SPE would probably consolidate the SPE."[58]

In a prior draft of the SPE Interpretation, the FASB proposed a "bright line test" that would allow a company to exclude an SPE from its consolidated financial statements if there was an independent equity investment of at least 10 percent in the SPE. The SPE Interpretation contains some exceptions as well as more flexibility, but also creates some ambiguity. The SPE Interpretation provides that an equity investment of less than 10 percent of the SPE's total assets will create a presumption that the SPE is incapable of financing its business activities without relying on financial support from other variable interest holders. This presumption can be successfully rebutted only if there is "persuasive evidence" that a lesser equity investment is comparable to the equity in similar businesses that are not SPEs and that engage in similar risks. However, even an equity interest of 10 percent is not considered sufficient unless it allows the SPE to finance its own activities without reliance on investments that are deemed to be variable interests.[59]

The SPE Interpretation provides that a subsidiary, division, department, branch, or other portion of a "substantive operating enterprise" (i.e., an enterprise that is not an SPE and that "conducts business operations other than those performed for it by an SPE, has employees, and has sufficient equity to finance its operations without support from any other enterprise or entity except its owners") that is the lessor for a leveraged lease, direct financing lease, or sales-type lease will not be consolidated with any enterprise other than its parent, even if it is otherwise similar to an SPE that would be subject to the requirements of the SPE Interpretation.[60] Furthermore, the SPE Interpretation would not require consolidation of an SPE by a transferor of assets of the SPE or its affiliates, or require consolidation of a qualifying employee benefit plan by an employer subject to the provisions of certain other FASB Statements.[61]

The determination of whether an SPE should be consolidated will depend to a great extent on the method the SPE uses to get its financial support. The FASB has identified four conditions, as set forth in the SPE Interpretation, that indicate whether the equity investment of the nominal owners of the SPE is sufficient to permit the SPE to independently finance its operations. Failure to meet any one of these conditions would result in a determination that support is provided by another party and would require consolidation. The four conditions are: (1) the nominal owners' equity investment is sufficient to permit the SPE to conduct its activities without additional financial support; (2) the nominal owners' equity investment (and the return thereon) is the most subordinate interest; i.e., it is not guaranteed and the return is not limited; (3) the invested assets provided by the nominal owners in exchange for their equity interests are not subordinated beneficial interests in another SPE (or SPEs); (4) the nominal owners' equity investment was not provided, either directly or indirectly, by the SPE or other parties involved with the SPE.[62]

Although the SPE Interpretation is not intended to limit the use of SPEs, the elimination of off-balance-sheet treatment will occur in many situations. The implementation of the SPE Interpretation will force thousands of U.S. companies to add synthetic-lease liabilities to their balance

sheets by the end of the first quarter of 2003. Many companies (including lessees in synthetic-leasing transactions) that have used SPEs will be required to bring assets and liabilities on the balance sheet with negative effects on their debt-to-equity ratios, return on assets, operating and profitability margins, and cost of financing. This could lead to downgraded credit ratings, regulatory concerns, and debt-covenant violations of loan agreements. It likely will be very difficult for many existing SPEs to be restructured in order to meet the new FASB criteria, and these transactions certainly will become more expensive for the participants.

Upon issuance of the SPE Interpretation, many corporations will be forced to revise structures used for many years as efficient sources of financing, and capital costs may increase as the result of having to seek less attractive and more costly alternative sources of financing. Investors will be looking for indications of these increased costs in the months to come. However, after implementation of the SPE Interpretation, SPEs will continue to be utilized in structured financing transactions, to the extent they represent cost-efficient financing vehicles and sources of capital. "Substantive lessors," such as bank leasing subsidiaries or specialty leasing companies that are substantive operating companies with significant "true" equity at risk in the transaction – as opposed to thinly capitalized, bankruptcy-remote, and transaction-specific SPEs – likely will be the preferred lessor entities after final issuance of the SPE Interpretation. It also may be possible for substantive lessor entities to enter into joint-venture relationships with other parties, so long as the substantive lessor entity is the "significant" equity partner and consolidates its activities with its parent. The alternatives to synthetic leasing, such as sale-leasebacks, credit tenant leases, conventional leases, and outright ownership with mortgage financing, have both advantages and disadvantages compared to synthetic leases, and some or even all of these alternatives may not be attractive to corporations even after issuance of the Interpretation.

Conclusion

The use of SPEs in connection with the financing of commercial real estate is now well established. A mortgage lender is justifiably concerned that the borrower's collateral for the loan (i.e., the real estate) be segregated as the sole asset of an SPE, which is established and organized in a manner sufficient to minimize the risk of a bankruptcy filing by the SPE or substantive consolidation of the SPE with a related person or entity. A body of law (both bankruptcy and non-bankruptcy), as well as relevant accounting rules and regulations, continues to evolve providing much-needed guidance with respect to the use of SPEs in real-estate financing transactions. Lenders and borrowers, and their counsel, must be careful to monitor the developing statutory and case law (and applicable accounting rules and regulations) regarding SPEs and should negotiate and draft the formative and operating documents of the SPE, and the loan documents evidencing the loan to the SPE, in a manner sufficient to achieve the respective goals of the parties while complying with applicable law and accounting principles.

Endnotes

1. *See* STANDARD & POOR'S, STRUCTURED FINANCE CRITERIA 68-70, 109-14 (1988); Committee on Bankruptcy and Corporate Reorganization, Association of the City of New York, *Structured Financing Techniques*, 50 BUS. LAW. 527, 553-60 (1995); Committee on Bankruptcy and Corporate Reorganization of the Association of the Bar of the City of New York, *New Developments in Structural Finance: Report by the Committee on Bankruptcy and Corporate Reorganization of the Association of the Bar of the City of New York*, 56 BUS. LAW. 95 (2000); Lynn M. LoPucki, *The Death of Liability*, 106 YALE L.J. 23-30 (1996); Thomas E. Plank, *The Outer Boundaries of the Bankruptcy Estate*, 47 EMORY LAW JOURNAL 1193, 1281-84 (1998); Stephen I. Glover, *Structured Finance Goes Chapter 11: Asset Securitization by Reorganizing Companies*, 47 BUS. LAW. 611, 613014 (1992); Deborah L. Fletcher and Jeffrey L. Tarkenton, *Protecting the Lender: Lock Boxes and Bankruptcy Remote Entities*, Fifth Annual Mortgage Financing Program, Real Property, Probate and Trust Law Section (American Bar Association 1999), Volume 2, Tab J at 2-6; William L. Myers, *The Use of Bankruptcy-Remote Entities in Real Property Securitizations and Structured Financings*, 15 CAL. REAL PROP. J. 24 (1997); Carl J. Seneker, *How to Document Securitized Commercial Real Estate Mortgage Loans*, 15 THE PRACTICAL REAL ESTATE LAWYER 41, 44-46 (1999).

2. *See, e.g., Barakat v. Life Ins. Co. of Virginia*, 99 F. 3d 1520, 1526 (9th Cir. 1996) (holding that where the only bona fide, impaired claim in the bankruptcy case was the claim of the mortgage lender, the debtor "should [not] be able to cramdown a plan that disadvantages the largest creditor"); John C. Murray, *The Lender's Guide to Single-Asset Real Estate Bankruptcies*, 31 REAL PROP. PROB. & TR. J. 393, 461-471 (1996); James R. Stillman, *Real Estate Mezzanine Financing in Bankruptcy*, Finance Topics, American College of Real Estate Lawyers, Midyear Meeting, Scottsdale, Arizona, April 4-5, 1997, Tab 24, at 3; Gregory V. Varallo and Jesse A. Finkelstein, *Fiduciary Obligations of Directors of the Financially Troubled Company*, 48 BUS. LAW. 239 (1992).

3. *See* William G. Murray, *Workouts in the Twenty-First Century*, 17 CAL. REAL PROP. J. 5 (1999).

4. *See* Committee on Bankruptcy and Corporate Reorganization of the Association of the Bar of the City of New York, *New Developments in Structural Finance:*

Report by the Committee on Bankruptcy and Corporate Reorganization of the Association of the Bar of the City of New York, 56 Bus. Law. 95 (2000); Tribar Opinion Committee, *Opinions in the Bankruptcy Context: Rating Agency, Structured Financing, and Chapter 11 Transactions*, 46 BUS. LAW. 717, 724-30 (1991); William L. Myers, *The Use of Bankruptcy-Remote Entities in Real Property Securitization and Structured Financings*, 15 CAL. REAL PROP. J. 2 (1997).

5. 214 B.R. 713 (Bankr. S.D.N.Y. 1997).

6. *Id.* at 735. *See also Geyer v. Ingersoll Pub. Co.*, 621 A.2d 784, 787-89 (1992); *Credit Lyonnais Bank, Nederland, N.V. v. Pathe Comm. Corp.*, No. 12150, 1991 WL 277613 (Del. Ch., Dec 30, 1991); *In re* Andreuccetti, 975 F. 2d 413, 421 (7th Cir. 1992); *Clarkson Co., Ltd. v. Shaheen*, 660 F.2d 506, 512 (2nd Cir. 1981); *Tampa Waterworks Co. v. Wood*, 121 So. 789 (Fla. 1929); *Francis v. United Jersey Bank*, 432 A.2d 814 (N.J. 1981); *In re* Schulz, 208 B.R. 723, 729 (M.D. Fla. 1997); *Equity-Linked Investors, L.P. v. Adams*, 705 A.2d 1040, 1042 n.2. (Del. Ch. 1997); *In re Brian Jacks*, 243 B.R. 385, 390 (Bankr. C.D. Cal. 1999); *Credit Agricole Indosuez v. Rossiyskiy Kredit Bank*, 708 N.Y.S.2d 25, 31 (N.Y. 2000) (stating that New York "trust fund" doctrine provides that once company is insolvent, officers and directors stand in position of trustees, holding corporate assets in trust for creditors' benefit); *Pereira v. Cogan*, 2002 U.S. Dist. LEXIS 8513 (S.D. N.Y., May 10, 2002) at *14-15 (holding that action for breach of fiduciary duty by corporate directors is equitable in nature and such a claim is insufficient to entitle plaintiff to jury trial); *LaSalle Nat'l Bank v. Perelman*, 83 F.Supp.2d 279, 291 (D. Del. 2000) (ruling that since none of plaintiff's claims against corporate officers and directors for breach of fiduciary duty were equitable in nature, they were not barred by "no recourse" provisions in indenture). *But see Steinberg v. Kendig (In re Ben Franklin Retail Stores, Inc)*, 225 B.R. 646, 655 (N.D. Ill. 1998), *remanded by Steinberg v. Kendig (In re* Ben Franklin Retail Stores, Inc.*)*, 2000 W.L. 28266 (N.D. Ill. Jan. 11, 2000) (ruling that directors' fiduciary obligation, when corporation is near insolvency, requires only that they "exercise judgment in an informed, good faith effort to maximize the corporation's long-term wealth-creating capacity"); *Fir Tree Partners, L.P. v. MCG Communications, Inc.*, No. 114674 (Sup. Ct. of N.Y., County of N.Y., Nov. 7, 2001) (dismissing complaint alleging corporation's board of directors owed fiduciary duty to creditors where financial statements strongly suggested impending insolvency, based on technical holding that broad "no action" clause in indenture prevented public debt holders from taking action with respect to indenture or underlying notes). *See also* Steven L. Schwarcz, *Rethinking a Corporation's Obligations to Creditors*, 17 CARDOZO L. REV. 647, 671 (1996) ("It is not the corporation's closeness to insolvency that is relevant, but rather whether, under the circumstances, a corporation's contemplated action would cause insolvency, meaning that insolvency is one of the reasonably expected outcomes"); Andrew D. Shaffer, *Corporate Fiduciary-Insolvent: The Fiduciary Relationship Your Corporate Law Professor (Should Have) Warned You About,"* 8 AM. BANKR. INST. L. REV. 479, 517 (2000); Christopher W. Frost, *The Theory, Reality and Pragmatism of Corporate Governance in Bankruptcy Reorganizations*, 72 THE AM. BANKR. L. J. 103, 107 (1998) ("the general rule is that directors do not owe creditors duties beyond the relevant contractual terms absent 'special circumstances . . ., e.g., insolvency . . . . When the insolvency exception does arise, it creates fiduciary duties for directors for the benefit of creditors"); Glenn E. Siegel, Stephen J. Gordon, and Eric Steven O'Malley, *What Duty is Owed in Vicinity of Bankruptcy?*, 227 N.Y. L.J. 1 (Feb. 19, 2002).

7. *See also In re Cumberland Farms, Inc.*, 249 B.R. 341, 349-51 (Bankr. D. Mass. 2000) (finding clear breach of duty where director caused cash flow from property to be used to repay loans from "his" company to detriment of debtor's finances generally, and noting that directors must act "with absolute fidelity and must place their duties to the corporation above every other financial or business obligation . . . They cannot be permitted to serve two masters whose interests are antagonistic"); Committee on Bankruptcy and Corporate Reorganization of the Association of the Bar of the City of New York, *New Developments in Structural Finance: Report by the Committee on Bankruptcy and Corporate Reorganization of the Association of the Bar of the City of New York*, 56 Bus. Law. 95, 162-66 (2000) (discussing fiduciary duties of directors and impact of *Kingston Square Associates, supra*); Gregory Varallo and Jesse A. Finkelstein, *Fiduciary Obligations of Directors of the Financially Troubled Company*, 48 BUS. LAW. 239 (1992); James R. Stillman, *Real Estate Mezzanine Financing in Bankruptcy*, Tab 24 at 3 (April 4-5, 1997) (transcript available from the American College of Real Estate Lawyers Midyear Meeting on Finance Topics).

