THE NATIONAL LAW REVIEW

2016-2017 Arizona Case Law and Legislative Developments Affecting Commercial Real Estate and Lending

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Publishing

- Construction Law
- Real Estate

- Arizona

Wednesday, March 15, 2017

Pending Arizona Legislation – GPLET Transactions

House Bill 2213, which recently passed the *Arizona House* by a 50-9 margin, would impose a number of restrictions on Arizona's GPLET program. The GPLET statute was enacted in 1996, and allows a city (Phoenix and Tempe are the most frequent participants) to acquire ownership of land and improvements in a blighted area (which then becomes exempt from property taxes due to their governmental ownership) and lease them back to the developer at a significantly reduced "*Government Property Lease Excise Tax*" rate; the property typically qualifies for an eight-year tax abatement, followed by a reduced or abated tax obligation (which can extend up to 25 years in total under current law). An estimated one-third of the largest buildings in downtown Phoenix have used GPLET leases.

HB 2213 was introduced by State Representative Vince Leach due to a 2015 Auditor General's report that found widespread miscalculation and underpayment of GPLET (the current statute requires the developer to calculate the tax) and the significant loss of property tax revenues by elementary and secondary school districts caused by taking GPLET properties off the tax rolls (meaning that the General Fund picks up the tab for the difference). HB 2213 would shift the burden of calculating the amount of the GPLET tax from the developer to the government entity that grants the tax abatement. In its initial version, it would also have limited the GPLET tax abatement for any development agreements after January 1, 2017 to only those taxes that go to the counties, cities, towns and community college districts, but not those that go to elementary and secondary school districts. HB 2213 redefines "slum" and "blighted" areas for GPLET purposes, and would require slum and blight tests to be updated for GPLET purposes every five years.

When the GPLET statutes were last revised in 2010, existing deals were fully grandfathered to protect investment expectations. HB 2213 protects **leases** entered into prior to June 1, 2010, but if only a development agreement, ordinance or resolution was approved by the government lessor before June 1, 2010, the ten-year window thereafter (in which to enter into a GPLET lease) that exists under current law would be subject to a hard January 1, 2017 cut-off date (which could affect, for example, multi-phase projects or projects with development agreements prior to June 1, 2010, but on which the building has not been fully constructed). The Cities of Phoenix and Tucson, the American Institute of Architects and the NAIOP Arizona chapter have all opposed HB 2213 on the basis that it weakens the most valuable economic development tool available to the cities.

Pending Arizona Case Law – GPLET Transactions

Englehorn v. Stanton (Maricopa County Superior Court, filed 3-01-2017)

Earlier this month, the Goldwater Institute sued the City of Phoenix and a number of its elected officials on behalf of the Englehorn family (the proprietors of Angel's Trumpet Ale House in downtown Phoenix) to invalidate a pending GPLET transaction [HB 2213 (above) does not yet (and might never) represent current law]. The City of Phoenix and Denver-based Amstar/McKinley, LLC signed GPLET documents in 2016 relating to the construction of a $36 million, 19-story high rise micro-housing (units containing just 400 to 500 square feet) apartment tower to be known as The Derby Roosevelt Row just south of Angel's Trumpet. The Goldwater Institute has challenged the Amstar/McKinley transaction as an illegal $8 million developer subsidy by the taxpayers under several provisions of the Arizona Constitution, as well as statutory limits on GPLET and the City's failure to follow competitive bidding requirements.[1]

Arizona Certified Question – Title Insurance

Equity Income Partners, LP v. Chicago Title Insurance Co. (AZ Supreme Court 2-7-2017)

The Ninth Circuit Court of Appeals certified to the Arizona Supreme Court several questions regarding the impact of a lender's full credit bid (i.e., in the full amount of the secured loan) at an Arizona trustee's sale on a title insurer's continuing liability under the lender's title insurance policies. In May 2006, Equity made two loans, each in the amount of $1,200,000, and each secured by a separate DOT, which the borrowers used to purchase two adjacent parcels of land. Chicago Title's predecessor, Transnation Title, issued Equity two ALTA 1992 Loan Policies.