8. *See, e.g., In re* John M. Cahill, M.D. Assocs. Pension Plan, 15 B.R. 639, 639-40 (Bankr. E.D. Pa. 1981). The Bankruptcy Code does not define a business trust. Under § 109(a) of the Bankruptcy Code, only a person is eligible to file a bankruptcy proceeding. *See* 11 U.S.C. § 109(a) (1994). Section 101(41) defines a "person" to include an "individual, partnership, and corporation," but not a trust, unless the trust is a "business trust" included within the definition of "corporation," set forth in § 101(9)(A)(v) of the Bankruptcy Code. *See* 11 U.S.C. §§ 101(41), 101(9)(A) (1994). *See also Hunt v. TRC Properties (In re* Hunt), 160 B.R. 131 (Bankr. 9th Cir. 1993); *In re* Westgate Village Realty Trust, 156 B.R. 363 (Bankr. D.N.H. 1993).

9. *See, e.g., In re* Margaret E. DeHoff Trust 1, 114 B.R. 189-92 (Bankr. W.D. Mo. 1990).

10. 38 F.3d 86 (2d Cir. 1994).

11. *Id.* at 87.

12. *Id.* at 91-92.

13. 177 B.R. 673, 675-76 (Bankr. C.D. Cal. 1995).

14. *See also In re* G-2 Realty Trust, 6 B.R. 549, 554 (Bankr. D. Mass. 1980) (dismissing the debtor's bankruptcy petition as a bad faith filing where the debtor transformed itself from a nominee trust to a business trust solely to meet the Bankruptcy Code's eligibility requirements); *In re* Mohan Kutty Trust, 134 B.R. 987, 989 (Bankr. M.D. Fla. 1991) (examining whether the trust at issue was created in compliance with state law); *In re* Eagle Trust, 1998 WL 635845 (E.D. Pa., Sept. 16, 1998), at *5 (not reported in F.Supp. 2d) (finding that the trust in question was not a business trust because it did not possess any of the common attributes of a business trust, and was not established for the purpose of carrying on a commercial activity or business); *In re* St. Augustine Trust, 109 B.R. 494, 495-96 (Bankr. M.D. Fla. 1990) (finding that trust was family trust intended for personal needs, use, and benefit of family members rather than any business purpose, and was therefore ineligible for relief under the Bankruptcy Code); *In re* Morgantown Trust No. 1, 177 B.R. 673, 676 (Bankr. C.D. Cal. 1995) (although not dispositive, characterization under state law is a significant factor in determining whether a trust is eligible to be a debtor under the Bankruptcy Code).

15. 50 B.R. 710 (Bankr. N.H. 1985).

16. *See also In re* Ophir Trust, 112 B.R. 956, 960 (Bankr. D. Wis. 1990) (noting that "[t]he Ophir Trust may look like a duck, but it neither walks nor quacks like a duck," the court held that, based on the history of the debtor's operations, the trust was not a business trust for purposes of eligibility for relief under the Bankruptcy Code); *Morrissey v. Comm'r*, 296 U.S. 344, 357, 56 S.Ct. 294, 295 (1935) ("In what are called 'business trusts' the object is not to hold and conserve particular property, with incidental powers, as in the traditional type of trusts, but to provide a medium for the conduct of a business and sharing its gains").

17. 103 B.R. 8, 10-13 (Bankr. D. Mass. 1989).

18. *Id.* at 10.

19. *See also* James B. Clark, *Resisting Bankruptcy: Selected Developments In Structured Financing and Similar Techniques,* Tab A at 5 (1997) (unpublished manuscript from the Real Estate Finance: Hot Tips and Workshop, American Bar Association Section of Real Property, Probate and Trust Law 1997 Annual Meeting).

20. *See In re* Dolton Lodge Trust No. 35188, 22 B.R. 918, 923 (Bankr. N.D. Ill. 1982); *In re* Old Second Nat'l Bank, 7 B.R. 37, 38 (Bankr. N.D. Ill. 1980); *In re* North Shore Nat'l Bank of Chicago, Land Trust No. 362, 17 B.R. 867, 869-70 (Bankr. N.D. Ill. 1982); *In re* Citizen Bank & Trust Co. of Park Ridge, 8 B.R. 812, 815 (Bankr. N.D. Ill. 1981).

21. *See In re* Treasure Island Land Trust, 2 B.R. 332, 336 (N.D. Fla. 1980); *In re* Cohen, 4 B.R. 201, 208 (N.D. Fla. 1980) (also ruling that trustee of a trust that is found not to be a business entity eligible for filing for bankruptcy relief cannot file for bankruptcy as the trustee, even if the trustee is a "person" as defined in the Bankruptcy Code).

22. See *In re* Dolton Lodge Trust No. 35188 and *In re* Old Second Nat'l Bank and *In re* Dolton Lodge Trust No. 35188, *supra* note 20. *But cf. In re* Metro Palms I Trust, 153 B.R. 922, 923-24 (Bankr. M.D. Fla. 1993) (holding that a trust, the sole business activity of which consisted of leasing and managing its only asset, a commercial office building, was not created to preserve the trust res for the beneficiaries and was, therefore, not a land trust, but a business trust eligible for relief under Chapter 11); *In re* Star Trust, 1999 WL 635525 (Bankr. M.D. Fla. 1999) ("It appears that the trusts were created not simply to hold and conserve the properties for the beneficiary, but to develop and maintain the properties, to rent and manage the properties, and ultimately to retain or dispose of the properties at a profit. The Court concludes that the trusts qualify as business trusts for relief under Chapter 11").

23. *See In re* ICLNDS Notes Acquisition, LLC, 259 B.R. 289, 292 (Bankr. N.D. Ohio 2001) ("an LLC is neither a corporation or a partnership, as those terms are commonly understood. Instead, an LLC is a hybrid").

24. Del. Code Ann. tit. 6, § 18-101, *et seq.*

25. *See* Larry E. Ribstein and Robert R. Keating, *Limited Liability Companies*, § 14.04, at 14-18 (2000) ("[F]rom a policy standpoint, LLCs probably should be considered corporations for bankruptcy purposes because the special bankruptcy provisions that apply to partnerships primarily relate to the general partner's duty to contribute to payment of the firm's debts"); Carter G. Bishop and Daniel S. Kleinberger, *Limited Liability Companies Tax and Business Law*, ¶1.04 (2)(a) (1999).

26. *See In* re ICLNDS Notes Acquisition, LLC, *supra* note 23, 259 B.R. at 292 ("There is no specific reference in the Code to a limited liability company. Under the rules of construction applicable to the Code, however, the use of the term "includes" is not limiting . . .. In other words, individuals, corporations and partnerships are clearly eligible for relief, but other similar entities are as well"); Committee on Bankruptcy and Corporate Reorganization of the Association of the Bar of the City of New York, *Limited Liability Companies in Bankruptcy*, in The Best Entity for Doing the Deal, at 747, 763-64 (PLI Corp. Law and Practice Course Handbook Series No. 747 (1996)).

27. *See In re* ICLNDS Notes Acquisition, LLC, *supra* note 23, 259 B.R. at 293 ("[a]s corporations and partnerships are eligible to be debtors, and because an LLC draws its character from both of those forms of doing business, an LLC is similar enough to those entities that it also comes within the definition of "person" and is eligible for protection under the Code").

28. *See* Sally S. Neely, *Partnerships and Partners and Limited Liability Companies and Members in Bankruptcy: Proposals for Reform*, 71 AM. BANKR. L.J. 271, 311 (1997).

29. 763 A. 2d 521 (Pa. Cmwlth. 2000).

30. *Id.* at 523.

31. *Id.* at 524.

32. *See* Richard M. Graf, *Use of LLCs as Bankruptcy-Proof Entities Widens*, THE NATIONAL LAW JOURNAL, April 10, 1995.

33. *See* Frederick Z. Lodge, Robert E. Michael, and Christopher S. Dewees, *Bankruptcy Remote Structures in Mortgage Loans*, PROBATE & PROPERTY, American Bar Association (May/June 1996), p. 49; Melanie Rovner Cohen and Christopher Combest, *Bankruptcy and Limited Liability Entities*, "Peas Porridge, Hot" – LLCs, Ps, LPs and Creditors, American Bar Association Section of Real Property, Probate and Trust Law, August 6, 1995, Sec. B, p. 23; Charles W. Murdock, *Limited Liability Companies in the Decade of the 90s: Legislative and Case Law Developments and Their Implications for the Future*, 56 BUS. LAW. 499 (2001).

34. Internal Revenue Code Regulations, § 301. 7701-2, -3.

35. Del. Code Ann. tit. 6, §18-101(7).

36. MCLA § 450.4102(n).

37. *See* Alexander Dill, Yaron Ernst, Michael Kanef, and Adam Toft, *Handle With Care: Single Member LLCs in Structured Transactions*, Special Report, Moody's Investor Services, March 19, 1999. However, if the outside managers are not truly independent and do not perform their fiduciary duty to the entity (and to all creditors, including unsecured creditors), as opposed to specific third-party creditors, the goal of bankruptcy-remoteness may not be achieved. *See, e.g., In re* Kingston Square Associates, *supra* note 5, 214 B.R. at 735.

38. 841 F.2d 198, 200 (7th Cir. 1988).

39. *See, e.g., Official Comm. of Former Partners of Brennan (In re* Labrum & Doak*)*, 227 B.R. 383, 389 (Bankr. E.D. Pa. 1998) (suggesting a *per se* rule that future rent obligations are contingent liabilities and are to be excluded for insolvency valuation purposes); *Covey v. Commercial Nat'l Bank of Peoria*, 960 F.2d 657, 660-62 (7th Cir. 1992); ("[d]iscounting a contingent liability by the probability of its occurrence is good economics and therefore good law"); *Davis v. Suderov (In re* Davis*)*, 169 B.R. 285, 302-03 (E.D. N.Y. 1994) ("[i]n order to value a contingent liability, a bankruptcy court must determine the likelihood that the contingency will occur, and multiply the total debt guaranteed by that probability"); *Mellon Bank, N.A., v. Metro Communications, Inc.*, 945 F.2d 635, 648 (3rd Cir. 1991) (requiring that the value of the guarantee be reduced to the extent that the guarantor was entitled to contribution from co-guarantors at the time of the loan); *In re* Chase & Sanborn Corp., 904 F.2d 588, 594 (11th Cir. 1990), ("a contingent liability cannot be valued at its potential face amount; rather, 'it is necessary to discount it by the probability that the contingency will occur and the probability will become real'" (quoting *In re* Xonics Petrochemical, Inc., *supra*, 841 F.2d at 200); *In re* Galen Monroe Oakes, 1993 U.S. App. LEXIS 23078 (6th Cir., Sept. 3, 1993) at *10 ("[t]o determine the value of a contingent liability, the court should multiply the total debt guaranteed by the probability that the debtor will be required to fulfill the guarantee"); *In re* Consolidated Capital Equities Corp., 175 B.R. 629, 632 (Bankr. N.D. Tex. 1994 (requiring that, for purposes of fraudulent transfer analysis, debtor's liability under guaranty must be discounted to account for contingent nature of liability where "[n]o *event occurred through the transfer dates* that would have triggered actual liability on a guaranty"); *In re* Hemphill, 18 B.R. 38, 47 (Bankr. S.D. Iowa 1982) ("[i]f the guarantee obligation is to be included among the debtor's liabilities for purposes of determining his insolvency, then the subrogation and contribution rights against other collateral must also be taken into account); *Manufacturers and Traders Trust Co. v. Goldman (In re* Ollag Construction Corp.*)*, 578 F.2d 904, 908 (2nd Cir. 1978) (holding that because debtor's obligations under guaranty were contingent obligations and were subject to rights of subrogation and contribution, such factors must be considered in calculating value of such obligations for purpose of determining whether debtor was insolvent); *cf. Commerce Bank of Kansas City, N.A., v. Achtenberg,* No. 90-0950-CV-W-6, 1993 WL 476510 (W.D. Mo. Nov. 10, 1993) (not reported in F.Supp), at *5 n.6 (finding that because evidence had established that debtors guaranteed loan to insolvent entity, contingency no longer existed and guaranty was fully payable). *But see Tri-Continental Leasing Corp., Inc. v. Zimmerman*, 485 F.Supp. 495, 499-500 (N.D. Cal. 1980) (holding that under California Uniform Fraudulent Conveyance Act, determination of debtor's insolvency requires that full amount of contingent claims be included in calculation of debtors' liabilities); *Davis v. Nielson*, 9 Wash. App. 864, 876-77 (Div. 1, 1973) (holding that full amount of debtor's obligations under certain notes had to be considered in determining debtor's insolvency, notwithstanding that statute of limitations had run on notes, because statute of limitations is personal defense and notes were existing debts under UFCA's broad definition). *See also* Brad R. Godshall and Robert A. Klyman, *"Wading 'Upstream' in Leveraged Transactions: Traditional Guarantees v. 'Net Worth' Guarantees,"* 46 BUS. LAW. 391 (1991); Jack F. Williams, *The Fallacies of Contemporary Fraudulent Transfer Models as Applied to Intercorporate Guaranties: Fraudulent Transfer Law as a Fuzzy System*, 5 CARDOZO L.REV.1403, 1442-48 (1994).

40. *Proposed Interpretation: Guarantor's Accounting and Disclosure Requirements for Guaranties, Including Indirect Guaranties of Indebtedness of Others*, FASB, May 22, 2002.

41. *FASB Issues Exposure Draft That Expands Disclosure Requirements for Guarantees*, FASB News Release, 5/22/02.

42. *Interpretation.*, no. 3.a.(3), p. 2. The *Interpretation* also requires disclosures with respect to "guarantees that are

issued to benefit entities that meet the definition of a related party in paragraph 24(f) of FASB Statement No. 57, *Related Party Disclosures*, such as joint ventures, equity method investors, and certain SPEs." *Interpretation*, no. 12, p. 7.

43. *Id.* at A19, p.21 n. 6. Appendix A to the *Interpretation* states that the FASB's "decision to undertake a project on guarantees was made in conjunction with its discussion of interpretive guidance related to identifying and accounting for SPEs. Guarantees are common in situations involving SPEs and in other commercial arrangements."

44. *See* Appendix A to *Interpretation*, p. 11.

45. The *Interpretation* states that "[t]he Board decided that this subsequent measurement issue is beyond the scope of this Interpretation." *Interpretation* at A17, p. 21.

46. There is an existing FASB accounting standard that may provide some guidance in this area. *See* SFAS No. 107, *Disclosures About Fair Value of Financial Instruments*. This standard defines the fair value of a financial instrument as the amount at which the instrument could be exchanged in a current transaction between willing parties, other than in a forced liquidation sale.

47. The initial recognition and measurement provisions would be applied in the first fiscal year beginning after September 15, 2002. The disclosure requirements in the Interpretation would be effective for financial statements of interim or annual periods ending after October 15, 2002.

48. *Proposed Interpretation: Consolidation of Certain Special-Purpose Entities*, Financial Accounting Standards Board, June 28, 2002.

49. *Id.*, no. 7.b., p. 3.

50. *Id.*, no. 18, p. 7.

51. *Id.*, no. 13.c., pp. 5-6.

52. *Id.*, no. 7.c., p. 3.

53. *Id.*, no. 13. b.-d., pp. 5-6.

54. *Id.*, no. 15, p. 6.

55. *Id.*, no. 16.d., p. 7. This section also provides that (for purposes of determining which party is the primary beneficiary if two or more parties hold variable interests in the SPE) if two or more parties with variable interests have an agency relationship, the principal is the primary beneficiary, and if the relationship is not that of a principal and an agent, the party with activities that are most closely associated with the SPE is the primary beneficiary. *Id.*, no. 16.b.-c., p. 6.

56. *Id.*, no. 17, p. 7.

57. *Id.*, Summary, p. ii.

58. *Id.* This may cause lenders to SPEs (such as insurance companies) involved in credit tenant lease transactions where there is no residual value guarantee by the tenant, to be deemed to be primary beneficiaries of SPEs and subject to the SPE Interpretation (even if the lease contains a purchase option at fair market value). *See also* Appendix A (Examples) to the SPE Interpretation at A2.d., p. 10, which states that an example of an arrangement that would cause an SPE to be subject to the Interpretation would be where "[a] variable interest holder other than the nominal owner guarantees residual values of the SPE's assets or agrees to future purchases of the SPE's assets at predetermined prices that protect the interests of other variable interest holders or lenders or has made arrangements for another party to do so."

59. *Id.*, no. 12, p. 5.

60. *Id.*, no. 8.c., p. 3. *See also* Appendix B (Background Information and Basis for Conclusions) to the SPE Interpretation at B18, p. 16, in which the FASB "considered whether an entity that is consolidated by a substantive operating enterprise (or a group of assets and related liabilities held by a substantive operating enterprise) could be an SPE covered by this Interpretation. An example is a subsidiary in which a parent has a very small equity investment that leases property financed by nonrecourse debt to a single lessee. If the lessee provides a residual value guarantee or if other provisions in the lease expose the lessee to essentially all of the risks related to the price of the leased property, the lessee could be considered the primary beneficiary of those assets and liabilities. However, the Board decided that an SPE-like subsidiary or group of assets and liabilities included in consolidated financial statements of a substantive operating entity should not be subject to the provisions of this Interpretation."

61. *Id.*, no. 8.a.-b., p. 3.

62. *Id.*, no. 9.b.-e., p. 4.

MICHIGAN'S NEW SLEEPER TAX ON SALES OF REAL ESTATE – THE "NEW" DEFINITION OF "GROSS RECEIPTS" UNDER THE SINGLE BUSINESS TAX ACT

by *Alan M. Valade** and *Aaron M. Silver***

Effective for tax years beginning after December 31, 2000, the Michigan Legislature enacted 2000 P.A. 477 and thereby amended the Single Business Tax Act (the "SBTA")[1] to change the definition of "gross receipts." Under P.A. 477 "gross receipts" means the "entire amount received by the taxpayer from any activity whether in intrastate, interstate, or foreign commerce carried on for direct or indirect gain, benefit, or advantage to the taxpayer or to others" with certain specified exceptions.[2] Under P.A. 477, the "entire amount received" from the sale or exchange of depreciable and non-depreciable real property (and other capital assets) is, with certain exceptions discussed below, subject to single business taxation. For those real estate taxpayers that sell improved and/or unimproved realty, this is a significant statutory change that will have a material adverse single business tax ("SBT") effect on many real estate sale transactions in Michigan.

This article explains the new legislation and reviews the detailed legislative history. The legislative history plainly indicates that the legislature never intended to impose a new or increased tax on real estate sale transactions in Michigan. The article discusses the Department of Treasury's ("Department") efforts to minimize some of the adverse tax affects of the legislation. The article also includes a number of examples that compare the SBT consequences under the old and the new definitions of gross receipts. We conclude the article by suggesting a possible strategy to minimize the adverse tax consequences associated with the new definition of gross receipts.

DISCUSSION

The Legislature Did Not Intend to Impose a New Tax on Real Estate

Senate Bill 1300 ("S.B. 1300"), which became P.A. 477, was originally introduced in the Michigan Senate on May 30, 2000. As originally introduced, S.B. 1300 would have resolved a long-standing dispute between the advertising

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industry and the Department regarding the SBT taxation of amounts paid to advertising agencies.

According to a Senate Fiscal Agency ("SFA") Bill Analysis (dated September 22, 2000), S.B. 1300 as originally introduced, would have amended the SBTA definition of "gross receipts" to exclude from gross receipts "amounts received by an advertising agency to acquire advertising media time, space, or talent on behalf of another person." According to this SFA Bill Analysis, S.B. 1300 "would **reduce** single business tax revenue an estimated $6.3 million in [fiscal year] 2000-01 . . . . In subsequent years, this bill would **reduce** single business tax revenue about $1.0 million per year." (Emphasis added.)

Subsequently, S.B. 1300 was amended in the Senate (by Senate Substitute S-1) to address the Court of Appeals' decision in *PM One, Limited v Department of Treasury*, 240 Mich App 255 (2000). According to SFA Bill Analysis (dated October 2, 2000), in *PM One Limited* the "Court [of Appeals] held that certain amounts received by a taxpayer for certain agency-related [real estate management] responsibilities could not be included in a taxpayer's gross receipts . . . . The provisions in the bill relating to amounts received while acting in an agency capacity would attempt to create greater conformity between the *PM One* decision and the [SBT] statute." According to the October 2, 2000 SFA Bill Analysis, under both *PM One* and amended S.B. 1300 (Substitute S-1), real estate management companies and other taxpayers would **reduce** their SBT liabilities: "Taxpayers [who restructure their operations] could eliminate all or a majority of their SBT liability." According to this SFA Bill Analysis, "The bill would **reduce** State General Fund revenues by an unknown amount . . . ." (Emphasis and material in brackets added.)

Later, S.B. 1300 was amended by the House of Representatives in Substitute Bill H-1. The House Legislative Analysis Section Report (dated November 29, 2000) discussed the "fiscal implications" of amended S.B. 1300 (Substitute H-1) in the following terms: "Both the House Fiscal Agency and Senate Fiscal Agency say the bill would **reduce** General Fund revenues from the SBT by an unknown amount . . . ." (Emphasis added).

From the foregoing legislative history, a clear picture emerges that the House and Senate staff reports provided to the House and Senate members informed those voting on S.B. 1300 that its enactment would **reduce** SBT taxes. In the final SFA Bill Analysis (dated January 31, 2001), which was prepared after the legislature had enacted P.A. 477, the SFA again declared that "The bill will **reduce** State General Fund revenues by an unknown amount."

For the reasons explained below, and although the legislature intended S.B. 1300 to decrease taxes, S.B. 1300, as enacted as P.A. 477, has actually **increased** the SBT taxes imposed on many real estate sale transactions, in some instances very significantly.

The New Definition of Gross Receipts

While not intended by the legislature, and hence a "sleeper" tax, P.A. 477 effected a substantial change from prior law in the circumstance where a taxpayer sells a capital asset, including depreciable or non-depreciable real estate, and elects under SBTA Section 31(2)[3] to use the 50% gross receipts method (the "Short Method") to calculate the taxpayer's annual SBT liability.

Under the prior statutory definition of "gross receipts,[4]" the sale or exchange of capital assets, including land and buildings, did not result in "gross receipts" under the SBTA because "gross receipts" (with a number of exceptions for certain agency, rental and lease receipts) only arose from the sale of inventory-type property or property held primarily for sale in the ordinary course of a taxpayer's trade or business.[5] For most taxpayers, this definition of gross receipts would not include proceeds from the sale of real estate held for investment or held for similar business purposes.

Under the pre-P.A. 477 definition of "gross receipts," a taxpayer could sell real estate on the first day of a tax year, recapture the Capital Acquisition Deduction ("CAD") previously deducted,[6] elect to use the 50% gross receipts Short Method under SBTA Section 31(2) to calculate the taxpayer's adjusted SBT base, and thereby pay tax on only 50% of the CAD recaptured, if any. The P.A. 477 definition of "gross receipts," since it includes the "entire amount received" from a sale, has changed this result for the vast majority of real estate sale transactions, including the sale of land which was not previously taxed at all (unless it was inventory in the hands of the taxpayer). P.A. 477 will result in a larger SBT adjusted tax base against which the 50% gross receipts Short Method election may be made. Since the adjusted gross receipts tax base will be larger, P.A. 477 will increase the amount of single business taxes owing upon the sale of most non-inventory real estate.

Determining SBT Tax Liability

Annually taxpayers can choose the lower of two different methods to calculate their SBT tax base: the regular method under SBTA Section 9 or the 50% gross receipts Short Method under SBTA Section 31(2). The Short Method is intended to ensure that the maximum SBT

tax imposed on a taxpayer will equal the single business tax rate times 50% of the taxpayer's adjusted gross receipts. While real estate taxpayers should compute their taxes under both methods in order to determine which method results in a smaller tax, for many single purpose entities (such as limited partnerships and limited liability companies) that sell real estate, until 2001 the Short Method almost always resulted in the smaller tax.

The Department's 2002 Notice Regarding the Post-2000 SBT Definition of "Gross Receipts"

Since many taxpayers, their advisors and the legislature were unaware of the significance of the application of P.A. 477 to the routine sale of real estate, taxpayers that sold real estate during 2001 did not learn of the new sleeper tax until their 2001 annual SBT returns were prepared in early 2002. Because of the controversy surrounding the double taxation of certain receipts under P.A. 477's definition of "gross receipts," in June 2002 the Department released a Notice[7] (the "2002 Notice") that, in some circumstances, mitigates against some of the adverse SBT tax consequences that result from the new definition.

While the tax results achieved under the 2002 Notice are difficult to reconcile with the language used in P.A. 477, according to the 2002 Notice, in the limited circumstance where a taxpayer sells or disposes of depreciable property that was previously subject to a CAD, the amount of the CAD recapture and gain on the sale should be removed from the "entire amount received" by the taxpayer. According to the examples used in the 2002 Notice, when depreciable assets are sold at a gain taxpayers should calculate their "adjusted gross receipts" so that the sales price (the gross receipts) received by the taxpayer is reduced by the sum of (a) the amount of any CAD recaptured ("CADR") and (b) any gain realized on the sale of the depreciable property. Any losses on the sale are added to and increase the amount of adjusted gross receipts.

Conversely, and while not discussed in the 2002 Notice, in the circumstance where a non-depreciable asset (for example, vacant land or an intangible) is sold after 2000, "gross receipts" and "adjusted gross receipts" under P.A. 477 include the "entire amount received" by the taxpayer without adjustments. While it is difficult to justify the different SBT tax treatment afforded to sales of depreciable versus non-depreciable property under the 2002 Notice, it is clear that different tax consequences will result under P.A. 477 and the 2002 Notice. These differences are highlighted in the following examples.

EXAMPLES

The following examples illustrate the application of P.A. 477's amended definition of gross receipts. Example 1 compares the SBT tax consequences that arise from the sales of depreciable property in 2000 (under prior law) and 2001 (under P.A. 477). While the SBT tax rate is actually decreasing over time at the rate of .01% per year,[8] the calculations in Example 1 use the 2% tax rate in effect for the tax year ending December 2000. All of the examples assume that the taxpayer elects to calculate its annual SBT liability in accordance with the 50% Short Method under SBTA Section 31(2).

Example 1

Assume that the taxpayer purchased land and building on January 1, 1995 for a total cost of $5 million. $1 million of the purchase price is allocated to land and $4 million to the building. In 1995 the taxpayer claimed a CAD deduction for the $4 million cost of the building. No CAD deduction was claimed on the land, as land is a non-depreciable asset.