In September 2006, the borrowers discovered they could not legally access the parcels, and informed Transnation of the title defect. Transnation attempted to cure the defect and obtain access to the parcels by suing Maricopa County, which owned the land surrounding the parcels. In 2010, the court in Transnation's lawsuit ruled in favor of Maricopa County, and Transnation stopped making the interest-only payments it had been making to Equity during the litigation to induce Equity to delay foreclosing. Equity conducted trustee's sales of the parcels in January 2011 and submitted full credit bids of approximately $2,600,000. Equity thereafter submitted a claim to Chicago Title for the full amount of the policies, and Chicago Title apparently rejected the claim on the basis that, by making a full credit bid at the trustee's sale, the lender had received full payment of the loan.

The Court of Appeals held that: (i) Section 2 (rather than Section 9) of the ALTA Loan Policy applies when a lender purchases property by a full credit bid at an Arizona trustee's sale;[2] (ii) a full credit bid at an Arizona trustee's sale is not a "payment" under Sections 2 or 9 of an ALTA Loan Policy; and (iii) a full credit bid at an Arizona trustee's sale neither terminates nor reduces title insurance coverage under Section 2 or Section 7 of the ALTA Loan Policy (the "payment" the lender receives equals the fair market value of the property it acquires as a result of foreclosure, which could be less than the lender's credit bid).[3] The Court further noted that, under Arizona law, a credit bid may have the same effect as a payment from the borrower's perspective, but it does not have the same effect from the lender's perspective (at least where the fair market value of the property acquired is less than the amount owed under loan plus enforcement costs). The court noted that the ALTA Loan Policy does not define "payment," but an ordinary lay person would not understand a credit bid to constitute a "payment." The Court of Appeals further noted that: (a) in an insurer/insured context, Arizona public policy protects insureds; (b) undefined terms in policies should be given the meaning used by lay people in every day usage; and (c) ambiguous policy terms and conditions should be interpreted in favor of coverage and against the insurer.

Lender takeaway: In light of this case, a lender would be well-advised to obtain its own owner's title policy, rather than rely on the continuation coverage of its lender's policy. Most lenders are unable to realize the statutory FMV (essentially USPAP market value less prior encumbrances) upon a resale of REO, which has the effect of further reducing the amount of continuation coverage under a lender's policy.

Arizona Case Law – Redemption Price

Helvetica Servicing, Inc. v. Giraudo (AZ Court of Appeals 2-09-2017)

In 2003, Michael and Kelly Pasquan bought a home in Paradise Valley with a cash payment and a $600,000 loan. The Pasquans refinanced the original loan and took out additional loans totaling $2.1 million to cover the costs of demolishing most of the old home and building a new one. In 2006, the Pasquans took out a $3.4 million loan serviced by Helvetica and secured by a DOT against the property. Giraudo then lent the Pasquans $200,000, which was secured by a junior DOT.

The Pasquans defaulted on the Helvetica loan, and Helvetica initiated judicial foreclosure proceedings in 2008, but did not join any of the junior lienholders as defendants.[4] Helvetica obtained a $3.6 million judgment against the Pasquans and the sheriff held a sheriff's sale in July 2009; Helvetica was the sole bidder for $400,000. The Pasquans divorced in October 2009, and Michael Pasquan filed an application to determine the fair market value of the property; in February 2010, the trial court determined the FMV to be about $2.2 million. In April 2010, Helvetica obtained a revised deficiency judgment of approximately $2 million, based on the FMV determination.

In March 2012, the Court of Appeals held that Helvetica's loan was at least partially a purchase money loan subject to Arizona's residential anti-deficiency statutes and remanded the case to the trial court to determine what portion of the loan was entitled to anti-deficiency protection. While those proceedings were pending, Kelly Pasquan attempted to assign her right to redeem the property to Gold, an intervenor in the proceeding. The Court of Appeals held that Michael Pasquan's request for a FMV determination had extinguished Kelly Pasquan's right to redeem, but that junior lienholders could still exercise their redemption rights.