Assume that on January 1, 2000, the taxpayer sold the land and building for $7 million. Of this amount, $5,750,000 of the sale proceeds is allocated to the building, and $1,250,000 is allocated to the land. The accumulated depreciation deducted on the building was $611,240, so the building's adjusted basis for federal income tax purposes is $3,388,760 ($4,000,000 - 611,240 = $3,388,760). The adjusted basis of the land is $1 million. For federal income tax purposes, the gain on the sale is calculated as follows:

	Building	Land
Amount realized	$5,750,000	$1,250,000
Less: adjusted basis	3,388,760	1,000,000
Gain	$2,361,240	$ 250,000

Application of Pre-P.A. 477 Definition of Gross Receipts

Under the pre-2001 definition of gross receipts, the SBT adjusted tax base under the Short Method is equal to the taxpayer's gross receipts plus CADR, multiplied by 50%. Since the pre-2001 definition of gross receipts includes only sales of inventory-type property and property held primarily for sale in the ordinary course of business, as well as rental or lease receipts, all of the sale proceeds are

excluded from "gross receipts." Accordingly, only the CADR is included in the adjusted gross receipts tax base under SBTA Section 31(2). In Example 1 the adjusted gross receipts tax base is calculated as follows:

	Land	Building	Total
Gross Receipts	$ –	$ –	$ –
Plus CADR			
Proceeds:	$ –	$5,750,000	$5,750,000
Less: federal gain	–	2,361,240	2,361,240
Plus: federal loss	–	–	–
CADR	$ –	$3,388,760	$3,388,760
Gross receipts tax base (before 50% reduction)			$3,388,760

Application of P.A. 477 Definition of Gross Receipts

After December 31, 2000, for sales of depreciable property, the adjusted tax base for the 50% Short Method is equal to the "entire amount received" from the sale as adjusted by the 2002 Notice. According to the Department's 2002 Notice, taxpayers can reduce the "entire amount received" by the CADR, since the CADR amount was already included in "gross receipts" as part of the entire amount received, and by the gain realized on the sale transaction. Therefore, under P.A. 477 as interpreted by the 2002 Notice, the calculation of the taxpayer's adjusted tax base is as follows:

	Land	Building	Total
Gross Receipts	$1,250,000	$5,750,000	$7,000,000
No CADR Recapture (Per 2002 Notice)		$ –	$ –
Less: Gain			($2,611,240)
Adjusted gross receipts tax base (before 50% reduction)			$4,388,760

Applying the 2% tax rate in effect for the 2000 tax year, P.A. 477 increases the taxpayer's SBT tax liability by $10,000. The calculation is as follows:

	Pre-P.A. 477	Post-P.A. 477
Adjusted Gross Receipts tax base (before 50% reduction)	$3,388,760	$4,388,760
Less 50% Reduction	x 50%	x 50%
Adjusted gross receipts tax base	$1,694,380	$2,194,380
Tax rate	2%	2%
SBT Tax Liability	$ 33,888	$ 43,888

Example 2

Assume that $1 million is paid on January 1, 1995 to purchase vacant land. Since land is non-depreciable property, the taxpayer did not claim a CAD in 1995. On January 1, 2000, the vacant land is sold for $7 million, and the taxpayer realized a $6 million gain on the sale ($7 million – 1 million = $6 million).

Under the pre-P.A. 477 definition of gross receipts, there are no (zero) "gross receipts" arising from the sale of the vacant land because (1) there is no CAD to be recaptured and (2) the land was held for investment and not primarily for sale to customers as inventory-type property. Assuming the taxpayer elects to use the SBTA Section 31(2) Short Method, no SBT taxes would be owing in 2000 in connection with the 2000 sale of the vacant land.

If the sale of the land takes place on January 1, 2001 (or thereafter), under P.A. 477 the "gross receipts" and "adjusted gross receipts" are $7 million, which is the "entire amount received" by the taxpayer. Since the sale includes only the sale of non-depreciable property (vacant land), the adjustments permitted by the 2002 Notice (in connection with the sale of depreciable property) do not apply. Assuming a 2% SBT rate in 2001,[9] the tax owing would be $70,000 ([$7 million x 50%] x 2% = $70,000). The effective SBT tax rate imposed on the sale of the non-depreciable property in Example 2 is substantially higher than the effective tax rate imposed in Example 1 on the sale of depreciable property.

Example 3

Assume the same facts as Example 1 except that the taxpayer was unable to use the full $4 million CAD claimed in 1995. Assume that the unused CAD generated a business loss carry forward and, as of January 1, 2001,

the amount of the business loss carry forward was $1 million.[10] The taxpayer sells the land and building on January 1, 2001 for $7 million as indicated in Example 1.

As under prior law, P.A. 477 does not allow the taxpayer to reduce the gross receipts by the amount of the $1 million unused SBT business loss carry forward.[11] Therefore, under P.A. 477 and the 2002 Notice, the taxpayer's adjusted gross receipts (before application of the 50% reduction) are $4,388,760 (same as Example 1).

CONCLUSION

While the Legislature should consider technical amendments to eliminate the sleeper tax on real estate, the Department's issuance of the 2002 Notice ameliorates some of the adverse tax effects of P.A. 477 when depreciable realty is sold. Taxpayers that sold depreciable property in 2001 should consider filing claims for refund (amended SBT returns) based on the 2002 Notice.

Unfortunately, since the Department's Notice does not apply to the sale of non-depreciable property, P.A. 477 will be especially troublesome for taxpayers that sell non-depreciable property. For sellers of non-depreciable property, such as vacant land, these taxpayers should consider constructing buildings (e.g., a build to suit) on their vacant land before they sell the property so that, at the time the property is sold, it should be subject to recapture of the SBT investment tax credit ("ITC") under SBTA Section 35a. By obtaining an ITC on the improvements to the real estate, it is at least arguable that the adjustments allowed in the Department's 2002 Notice should apply in calculating the taxpayer's gross receipts and adjusted gross receipts under P.A. 477 when the (now) depreciable property is sold.

Caveat: The Department's Notice may not be the final word on the difficult issues raised by P.A. 477 and caution is urged.

Endnotes

1. 2000 P.A. 477, amending SBTA Section 7(1) and 7(3) (filed with the Secretary of State on January 10, 2001).

2. In addition to adding the "entire amount received" language to SBTA Section 7(3), P.A. 477 also amended Section 7(3) to generally track the "agency exceptions" discussed in *PM One, Limited v Department of Treasury*, 240 Mich App 255 (2000). Under PA 477 "gross receipts" do not include: (1) proceeds from sales by a principal that the taxpayer collected in an agency capacity solely on behalf of the principal and delivered to the principal; (2) amounts that were excluded from gross income of a foreign corporation engaged in the international operation of aircraft under §833(a) of the Internal Revenue Code; (3) amounts received by an advertising agency used to acquire advertising media time, space, production, or talent on behalf of another; (4) amounts received by a taxpayer that manages real property owned by the taxpayer's client that are not reimbursements to the taxpayer and are not indirect payments for management services that the taxpayer provides to that client; and (5) amounts received by the taxpayer as an agent solely on behalf of the principal that were expended by the taxpayer for any of the following six purposes: (a) the performance of a service by a third party for the principal's benefit that was required by law to be performed by a licensed person; (b) the performance of a service by a third party for the principal's benefit that the taxpayer had not undertaken a contractual duty to perform; (c) the principal and interest under a mortgage loan or land contract, lease or rental payments, or taxes, utilities, or insurance premiums relating to real or personal property owned or leased by the principal; (d) a capital asset of a type that is or, under the IRC, will become eligible for depreciation, amortization, or accelerated cost recovery by the principal for federal income tax purposes, or for real property owned or leased by the principal; (e) property not described in (d) purchased by the taxpayer on behalf of the principal and that the taxpayer did not take title to or use in the course of performing its contractual business activities; and (f) fees, taxes, assessments, levies, fines, penalties, or other payments established by law that were paid to a governmental entity and that were the legal obligation of the principal.

3. MCL 208.31(2). Under SBTA Section 31(2), taxpayers can elect to calculate their annual SBT liability using the Short Method, in lieu of using the standard addition/subtraction method to calculate their SBT tax base under SBTA Section 9. Under the Short Method, taxpayers calculate their "adjusted tax base" by first determining their total "gross receipts." Total gross receipts are then apportioned among the states if the taxpayer is taxable in Michigan and in other states. Recaptured capital acquisition deduction is then added to the taxpayer's apportioned gross receipts. To the extent that the "adjusted tax base" exceeds 50% of the "gross receipts," the taxpayer can reduce its gross receipts by the amount of the excess. In effect, the SBT tax rate is applied against 50% of the taxpayer's gross receipts.

4. MCL 208.7(3)(2000) defined "gross receipts" as follows:

   (3) Gross receipts means the sum of sales, as defined in subsection (1), and rental or lease receipts. Gross receipts does not include the amounts received in an agency or other representative capacity, solely on behalf of another or others but not including amounts received by persons having the power or authority to expend or otherwise appropriate such amounts in payment for or in consideration of sales or services made or rendered by themselves or by others acting under their direction and control or by such fiduciaries as guardians, executors,

administrators, receivers, conservators, or trustees other than trustees of taxes received or collected from others under direction of the laws of the federal government or of any state or local governments. (Emphasis added.)

"Sale" or "sales" were defined by prior MCL 208.7(1) (2000) as follows:

(1) Sale or sales means the gross receipts arising from a transaction or transactions in which gross receipts constitute consideration: (a) for the transfer of title to, or possession of, property that is stock in trade or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the tax period or property held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business, or (b) for the performance of services, which constitute business activities other than those included in (a), or from any combination of (a) or (b). (Emphasis added.)

5. See, Department's SBT Questions & Answers ("Q & A"), E14 ("Is the sale of a capital asset included in gross receipts for a gross receipts taxpayer and in the sales factor for a multi-state taxpayer? [Answer] The sale of a capital asset is not included in with the gross receipts or the sales factor") and Q & A E18 ("Capital gains and losses under the IRC generally apply to dispositions of capital assets. The definition of capital assets . . . [excludes] property primarily held for resale to customers or . . . inventory of the taxpayer . . . . [C]an it be concluded that receipts from any disposition of property receiving capital gain or loss treatment are not gross receipts? [Answer]. Yes. As a general rule, receipts from the disposition of property (capital assets) receiving capital gain or loss treatment are not included as gross receipts. For certain calculations, the SBTA does require the combination of the recapture of capital acquisition deduction with gross receipts.") (Emphasis added.)

6. MCL 208.23, *et seq.*

7. The Department's 2002 Notice is attached to this article Exhibit 1. In its 2002 Notice the Department states that "gross proceeds . . . includes the entire proceeds for the sale of a **depreciable**, tangible asset. However, the taxpayer is not required to report the proceeds from the asset sale twice when calculating "adjusted gross receipts" . . .' gross receipts' as used in the above section already includes the gross proceeds from the sale of tangible assets that are subject to capital acquisition deduction recapture. Therefore, to avoid double reporting of these receipts, . . . the taxpayer shall subtract the gain from gross receipts or add the loss to gross receipts . . . ." (Emphasis added.) It is the authors' understanding that the Department's position is that the 2002 Notice does not apply to the sale of non-depreciable assets, such as land.

8. See 1999 P.A. 115.

9. Under 1999 P.A. 115, the actual 2001 SBT rate is 1.9%.

10. See SBTA Section 23b(h). Business loss carry forwards may be carried forward for nine years.

11. See Department's Q & A Number J4 ("In using the gross receipts method of computing the tax, can a taxpayer reduce the gross receipts by a business loss, a Michigan NOL carry forward, and the statutory exemption? [Answer] No. However these items are used in computing the adjusted tax base, which is necessary to determine whether or not the gross receipts method should be used." (Emphasis added.)

    In Example 3 the taxpayer can claim the $1 million business loss carry forward if the taxpayer uses the standard SBTA Section 9 method to calculate the taxpayer's SBT base.

EXHIBIT 1

STATE OF MICHIGAN
DEPARTMENT OF TREASURY
LANSING

JOHN ENGLER
GOVERNOR

DOUGLAS B. ROBERT
STATE TREASURER

NOTICE FOR SBT FILERS
Adjusted Gross Receipts; Capital Acquisition Deduction Recapture
And Investment Tax Credit Recapture

General Summary

Pursuant to 2000 PA 477, "gross receipts" as defined in the Single Business Tax Act ("SBTA") includes the entire proceeds from the sale of a depreciable, tangible asset. However, the taxpayer is not required to report the proceeds from the asset sale twice when calculating "adjusted gross receipts" as described in this notice.

Adjusted Gross Receipts

For tax years that begin on or after January 1, 2001, this notice explains the calculation of "adjusted gross receipts" and "gross receipts plus" capital acquisition recapture ("CADR") for the following purposes only:

1) Gross Receipts Reduction [MCL 208.31(2)]
2) Investment Tax Credit Percentage [MCL 208.35a(10)]
3) Filing Threshold [MCL 208.73]

This notice does not change the calculation of CADR that is added to the tax base under MCL 208.23a.

Please note that assets eligible for the investment tax credit ("ITC") are not included in the adjusted gross receipts calculation for gross receipts reduction and filing threshold purposes, but are included for purposes of calculating the ITC rate. For gross receipts reduction and filing threshold purposes, only capital acquisition deduction ("CAD") assets are included in the calculation. For gross receipts reduction purposes [MCL 208.31(2)] include only the adjustments provided for under Sec. 23b(a) to (g). For filing threshold purposes [MCL 208.73] include only adjustments under Sec. 23b(a),(b) and (c). For ITC percentage purposes [MCL 208.35a(10)] include the adjustments under sections 23b(a) to (g) and 35a(1)(d) to (f).

Explanation and Examples

For tax years that begin on or after January 1, 2001, gross receipts as defined by MCL 208.7(3) includes, among other items, the gross proceeds from the sale of property used in the taxpayer's business activity. When calculating "adjusted gross receipts" for the purposes of the sections cited in paragraphs 1), 2), and 3) above, the taxpayer is required to add certain amounts to gross receipts. The phrase "gross receipts plus adjustments" appears in MCL 208.31(2):

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> "As used in this section, "adjusted tax base" means the tax base allocated or apportioned to this state pursuant to chapter 3 with the adjustments prescribed by sections 23 and 23b and the exemptions prescribed by section 35. If the adjusted tax base exceeds 50% of *the sum of gross receipts plus the adjustments provided in section 23b(a) to (g)*, apportioned or allocated to Michigan with the apportionment fraction calculated pursuant to chapter 3, the adjusted tax base may, at the option of the taxpayer, be reduced by that excess...." MCL 208.31(2).

"Gross receipts" as used in the above section already includes the gross proceeds from the sale of tangible assets that are subject to capital acquisition deduction recapture. Therefore, to avoid double reporting of these receipts, for purposes of the above-cited sections only, when calculating the adjustments under section 23b(a) to (g), the taxpayer shall subtract the gain from gross receipts or add the loss to gross receipts, as illustrated in the following example.

> **Example**: The taxpayer's gross receipts for the tax year are $90. This includes "sales" of inventory of $75 and gross proceeds from the sale of an asset subject to CADR of $15. The sale of the asset resulted in a loss of $5 for federal income tax purposes. For purposes of calculating gross receipts plus adjustments under section 31(2), the taxpayer starts with gross receipts of $90, then adds the loss of $5, for a total adjusted gross receipts of $95.

The same reasoning described above applies when calculating "gross receipts plus the adjustments" provided in sections 23b(a), (b), and (c), for filing threshold purposes under MCL 208.73.

The calculation of "adjusted gross receipts" for purposes of determining the percentage rate for the Investment Tax Credit (ITC) also follows the same reasoning as above. Section 35a(10) describes the "adjusted gross receipts" calculation as follows:

> MCL 208.35a(10) As used in subsection (2), "adjusted gross receipts" means the sum of the following:
>
> (a) *Gross receipts* apportioned or allocated to Michigan with the apportionment fraction calculated pursuant to chapter 3.
> (b) Adjustments provided in section 23b(a) to (g).
> (c) Adjustments provided in subsection (1)(d) to (f).

"Gross receipts" as that term is used in section 35a(10)(a) [in italics above] already includes the gross proceeds from the sale of tangible assets that are subject to recapture related to the investment tax credit or the capital acquisition deduction. Therefore, the taxpayer shall not include the gross proceeds from the sale of such depreciable, tangible assets again when calculating the adjustments provided in sections 23b(a) to (g) and 35a(1)(d) to (f). The following example demonstrates the adjustments for CAD or ITC recapture as provided by sections 23b(a) to (g) and 35b(1)(d) (f) (assume the asset was subject to CAD recapture):

> **Example**: The taxpayer's gross receipts for the tax year are $100. This $100 in total gross receipts includes the gross proceeds from the sale of a depreciable capital asset used in the taxpayer's business activity equaling $25. The gain for federal income tax purposes on the sale of the asset is $5. Subtract the gain from gross receipts [$100 Gross Receipts – $5 gain on sale of asset = $95 Adjusted Gross Receipts].

For simplicity, the above examples involve taxpayers not subject to apportionment. However, taxpayers that are subject to apportionment must make similar adjustments in order to avoid accounting for the same proceeds more than once in the calculation of adjusted gross receipts.

PROPOSAL A OF 1994 AND AGRICULTURAL PROPERTY: FARMER, DEVELOPER AND TITLE COMPANY BEWARE

by *David E. Nykanen**

I. Introduction

In colonial times, a large segment of the nation's population participated in the agrarian economy. Today, only 2.46% of the population is involved in agriculture as an occupation.[1] Notwithstanding the vast reduction in numbers, society's love (or perhaps the political prowess) of farmers endures. Recent changes[2] to the General Property Tax Act's[3] definition of a "transfer of ownership"[4] furthers the favored status of owners of agricultural property.[5] This article analyzes the relationship between the General Property Tax Act's[6] cap on the increase in the taxable value of real estate, the Agricultural Exemption, and the purchase and sale of agricultural property.

This article discusses two main property tax benefits available to owners and purchasers of agricultural property: (a) the Agricultural Exemption and (b) the deferred lifting of the cap on taxable value. These benefits arise out of the adoption by Michigan voters of Proposal A on March 15, 1994,[7] as well as the recent amendment of the definition of "transfer of ownership."[8] Because of the risks associated with some of these tax benefits, buyers and sellers of agricultural property need to be aware of these provisions when negotiating a purchase agreement. Title companies also need to be aware of the recapture tax discussed herein.

Proposal A imposed a cap on increases in the taxable values of real estate assessments, and concurrently increased Michigan's sales and use tax from four percent to six percent.[9] In addition, homeowners were given an 18 mill cut in property tax rates on their "homestead;" owners of agricultural property were given an 18 mill cut in property tax rates on agricultural property (commonly known, and referred to in this article, as the "Agricultural Exemption"); and the State Real Estate Transfer Tax Act was introduced.

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As a result of Proposal A's enactment in 1994, assessment notices now contain a "taxable value" and a "state equalized value."[10] The General Property Tax Act caps the annual increase of taxable value at the lesser of: (a) five percent or (b) the inflation rate.[11] However, the state equalized value increases without a cap, and is to represent fifty percent of the property's true cash value.[12]

II. The Agricultural Exemption

Agricultural property may receive an exemption from the school tax rate, which may be up to 18 mills,[13] if the property qualifies for the Agricultural Exemption. The Agricultural Exemption is available to qualified agricultural property, which includes (a) property that is classified as "agricultural real property" by the assessor[14] and (b) property that meets the statutory definition of qualified agricultural property[15] and for which a Claim for Farmland Exemption From Some School Operating Taxes[16] is timely filed with the assessor.

The local assessor may classify property as "agricultural real property" if the property contains parcels used wholly or partially for agricultural operations. "Agricultural operations" are defined as:

> (i) Farming in all its branches, including cultivating soil.
>
> (ii) Growing and harvesting any agricultural, horticultural, or floricultural commodity.
>
> (iii) Dairying.
>
> (iv) Raising livestock, bees, fish, fur-bearing animals, or poultry.
>
> (v) Turf and tree farming.
>
> (vi) Performing any practices on a farm incident to, or in conjunction with, farming operations. A commercial storage, processing, distribution, marketing, or shipping operation is not part of agricultural operations.[17]

If property is not classified as "agricultural" by the assessor, the property must meet the definition of "agricultural use."[18] The statute requires that the property be unoccupied property and related buildings that are "primarily devoted" to agricultural use. "Primarily devoted" means that "more than 50% of the parcel's acreage is devoted to 'agricultural use.'"[19] Agricultural use is defined as follows:

> "Agricultural use" means substantially undeveloped land devoted to the production of plants and animals useful to humans, including forages and sod crops; grains, feed crops, and field crops; dairy and dairy products; poultry and poultry products; livestock, including breeding and grazing of cattle, swine, captive cervidae, and similar animals; berries; herbs; flowers; seeds; grasses; nursery stock; fruits; vegetables; Christmas trees; and other similar uses and activities. Agricultural use includes use in a federal acreage set-aside program or a federal conservation reserve program. Agricultural use does not include the management and harvesting of a woodlot.[20]

Counsel for a party seeking an Agricultural Exemption should closely examine both definitions of "agricultural" contained in the two separate statutes to determine whether the use of the property satisfies either definition. Note that property classified by the assessor as "agricultural real property" does not have to be primarily devoted to an agricultural use. In other words, the property does not have to satisfy the "more than 50%" test. Therefore, under the plain language of the statute, property classified by the assessor as "agricultural real property" will automatically receive the agricultural exemption for that portion of the property used for agricultural purposes even if the property as a whole does not satisfy the "more than 50%" test.

Counsel should be creative when considering whether the Agricultural Exemption applies to a client's property. Some uncommon agricultural uses include, for example, raising deer for harvesting,[21] growing flowers,[22] and breeding dogs.[23]

Not more than ninety days after the property ceases to be qualified agricultural property, the owner is obligated to rescind the Agricultural Exemption by filing a form prescribed by the Michigan Department of Treasury, commonly known as the Request to Rescind the Qualified Agricultural Property Exemption.[24] Penalties similar to those for failing to file a Property Transfer Affidavit are applied to an owner who fails to file the Request to Rescind.[25]

III. The Deferral of the Lifting of the Cap and the Agricultural Property Recapture Act

Under Proposal A, when a transfer of ownership[26] occurs, the cap on the taxable value is lifted and the taxable value is raised in the year following that transfer to the state equalized value. Therefore, it is essential to understand when a transfer of ownership has, and has not, occurred.

A "transfer" will trigger the uncapping of the taxable value and a commensurate increase in the taxable value of the property.

For certain agricultural property, there is an added twist to the general rules. If a party that desires to continue an agricultural use on the property purchases "qualified agricultural property,"[27] there is an opportunity to defer the uncapping of the taxable value. However, if the use of the agricultural property is later converted, a recapture tax is collected at the time of such conversion.

A. The Deferral of the Lifting of the Cap on Taxable Value

If a purchaser of qualified agricultural property intends to continue the agricultural use of the property, the taxable value of the property remains capped if the purchaser files with the assessor and the register of deeds an Affidavit Attesting that Qualified Agricultural Property Shall Remain Qualified Agricultural Property.[28] This is accomplished because a transfer of qualified agricultural property to a user filing the Affidavit is excluded from the definition of "transfer of ownership."[29]

Significantly, for the property to qualify for the deferred lifting of the cap on taxable value, the property need not be receiving the Agricultural Exemption prior to the transfer, and need not be classified as agricultural for assessment purposes; the property need only satisfy the definition of "qualified agricultural property," as discussed earlier. In addition to seeking the deferred lifting of the cap on taxable value, if the property has not previously been receiving the benefit of the Agricultural Exemption, a purchaser may request the Agricultural Exemption by filing the Claim for Farmland Exemption From Some School Operating Taxes[30] upon purchase.

Significantly, if the property is classified as, for example, sixty percent agricultural by the assessor, then forty percent of the taxable value will be uncapped.[31]

B. The Agricultural Property Recapture Act

The deferred lifting of the cap upon the transfer of agricultural property is not without a cost. If the lifting of the cap on taxable value is deferred due to continued agriculture use, and the property's use is later converted to a non-agricultural use, a recapture tax is then collected.[32] The recapture tax is based upon a calculation of the tax revenues lost by the deferral of the lifting of the cap on taxable value.

(1) *What triggers the recapture tax?*

The recapture tax is triggered when all of the following are satisfied:

(a) Real property is qualified agricultural property,

(b) That real property is transferred,

(c) The transferee files an Affidavit Attesting that Qualified Agricultural Property Shall Remain Qualified Agricultural Property with the assessor and register of deeds, and the taxable value in not uncapped,

(d) The then-present owner of the property converts the property to a non- agricultural use, or a potential purchaser files a Notice of Intent to Rescind the Qualified Agricultural Exemption.[33]

The change in use issue becomes more complicated if the use of only a portion of the property is changed. If the portion of the property where the use is changed was split off as a new parcel, then only that portion will have a recapture tax collected at that time. The parent parcel's taxable value will remain capped.[34] However, if the use of a portion of the property is changed (e.g., ten acres of an eighty-acre parcel is converted to a commercial or residential use), the taxable value of the entire property will be uncapped, and a recapture tax on the entire parcel will be collected.[35] Obviously, advance planning is critical in these situations.

(2) *When is the tax due?*

The tax is due when the use is converted, if the change in use triggers the tax.[36] The tax is due when conveyance documents are recorded with the register of deeds, if the filing of the Notice of Intent to Rescind the Qualified Agricultural Exemption triggers the tax.[37] Therefore, a title company should be careful to determine whether the recapture tax will be due when preparing closing statements and issuing title insurance commitments and policies. Without payment of the recapture tax the deed will not be recordable, and a title company could find itself advancing the funds necessary to pay the recapture tax to record the deed in order to accomplish insurable title.

(3) *Who pays the tax?*

The tax is paid by the owner of the property when the use is converted if the change in use triggers the tax.[38] The tax is paid by the seller if the tax is triggered by the filing

of a Notice of Intent to Rescind the Qualified Agricultural Exemption.[39] Therefore, if a seller believes that the purchaser is going to continue to use the property as qualified agricultural property, a prohibition on the filing of a Notice of Intent to Rescind the Qualified Agricultural Exemption should be incorporated into the purchase agreement, so that the seller is not obligated to pay the recapture tax. Conversely, a purchaser intending to change the use should insure that the Notice of Intent to Rescind is filed prior to closing, so that the seller is obligated to pay the recapture tax.