In September 2009, Giraudo filed a notice of his intent to redeem the property with the county recorder and tendered a $432,000 cashier's check (the $400,000 bid price plus the 8% statutory sheriff's commission). Helvetica then filed an emergency motion to stop the sheriff from allowing Giraudo's redemption, contending that Giraudo had to pay the *full value of Helvetica's original lien* ($3.7 million, net of the $400,000 credit bid).

The court had to determine the redemption price to the redeeming junior lienholder (Giraudo) in the face of three potentially conflicting Arizona statutes.[5] The Court of Appeals: (a) determined that the redemption price should be the sales price at auction, plus 8%, plus the value of the deficiency judgment that is enforceable against the mortgage debtors when the junior lienholder's redemption right ripens; and (b) remanded the case to the trial court for further proceedings to determine the redemption price. Bear in mind that this decision under Arizona law would not necessarily bind the IRS as a redeeming party under federal law.

Arizona Case Law - Agricultural Lending

ABCDW LLC v. Banning (AZ Court of Appeals 12-30-2016)

Banning farmed several parcels of land under a 2006 lease with a two-year initial term and three automatic one-year extensions, ending in January 2011. If the landlords wished to lease the land beyond the five-year term, the lease gave Banning a right of first refusal to continue leasing the land. In 2009, one year before the end of the lease, Banning planted 549 acres of alfalfa, and in the fall of 2010, he planted another 360 acres of alfalfa, with no assurance from the landlords that the lease would be renewed. In November 2010, the landlords informed Banning that they would *not* be renewing the lease, and, pursuant to the right of first refusal, they provided Banning with notice of an offer from Double Anchor Farms to lease the land for $275 per acre, based on the understanding that the existing alfalfa stands would remain on the land. Banning informed the landlords that he would not exercise his right of first refusal for a rental rate of $275 an acre.

The landlords produced the Double Anchor lease, which (a) called for a rental rate of $275 per acre for a term of one year, commencing in January 2011 and expiring in January 2012, and (b) provided that, if the crops then planted on the premises were disced or otherwise destroyed prior to the commencement of the lease, the rent would be equitably adjusted. Banning informed the landlords that he would complete his last alfalfa cutting in early January 2011, and that the newly planted alfalfa stands were available for Double Anchor Farms to purchase. Banning also stated if he was not paid for the alfalfa, he would plow it under at the conclusion of his lease. The landlords refused to pay Banning for the alfalfa because they contended that Banning did not own it. In January 2011, shortly before the conclusion of his lease, Banning harvested his last alfalfa cutting and then disced the fields, destroying all of the alfalfa plants. The landlords then renegotiated the Double Anchor Farms rental rate down to $125 per acre and sued Banning on a number of theories, including conversion and unauthorized destruction of a crop under A.R.S. § 3-114.

The key issue in this case was which party owned the alfalfa plants. The law generally distinguishes between ownership of the perennial *plant* (the roots of the alfalfa that will produce cuttings for a number of years) and the alfalfa *crop* (the cuttings periodically harvested from the plants). The parties agreed that Banning owned the alfalfa crops he cut and harvested during the term of his lease, but disagreed as to whether the perennial alfalfa plants were fixtures that belonged to the landlords.

The court noted that live plants can become **fixtures** to realty (which generally belong to the landlord after the lease term ends), but noted that one legal test to be satisfied in that regard was whether the tenant intended to make the plants a permanent accession to the realty.

The court also noted that, under the **doctrine of emblements**, if a crop is planted by a person rightfully in possession of the land (such as a tenant), and the person *unexpectedly* loses possession of the land prior to harvest, he still has ownership rights to the crops he planted. However, the doctrine of emblements does *not* apply if the tenancy is of a fixed rather than infinite duration, or if the tenancy is terminated due to the tenant's act or default.