Further, a purchaser of agricultural property should incorporate a seller's representation as to whether a previous Affidavit Attesting that Qualified Agricultural Property Shall Remain Qualified Agricultural Property has been filed, because such filing will cause the purchaser to be obligated to pay the recapture tax if there is a later change in use. Finally, a seller who will be obligated to pay the recapture tax due to the filing of a Notice of Intent to Rescind should, all other things being equal, attempt to close a sale transaction in the later part of a calendar year, rather than the beginning of a year. This is because the year of the transfer is not counted in calculating the recapture tax, as discussed below.

(4) *How is the tax calculated?*

The tax is equal to the "benefit" received, as defined below, for each year of the "benefit period," as defined below. The "benefit" received each year is the product of:

i. The sum of the number of mills levied in the local tax collecting unit on the property, multiplied by

ii. the difference between the taxable value for such year and the true cash taxable value[40] of the property for such year.[41]

The "benefit period" is equal to:

The period in years between the date of the first exempt transfer and the conversion by a change in use, not to exceed the 7 years immediately preceding the year in which the qualified agricultural property is converted by a change in use.[42]

Again, the year of the transfer is not counted when calculating the benefit period.

IV. Conclusion

Proposal A affects almost every transfer of property in the State of Michigan. The effects on agricultural property are additionally complex due to the potential deferral of the lift of the cap on taxable value, and the subsequent recapture tax. Therefore, particular attention must be paid to transactions involving the transfer of agricultural property.

Endnotes

1. U.S. Census Bureau, Statistical Abstract of the United States 410 (2000). Statistics are for calendar year 1999.
2. PA 260 of 2000.
3. MCL 211.1 et seq.
4. See MCL 211.27a(6)(n).
5. This article does not debate the merits of such property tax benefits. The sole purpose of this article is to discuss the benefits themselves.
6. MCL 211.1 et seq.
7. See Goodin, "Assessments Up; Prop A Keeps Tax Rates Level," Crain's Detroit Business, May 1, 1995, at p. 19. For discussion of the practical effects of Proposal A on homeowners, see Christoff, "Proposal A Has Pricey Pitfall," Detroit Free Press, April 25, 2002 at p. A1.
8. MCL 211.27a(6)(n).
9. See Goodin, supra.
10. Technically, assessment notices contain a capped value, a state equalized value, and a taxable value. The taxable value is the lesser of the capped value and the state equalized value. Since Michigan real estate values have increased each year since the enactment of Proposal A at a rate greater than the rate of inflation, the taxable value has been almost without exception equal to the capped value. See State Tax Commission Bulletin No. 16 "Transfers of Ownership," September 20, 1995. However, given the economic climate after September 11, 2001, it is possible that the state equalized value could decrease, and, therefore, recently transferred property may have a taxable value equal to the state equalized value.
11. MCL 211.27a(2)(a). The statute also allows for inclusion of "additions" and subtraction of "losses." For further discussion of these issues, see Rhoades and Itnyre, "Property Tax Cap and Transfer Taxes," 27 Mich. Real Prop. Rev. 63 (Summer 2000).
12. MCL 211.27(1); MCL 211.27a(1).
13. MCL 380.1211. Each school taxing unit sets its own millage, but that millage is capped at 18 mills. A "mill" is equal to "one-tenth of one cent" Black's Law Dictionary, (6th Ed., p. 993). Therefore, a tax rate of 18 mills is a tax of $18 per $1,000 of taxable value. See e.g., Black's Law Dictionary, 6th Ed., p. 994.
14. MCL 211.34c(2)(a).

15. MCL 211.7dd(e). The statute incorporates by reference the definitions contained in MCL 324.36101. Somewhat awkwardly, MCL 380.1211d (the School Code) contains a verbatim copy of the definitions contained in MCL 211.7dd (the Property Tax Act).

16. State Tax Commission Form 2599. All State Tax Commission forms referred to in this article are available online at http://www.michigan.gov/treasury. Counsel should not be confused by the titling of this form as "Farmland" rather than "Agricultural." This wording does not mean the definition of "farmland" contained in MCL 324.36101 is relevant to claiming the Agricultural Exemption.

17. MCL 211.34c(2)(a).

18. MCL 211.7dd(e).

19. MCL 211.7dd(e).

20. MCL 324.36101(a).

21. MCL 211.34c(2)(a)(iv).

22. MCL 211.34c(2)(a)(ii).

23. MCL 211.34c(2)(a)(iv) defines raising fur-bearing animals as an agricultural operation. As a practical matter, however, almost all dog breeding is done on property already benefiting from the homestead exemption, which provides identical tax rate benefits (but does not provide for deferral of the lifting of the cap on taxable value).

24. State Tax Commission Form 2743.

25. See MCL 211.7ee(5).

26. MCL 211.27a(6) defines "transfer of ownership."

27. See MCL 211.7dd(e); MCL 324.36101.

28. State Tax Commission Form 3676.

29. MCL 211.27a(7)(n).

30. State Tax Commission Form 2599.

31. See State Tax Commission Draft Bulletin No. 10 of 2000, "Transfers of Qualified Agricultural Property," December 6, 2000. A more complete discussion of partial uncapping of the taxable value is contained in State Tax Commission Bulletin No. 16, "Transfers of Ownership," September 20, 1995.

32. See MCL 211.1001-.1007.

33. MCL 211.1003(1).

34. See State Tax Commission Draft Bulletin No. 10 of 2000, "Transfers of Qualified Agricultural Property," December 6, 2000.

35. Id.

36. MCL 211.1003(2).

37. MCL 211.1002(c)(ii); 211.1003(3).

38. MCL 211.1003(2).

39. MCL 211.1003(2).

40. Although the statute refers to "true cash taxable value," in practice this means the state equalized value for the property. See MCL 211.1002(b).

41. MCL 211.1002(b).

42. MCL 211.1002(a). For further discussion of these issues, please refer to State Tax Commission Bulletin No. 4, January 24, 1997, "'Qualified Agricultural Property' Exempt from 18 Mills of Local 'School Operating' Levy;" State Tax Commission Draft Bulletin No. 10, December 6, 2000, "Transfer of Qualified Agricultural Property"; State Tax Commission Bulletin No. 8, June 25, 2001, "Changes to Definition of Agricultural Uses Contained in Public Act 262 of 2000." These bulletins can be accessed online at http://www.treas.state.mi.us/mitax/proptax/STCbulls/bullindx.htm

UPDATES TO THE NEW AMENDMENT TO THE MICHIGAN CONDOMINIUM ACT

by *C. Kim Shierk**

The Summer 2002 issue of the *Michigan Real Property Review* contained an article that summarized Act 379 of the Public Acts of 2000 ("Act 379"), which extensively amended the Michigan Condominium Act (Act 59 of the Public Acts of 1978, as amended) ("Condominium Act").[1] After that article was published, the Condominium Act was further amended by Act 283 of the Public Acts of 2002 ("Act 283") to correct certain errors and omissions in Act 379. Below is a summary of the provisions found in Act 283.

Act 379 had added to Section 54 of the Condominium Act requirements that the condominium bylaws contain provisions that provide generally for:

(a) arbitration to settle disputes relating to the interpretation of or arising out of the condominium documents,

(b) the right to petition the courts if arbitration is not elected, and

(c) the prohibition of the right to petition the courts if arbitration is elected.

Act 283 clarifies that this new requirement applies to condominium projects established on or after the effective date of Act 379 (January 2, 2001).

Section 58 of the Condominium Act had been amended by Act 379 to remove the provision that unpaid assessments are common expenses collectible from all condominium unit owners. An erroneous reference that assessments had priority over first mortgages under Section 108 of the Condominium Act was also added by Act 379. Act 283 removes this erroneous reference.

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A new Subsection (3) had been added to Section 67 of the Condominium Act by Act 379 to allow for the removal of areas from a condominium project that have not been completed within a period ending ten years from the date of commencement of construction of the project or within six years from the date the developer last exercised its expansion, contraction or convertibility rights (whichever is later). Act 283 revises this section slightly to make it clear that the developer is not relieved of any obligation to construct improvements that have been designated in the condominium documents as "must be built."

Section 71 of the Condominium Act is amended by Act 283 at the request of various governmental agencies to redirect the notice that is required to be delivered not less than ten days before taking reservations in a condominium project, recording a master deed or beginning construction of a project. The notice is now to be delivered to the following governmental agencies: (a) the appropriate city, village, township or county, (b) the appropriate county road commission and county drain commissioner, (c) the Michigan Department of Environmental Quality and (d) the Michigan Department of Transportation.

Act 379 had made a number of changes dealing with the rights of condominium associations to amend condominium documents, and the circumstances when it is necessary to obtain the approval of mortgagees. In particular, the gray area as to what constitutes a "material" amendment to the condominium documents requiring mortgagee approval was intended to be removed. Two alternative approaches addressing this issue had been submitted in connection with the preparation of Act 379 without the intent, however, that both would be incorporated in the Condominium Act. Act 283 removes the alternative provision that had been inserted in Section 90(1), thereby eliminating the unintended confusion between Sections 90a(9) and 90(1).

Section 90a is also modified by Act 283 (i) to clarify that, of mortgagees, only first mortgagees are entitled to vote on the material amendments and (ii) to supplement Subsection (9) to include in the list of material amendments requiring mortgagee consents those amendments described in Section 90(4) of the Act that involve the modification of the method or formula used to determine the percentage of value of units in the project for other than voting purposes.

Section 108 of the Condominium Act is modified by Act 283 to clarify that, if a receiver is appointed in an action for foreclosure of the assessment lien, it is empowered to take possession of the condominium unit if the unit is not occupied by the co-owner and to then lease the unit and apply the rental to the assessment.

Act 379 had changed Section 112 of the Act regarding rental rights. Act 283 clarifies that in those circumstances when a co-owner is leasing the unit but no lease is to be used, the co-owner is then to supply the association with the name and address of the lessees or occupants, along with the rental amount and due dates of any rental or compensation payable to the co-owner, the due dates of that rental and compensation, and the term of the proposed arrangement.

Section 135 had been modified by Act 379 to exclude from the definition of "successor developer" persons who are not obligated for, or who in fact do not construct, common elements. Because that exclusion appeared to be an oversight created in the legislative process, Act 283 removes the language from Section 135 and adds a new Subsection 5 that, in general, exempts from liability under Section 135 of the Condominium Act, builders who are unaffiliated with the developer and who do not either construct or refurbish common elements, absent a specific assignment of obligations or rights from the developer. A residential builder nevertheless remains obligated to deliver to the purchaser of the condominium unit the condominium documents that the developer is required to deliver to purchasers under Section 84a(1) of the Act. This is a new requirement that applies to condominium projects established on or after the effective date of Act 283 (May 9, 2002).

Act 379 had created a new Section 176 that established a statute of limitations for actions against those responsible for construction and administration of condominium projects. Certain legislative aides thought that Section 176 was poorly drafted. As a result, the legislative bureau proposed to reorganize this section. Section 176 now provides that a cause of action arising out of the development or construction of the common elements of a condominium project, or the management, operation or control of the condominium project that arose on or before the transitional control date, must be brought against the developer, residential builder, licensed architect, contractor, sales agent or manager of a condominium project no later than three years after the transitional control date or two years after the date on which the cause of action accrued, whichever occurs later. If the cause of action accrues after the transitional control date, then the action must be brought no later than two years after the date on which the cause of action accrued. Act 283 also clarifies that Section 176 applies only to condominium projects established on or after the effective date of Act 379 (January 2,

2001), the amendatory act that added Section 176 to the Condominium Act.

In conclusion, to ensure compliance with the revised sections of the Condominium Act, it is imperative to read Acts 379 and 283 in concert so that there are no oversights or misunderstandings of the amendments to the Condominium Act.

Endnote

1. Makower and Shierk, The New Amendments to the Michigan Condominium Act - Know the Changes that will Affect the Practice of Condominium Law, 29 *Mich Real Prop Rev* 69 (2002).

CASE COMMENTS

Recovery of Business Interruption Damages in Condemnation and Effect of Non-Conforming Use on Value
City of Novi v Gavar, 2002 WL 1291312
____ Mich App ____; NW2d ____ (2002)

In 1981, the Woodsons wanted to purchase a lot for the purpose of storing wood and equipment in connection with their tree removal business. The Woodsons met with City of Novi personnel to determine whether outdoor storage was permitted on a particular lot owned by the Gavars. A City official advised the Woodsons that no site plan would be necessary because their intended use was the same as the Gavars' use of the lot. Accordingly, the Woodsons purchased the lot without submitting a site plan or obtaining a certificate of occupancy. Over the years, the Woodsons' tree removal business grew and they expanded their use of the property. Further, during the Woodsons' ownership, the property's zoning classification changed.

In 1997, the City of Novi made a statutory good faith written offer in the amount of $38,000 to purchase the Woodsons' property for a road project. The Woodsons rejected the offer, and on July 30, 1997, the City filed a condemnation action to take the Woodsons' property by eminent domain. On August 25, 1997, the Woodsons sent a letter to the City which provided as follows:

> The Uniform Condemnation Procedures Act ("UCPA"), Section 5(3), as amended, establishes the procedure for owners to follow when they believe that the condemning agency's "good faith written offer" is incomplete. Be advised that, in connection with the above-captioned action, the Woodson Defendants believe that Plaintiff's "good faith written offer" is incomplete. The Woodsons *reserve the right to claim* just compensation for:
>
> 1. Real estate;
> 2. Business interruption avoidance damages and/or going concern damages;
> 3. Inventory; and
> 4. Immovable fixtures, movable business property, trade fixtures, equipment, and the like (emphasis added).

One year later, on August 26, 1998, the City filed a Motion in Limine to prohibit the Woodsons from submitting evidence at trial regarding any damages other than those

concerning the fair market value of the property. Specifically, the City argued that the Woodsons' business interruption damages were barred under UCPA Section 5(3), which requires a claim for business interruption to be filed within 90 days after the good faith written offer is made or 60 days after the Complaint is filed, whichever is later. MCL 213.55(3). The City argued that the Woodsons' letter of August 25, 1997, did not constitute a written claim.

The trial court denied the City's Motion in Limine. Experts testified at trial for both parties regarding the value of the real estate and the amount of the Woodsons' business interruption damages. The jury awarded the amount of $160,000 to the Woodsons as the value of the real estate and the amount of $90,000 for business interruption damages. The trial court ordered reimbursement for the Woodsons' attorneys' fees, expert witness fees, and statutory interest. From that award, the City filed an appeal to the Michigan Court of Appeals on two theories.

First, the City contended that the trial court erred in denying its Motion in Limine under MCL 213.55(3). The Court of Appeals agreed:

> The trial court erred to the extent that it ruled that the Woodsons' August 25, 1997 letter constituted a timely, written claim under MCL 213.55(3). Under the statute, a letter which simply 'reserves' the right to make a future claim or challenge to a good faith offer is, by its own terms, not a claim or a challenge, but a statement of intent to do so in the future.

Second, the Court of Appeals ruled that UCPA Section 5(3) is a "statute of repose." The Court of Appeals held that the trial court erred in finding that the City was estopped from asserting the lack of notice. The City was not estopped despite negotiations with the Woodsons over deadlines for exchanging the parties' business interruption reports, the filing of a motion to set an appraisal exchange deadline, and the passage of one year before the City filed its Motion in Limine. In holding that UCPA Section 5(3) is a statute of repose, the Court of Appeals reversed the trial court on that basis, as well.

The Court of Appeals vacated the jury's business interruption award, and reversed the trial court's award of interest, attorneys' fees, and expert witness fees for reconsideration in light of its ruling.

In addition to the dispute over the award of business interruption damages, there was a further dispute over the "highest and best use" of the property for purposes of valuing the property. The City argued that the jury could only consider the Woodsons' actual use of the property in determining the property's "highest and best use" if that use was legal and did not violate the City's zoning laws. The City argued that the Woodsons' use of the property for outdoor storage was an illegal non-conforming use and, therefore, could not constitute the "highest and best" use of that property. In contrast, the Woodsons attempted to prove that their use was a legal non-conforming use. The Court of Appeals ruled in favor of the Woodsons on that point:

> Overwhelming evidence showed that Novi did not cite the Woodsons for an "illegal use" over the sixteen years they used the property as a wood lot. Indeed, the evidence clearly showed that Novi only raised the issue of the legality of the use once it learned it would have to pay the Woodsons for the land. It follows that the Woodsons should not be penalized for making the most advantageous use of the lot to which Novi acquiesced, despite a belated assertion that they technically violated the zoning rules.

Accordingly, the Court of Appeals affirmed the jury's verdict concerning the market value of the Woodsons' property, based upon the highest and best use of that property.

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Failure to Disclose Tax Lien Did Not Render Title Policy Void AB Initio *Archambo v Lawyers Title Insurance Corporation, 466 Mich 402 (2002)*

Plaintiff had been one of three shareholders in a corporation which had failed to pay federal withholding taxes, resulting in the imposition of a lien against Plaintiff and others by the Internal Revenue Service (IRS). Plaintiff eventually formed a new company and built a home for a client, taking title to the property after a dispute over payment arose with the client. When he took title, Plaintiff believed that the tax lien against him was no longer effective.

In fact, however, the tax lien was still valid and had attached to the property Plaintiff purchased. The bank financing the purchase obtained title insurance from an agent of Lawyers Title Insurance Company, which failed to discover the tax lien until Plaintiff attempted to sell the

home to third parties in 1993. Plaintiff had to borrow money to satisfy the IRS lien in order to complete the sale of the property, and subsequently sued Lawyers Title.

At trial, Lawyers Title argued that the title commitment controlled, and required that Plaintiff disclose all known liens, whether recorded or not. The commitment also provided that if a party to be insured failed to disclose personal knowledge or intimation of any defect, objection, lien or encumbrance affecting the subject land, the commitment and any policy issued pursuant to the commitment would be rendered "null and void as to such defect, objection, lien or encumbrance."

The policy issued, however, required only the disclosure of known, unrecorded liens. The policy also contained an integration clause, reflecting that the policy "is the entire contract between the insured and the Company."

Following a bench trial, the trial court ruled in favor of Plaintiff and held that the policy controlled. The Michigan Court of Appeals, in a split decision, reversed the trial court, and concluded that Plaintiff's failure to disclose a known lien effectively voided the policy. Following the Court of Appeals' denial of Plaintiff's Motion for Rehearing, Plaintiff sought and was granted leave to appeal. The Real Property Law Section participated as *amicus curiae*, urging reversal of the Court of Appeals' decision.

Upon review, the Michigan Supreme Court reversed the Court of Appeals, pointing to inconsistencies in the Court of Appeals' decision over whether the failure to disclose a known, recorded tax lien voided the entire policy or only voided the policy as to the particular lien. The Supreme Court concluded that the policy was not rendered void *ab initio* as a result of Plaintiff's failure to disclose the tax lien, and thus the policy was effective, and its integration clause accordingly controlled. Since the policy only required the disclosure of known, unrecorded tax liens, the lien was not excluded from coverage for failure of the Plaintiff to disclose the known, but recorded, lien.

The decision of the Court of Appeals was reversed. However the case was remanded "to decide whether coverage is excluded under § 3(a) of the policy, which excludes coverage for liens 'created, suffered, assumed or agreed to by the insured claimant . . .'"

As such, while the policy was not rendered void *ab initio*, the Supreme Court left open the question of whether coverage for this particular tax lien was excluded under a specific exclusion of the policy.

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A Challenge to Detroit's Tax Collection System is Resolved
Booker v City of Detroit, 251 Mich App 167 On Remand from Magee v City of Detroit, 203 Mich App 228 (1984)

The City of Detroit has a tax foreclosure and enforcement procedure different than that provided by the General Property Tax Act (GPTA). Under the City's system there is a deemed sale to the Finance Director of Delinquent Taxes. When the taxes are three-years delinquent, the City may foreclose through individual circuit court foreclosure actions. The City is also authorized to use other remedies provided for by state law. See Detroit City Charter, §8.403.

The system for enforcing real property taxes provided in the GPTA, which was in effect as of the *Booker* case, provided for real property taxes to be collected by the local township or city and returned to the county upon delinquency at the end of one year. Two years later (when the taxes were three-years past due), a petition would be filed in the circuit court to permit the sale of tax liens. Those liens would then be sold on the first Tuesday of May at the county tax sale, and if there was no bidder, they would be deemed bid to the State.

The purchaser at the tax sale obtained a tax certificate, which upon notice and expiration of the redemption periods, could result in acquiring title to the property. After the sale there was a one-year redemption period during which the taxes, interest, penalties and fees could be paid at the County Treasurer's office, and an additional redemption period of at least 6 months during which the taxes, interest, penalties and fees could be paid to the purchaser of the tax certificate or the State. The entire tax reversion procedure changed as a result of P.A. 123 of 1999.

Owners of property in the City of Detroit receive separate tax bills from the city and the county. The city tax bill is for the City and the schools; the county tax bill is for the County and other taxing units. It is possible to pay the county taxes and not the city taxes. (This often occurred because while the county tax sale sold all or almost all liens which could be sold, the City often did not commence its actions as soon as lawfully permitted.) If taxpayers failed to pay both the county and city taxes, two separate tax collection and enforcement procedures could begin at the same time. This is what happened to Mr. Magee.

In 1979, Mr. Magee purchased a parcel of real property in Detroit and failed to pay the 1979 city taxes. He paid his county taxes until 1981 and then stopped paying those as well.

In 1984, the City filed a foreclosure action against Mr. Magee, for unpaid 1979, 1980 and 1981 real property taxes. Magee was served, did not appear, and a default judgment was entered on May 10, 1985. Pursuant to the Detroit City Charter, judgment provided that absolute title would vest in the City sixty (60) days following the judgment unless the tax, interest and penalty were paid. The City obtained title on July 10, 1985, subject only to the outstanding state and county tax liens.

Meanwhile, the County sold its 1982 tax lien at the 1985 county tax sale in May of 1985. There were no bidders, so the lien was deemed sold to the State. On October 10, 1985, Mr. Magee redeemed from the State by paying the tax, penalty and interest due at the County Treasurer's office.

Three or four months before redeeming the county tax, but after the 60-day city redemption period had run, Mr. Magee met with an employee of the City's Community and Economic Development Department, which managed City owned properties. The department employee assured Mr. Magee that if he paid the taxes he would have no trouble with the city. Mr. Magee paid his city taxes at the Treasurer's cashier office.

In 1986, the City sold the property to a third party. Magee sued to quiet title and for unlawful taking. Summary disposition was granted in favor of the City based on Magee's failure to redeem within the 60-day period under the City Charter. The trial court commented that plaintiff was probably entitled to a refund of taxes paid to the City based upon the above representations, but Magee had not asked for such relief.

The Circuit Court's decision was appealed. In *Magee v City of Detroit*, 203 Mich. App. 228; 511 N.W. 2d 717 (1984), the Court of Appeals remanded for determination of whether or not the City system was in conflict with the GPTA. The Court of Appeals cited several apparent inconsistencies between the City's procedures and various provisions of the GPTA but noted that it did not have a copy of the City Code for review. The Court of Appeals indicated the Plaintiff upon remand, should be allowed to amend his Complaint to include a count of unjust enrichment.

On remand, the case was reported under the name of *Booker*, as Mr. Magee died and Mr. Booker was his estate's personal representative. On remand, the Circuit Court permitted Plaintiff to amend the Complaint. The Circuit Court awarded money damages to the Plaintiff. On appeal, the Court of Appeals held that the City's procedures for tax enforcement were not required to be consistent with the procedures described in the GPTA, because Section 107 of the GPTA (MCL 211.107) and the Home Rule Cities Act (MCL 117.3) permitted cities to enact tax procedures which were different than those contained in the GPTA. The earlier decision of the Court of Appeals was held to be wrongly decided.

Concerning the claim for damages, the Court of Appeals held that the facts did not support a finding of promissory estoppel because the City of Detroit's employee was not authorized to make the representations about whether the City would accept payment after the redemption period had expired and the City Treasurer's office had no authority to accept a payment after the expiration of the redemption period. Although the City mistakenly accepted untimely payment, Mr. Magee was also partially at fault and negligent for not determining his own ownership interest at the time he tendered payment. The Court of Appeals, therefore, held that the payment was a voluntary tax payment which could not be recovered.

Concerning the interplay of the former county tax sale system and the city foreclosure system, the Court of Appeals held that under the county tax sales system described in the GPTA, title did not become absolute in the state until all redemption rights had run. The quit claim deed which Mr. Magee received from the State, upon his redemption from the county tax sale procedure, did not vest Mr. Magee with absolute title to the property and terminate the rights of the City in the property, because all redemption rights had not expired.

The *Booker* decision supports the City's long-existing practices concerning tax collection and enforcement.

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LEGISLATION AFFECTING REAL PROPERTY

by *Lawrence M. Dudek*

During the previous twelve months the legislature passed a number of Bills which were been actively supported by the Real Property Law Section.

Public Acts 19, 20, 21 and 23 eliminated witnessing and other requirements with respect to the recording of certain conveyancing instruments and further eliminated the requirement that the signing of a proprietor's certificate on the final plat be witnessed by two persons. This legislation became effective March 4, 2002. The Council supported passage of his legislation for reason that the elimination of the witnessing and other requirements make it easier for the Registers of Deeds to determine the adequacy of the documents for recording purposes, without having any significant adverse affect. An article entitled "Michigan Eliminates Witness Requirement," authored by Anthony J. Viviani and Dawn M. Patterson, appears in the Summer 2002 issue of the Michigan Real Property Review.

PA 147 of 2002, amended MCL 565.356, to correct a technical problem regarding the definition of a "real estate mortgage". MCL 565.356 sets forth a safe harbor for use of a mortgage to secure a land contract vendor or vendee's interest in the land contract. The Council had actively supported passage of this legislation.

PA 42 of 2002, amended the Occupational Code. PA 42 of 2002 provides that a broker may take actions to deliver and hold the earnest money deposit payable to a title company and deliver the checks to the title company to hold the deposit in escrow. The bill eliminates any requirement existing under an interpretation by the Attorney General which would have precluded the broker from making such a delivery. The Council had supported passage of this legislation as being consistent with common practices.

Public Act 283 of 2002 became effective May 14, 2002 and sets forth amendments to the Condominium Act. Passage of this legislation was actively supported by the Council. The Special Committee on Condominiums, PUDS and Cooperatives had an instrumental role in drafting the Act and ushered through its passage, led by the efforts of Mark F. Makower and C. Kim Shierk, who also authored an article on the amendments entitled, "The New Amendments to the Michigan Condominium Act – Knowing the Changes that will Affect the Practice of Condominium Law" contained in the Summer 2002 issue of the *Michigan Real Property Review*.

Public Acts 94 through 101 of the Public Acts of 2001 set forth various technical amendments and clarifications with respect to the Real Property Tax Foreclosure process under the General Property Tax Act. In 1999, the Michigan Legislature enacted major revisions to the Notice and Hearing requirements of the Act and re-wrote the foreclosure process. An article addressing the significant changes entitled , "Foreclosure of Real Property Tax Liens Under

Michigan's New Foreclosure Process," authored by Kevin T. Smith, appears in the Summer 2002 issue of the Michigan Real Property Review.

Public Act 27 of 2002 defines and sets forth a procedure whereby a municipality may designate a structure or lot as a "blighting property."

There was also various land use legislation enacted during the previous twelve months. This includes Public Acts 263, 264 and 265 of 2001 which set forth requirements for the adoption of land use plans by townships, counties and municipalities. Public Acts 177, 178 and 179 of 2001 set forth requirements with respect to township, county and village zoning ordinances.

In addition to supporting passage of various legislation, the Council also opposed various pending legislation. This included opposition to proposed legislation which would set forth certain amendments to the foreclosure by advertisement statute set forth in Senate Bill 349. This legislation was opposed based upon the recommendations of the various Special Committees on the grounds that the provisions in the Bill could operate in a manner so as to interfere with the orderly foreclosure procedure.

The Council also opposed proposed legislation which would eliminate the standing of a purchaser under a real estate purchase agreement from challenging a zoning ordinance or decision made by a Zoning Board of Appeals, legislative body, municipal agency or commission. The basis for the Council's opposition was that the courts, and not the legislature, should determine the standing of a party with an interest in real property to pursue remedies with regard to zoning challenges.

The Council continued to oppose legislation which was proposed with respect to abolishment of the doctrine of adverse possession. The Council is currently considering a position to take with respect to proposed legislation which would eliminate dower rights.

House Bill 5096 was introduced in the legislature and reported out of Committee on May 22, 2002. This legislation addresses the situation where there is a conveyance of property by an individual into an Inter Vivos Trust. It appears that there is a practice to convey the property to the Trust as opposed to conveying the property to the Trustee for the benefit of the beneficiaries. The proposed legislation would amend the title insurance statutes to provide that if a conveyance of property is made to a "Qualifying Trust" (defined as a trust where both the settlor and beneficiary are the grantor and/or grantor's spouse) the Trust be deemed insured under the title insurance for the property. The Council voted by majority vote to oppose the Bill on the basis that the scope of coverage under insurance policies is a matter of contract which is not appropriately unilaterally modified by the legislature. It was the further view of the Council that there were technical problems with the bill, since title should be conveyed to the Trustee and not the Trust.

Public Act 479 of 2002, amended the property tax statutes. Under the Act, buildings and improvements located on leased real estate are taxed as real property. However, if the taxes become delinquent, they are collected using procedures applicable to personal property taxes, as opposed to procedures applicable to real property taxes. The Council opposed this legislation because the personal property tax collection procedures do not contain the same degree of procedural safeguard as real property tax foreclosure procedures, which are designed to meet minimum constitutional due process requirements. The issue typically arises in connection with a "ground" lease, where the land owner retains title to the land, but enters into a long term lease with a "tenant", who develops and owns the building and improvements that are built on the land. This structure is often seen in projects that were financed by Detroit bonds, where the City of Detroit Downtown Development Authority or other municipal entity retains legal title and "leases" the land to the project developer for rental equal to the amounts required to pay off the financing.

Current information can be obtained about pending legislation through the web site of the Michigan Legislature at www.michiganlegislature.org.

CONTINUING LEGAL EDUCATION

by
Ronald E. Reynolds
Chairperson
and
Arlene R. Rubinstein
Administrator

HOMEWARD BOUND

The Continuing Legal Education Committee is pleased to announce its Twenty-seventh season of "Homeward Bound" seminars. This season's series is under the direction of Ronald E. Reynolds of Berry & Reynolds, PC, in Farmington Hills. In our continuing effort to provide innovative and practical educational programs for our members, the Committee has revamped our Homeward Bound series for 2002-2003.

NEW!
BREAKFAST ROUNDTABLE SESSIONS

Our first Breakfast Round Table program will be held on October 10, 2002, at the Townsend Hotel, 100 Townsend Street, Birmingham. The Program will begin at 8:00 a.m. and end at 9:30 a.m. A full breakfast will be served. Registration fee is $35.00 per person. Space is limited!

Susan A. Kovach of Dykema Gossett, PLLC is the program coordinator. She has planned a timely and informative program on **Leasing**. The Keynote Speaker will be Mitchell Lipton of the Friedman Real Estate Group, Inc. He will speak on the **"State of the Commercial Leasing Market."** Mr. Lipton will discuss key trends in the current Metropolitan Detroit commercial leasing market, including trends in occupancy and lease negotiations with respect to retail, office and other commercial segments of the market.

ROUNDTABLE DISCUSSION TOPICS AND LEADERS:

"Operating Expense Issues"
Dennis M. Gannan
AARMAX Commercial Realty Group, Inc.

"Bankruptcy Issues Relating to Leases"
Paul S. Magy
Kupelian Ormond & Magy, PC

"Assignability: Transfers of Interests in Leases and Tenants"
Adam M. Fishkind
Dykema Gossett PLLC

"Lease Provisions that May Defeat Financeability of a Project"
Karen R. Pifer
Honigman Miller Schwartz and Cohn LLP

"A Tenant's Due Diligence Checklist"
Robert A. Berlow
Dykema Gossett PLLC

For further information, please call Arlene at 248-644-7378.

Our second Breakfast Roundtable Session will be held on March 13, 2003, on **Land Use and Eminent Domain**. Program coordinators are Susan K. Friedlaender of Honigman Miller Schwartz and Cohn and Jerome P. Pesick of Steinhardt Pesick & Cohen, PC.

HOMEWARD BOUND SERIES

This year the Homeward Bound series will have 6 seminars and will be held in Troy at the MSU Management Education Center, 811 W. Square Lake Road. The series will begin November 14, 2002 with the first of our two part program **"The Mechanics of Commercial Development from Start to Finish." Part One – Pre Purchase: Due Diligence, Acquisition of Land and Purchase Agreements."** This program will be presented by Joseph M. Fazio of Miller, Canfield, Paddock & Stone, LLP; Mark S. Frankel of Couzens, Lansky, Fealk, Ellis, Roeder & Lazar, PC; Jason M. Horton, Executive Vice President of Real Estate Development and Investment Corp. (REDICO) and Ruben Acosta of Williams Acosta, PLLC. The presentation will focus on pre-closing issues faced by both Purchasers and Sellers in conjunction with the purchase and sale of commercial real estate, including Seller valuation issues and negotiation strategies. The presentation will also focus on the practical application of these concepts in specific transactions. Critical purchase agreement terms will be analyzed and negotiated from both Purchaser and Seller's perspective and significant changes in current law will be reviewed as they impact the negotiation process.

On December 5, 2002 we will continue with **Part 2 – Post Purchase: Financing, Construction and Leasing Issues**. David E. Nykanen of Steinhardt Pesick and Cohen, PC, Kenneth F. Silver of Hertz, Schram and Saretsky, PC and Ronald P. Strote of May, Simpson & Strote, PC will present this seminar. This program is a continuation of the commercial development process, with a focus on critical post-acquisition issues: construction and permanent financing, construction contracts, and leasing of space.

Gregg A. Nathanson of Couzens, Lansky, Fealk, Ellis, Roeder & Lazar, PC; Jamie Passon Brooks or House Counsel, Laura A. Nieber of Standard Federal Bank, Clarence L. Stone Jr., Michigan State Housing Development Authority and Anthony J. Viviani of Stewart Title Guaranty Co. will speak on January 16, 2003, on **"Residential Real Estate Transactions 101."** The speakers will present an overview of the steps necessary to complete a residential real estate transaction including drafting of a purchase agreement, financing issues, fulfilling contractual contingencies, title insurance, closing documentation and post-closing issues.

Registrations for individual seminars is $80 for member of the Section and $90 for non-members. A substantial savings can be made by purchasing a "Series Subscription"! The registration fee is $240 for Section Members and $390 for Non-section Members. Section members register for the full series and save $240!! A Homeward Bound/Breakfast Roundtable Session brochure has been included in this issue. For more information please call Arlene Rubinstein at 248-644-7378 or e-mail at LAWA1@aol.com.

Mark your Calendars!
TWENTY-EIGHTH ANNUAL SUMMER CONFERENCE
July 16 -19, 2003
Crystal Mountain Resort
Thompsonville, Michigan

COURSE CALENDAR

Set forth is a schedule of Continuing Legal Education courses sponsored or co-sponsored by the Real Property Law Section through January 2003.

Key: HB = Homeward Bound
ICLE = Courses co-sponsored with the Institute of Continuing Legal Education

Date	Location	Program	Topic
October 10	The Townsend Hotel Birmingham	Breakfast Roundtable	Leasing
November 7	GVSU Eberhard Center Grand Rapids	ICLE	John Cameron on Real Estate 2002 - Updates and Practice Advice
November 14	MSU Management Education Center - Troy	HB	Part 1: Pre Purchase: Due Diligence, Acquisition of Land and Purchase Agreements
November 22	MSU Management Education Center - Troy	ICLE	John Cameron on Real Estate 2002 - Updates and Practice Advice
December 5	MSU Management Education Center - Troy	HB	Part 2: Post Purchase: Financing, Construction and Leasing Issues
January 16	MSU Management Education Center - Troy	HB	Residential Real Estate 101

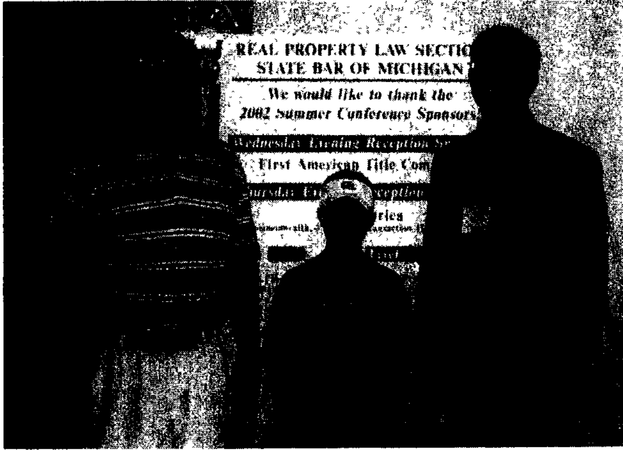
For ICLE video times and locations visit: www.icle.org.

Further information on all Breakfast Roundtable Sessions and the Homeward Bound series can be found on the Section's website at: http:www.michbar.org/sections/realprop/

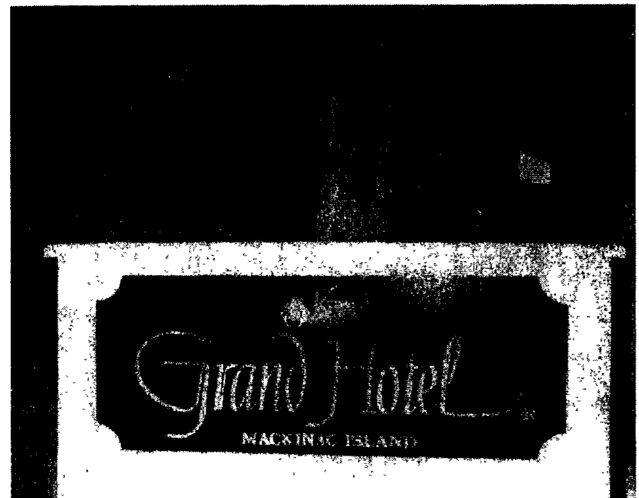
2002 Annual Summer Conference
Grand Hotel, Mackinac Island

From left to right:
Larry Dudek (Vice-chairperson) of Miller, Canfield, Paddock & Stone, Bob Nix (Past Chairperson) of Kerr, Russell & Weber, Mark Makower of Mark F. Makower & Associates, and Vicki Harding of Pepper Hamilton.

2002 Annual Summer Conference
Grand Hotel, Mackinac Island

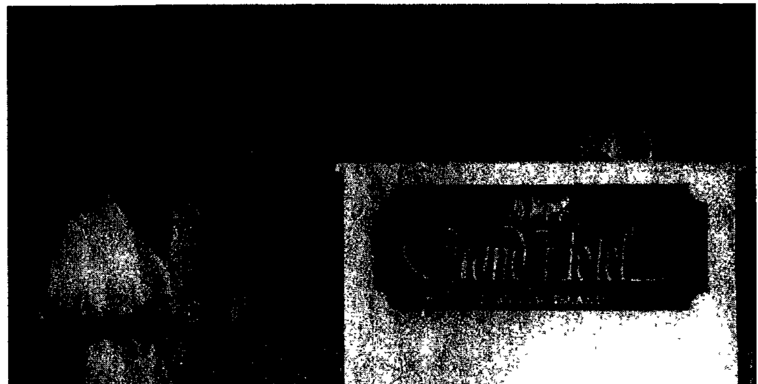


Bill Freeman and his son, Carter Freeman, with Brian Henry, Program Chairperson. Both are with Freeman Cotton & Norris in Bloomfield Hills.



Bob Berlow, Chairperson of the Real Property Law Section, of Dykema Gossett in Bloomfield Hills, with Vicki Harding, Chairperson-elect, of Pepper Hamilton in Detroit.

Susan Wartell, Bob Berlow and Peter Nathan, Past Chairperson.



Susan Wartell to present the C. Robert Wartell Distinguished Service Award with Bob Berlow. (Not shown, Gary A. Taback who received the award.)