Under the **doctrine of away-going crops**, a tenant who plants a crop knowing the terms of his lease will expire before it can be harvested loses all his interest in the crop upon termination of the lease. Therefore, under the doctrine of away-going crops, a tenant for a fixed term of years who plants a crop that will produce beyond the term of the lease is viewed as having intended the plant and any future crops harvested from that plant to remain with the realty. Because alfalfa has a useful life of at least 3 to 5 years and Banning planted the alfalfa in the last year of his fixed-term tenancy, his *inferred intent* was for the alfalfa plants to remain with the realty and become fixtures that would belong to the landlords and be surrendered with the premises when the lease expired. The court therefore held that Banning's intentional destruction of the newly planted alfalfa crop was wrongful and constituted intentional interference with the landlords' lease with Double Anchor Farms.

Lender takeaways. While the *Banning* case does not involve a loan, it illustrates that a lender that has either crops and/or farm land as its security needs to understand whether the crop on the land constitutes realty or personalty. While the tenant's crop lender commonly requests lien waivers from the landlord and the fee mortgagee, those waivers often relate only to *personal* property (which would be subject to a statutory or contractual landlord's lien) and not to fixtures.

Arizona Case Law – Creditor Claims Against Probate Estates

Ader v. Estate of Felger (AZ Court of Appeals – 5-27-2016)

Ader funded the purchase of commercial properties with Felger, who rehabilitated, managed and eventually refinanced or sold them. Felger created separate LLCs for each of the properties; the members of each LLC were Ader and the Felger Family Trust, of which Felger was the trustee. Felger died in November 2010, and sometime thereafter Ader stopped receiving her monthly interest payments from the properties. In January 2014, Ader filed a lawsuit against the Felger Family Trust, Felger's widow and Felger's estate alleging numerous claims, including breach of contract, breach of fiduciary duty and conversion. No personal representative was ever appointed for the Felger estate, and creditors received no notice to present their claims. However, Ader was aware of Felger's death within a week after Felger died.

The Court of Appeals held that claims against a probate estate that arose before a decedent's death must generally be presented within two years after the decedent's death. Because creditors' claims cannot be presented until a personal representative has been appointed for the estate, the onus is on the creditors to discover whether an obligor's death has occurred and to initiate probate proceedings if the estate fails to initiate them. Otherwise, if a personal representative is not appointed within two years of the decedent's death, claims cannot be presented against the estate. The Court of Appeals therefore held Ader's claims against Felger's estate to be time-barred.

Arizona Case Law – Real Property Conveyances

Larmer v. Estate of Larmer (AZ Court of Appeals – 11-08-2016)

Chauncey Larmer and his wife, Gloria, owned real property as JTWROS. In July 2013, Gloria signed a durable POA authorizing Chauncey to act as her agent if she became incapacitated. The POA granted Chauncey broad powers, including the power to convey Gloria's real property. In November 2013, Chauncey, on behalf of himself and Gloria, conveyed their real estate to his son, James, reserving a life estate for himself and Gloria. Chauncey acknowledged his execution of the deed before a notary, but instead of affixing her official seal to the deed when she notarized the deed, she used her embossing seal (to crimp the document). Chauncey died in April 2014, and Gloria thereafter sued James and others, seeking to quiet title to the property in her name, alleging that the deed was invalid because the notary failed to notarize it with her official seal. [I assume that the deed was never recorded, but the opinion is silent on that point.]

The Court of Appeals held that an acknowledgment consists of two parts: (i) the grantor acknowledges the conveyance before an official authorized to take acknowledgments; and (ii) the official certifies the grantor's acknowledgment. While the notary failed to use her official seal on the deed, the deed still met the "duly acknowledged" requirement of Arizona law because it complied with the acknowledgment and certification requirements. The deed included the Arizona short-form statutory acknowledgment ("the foregoing instrument was acknowledged before me"), which meets Arizona's certification requirement.

The Uniform Recognition of Acknowledgments Act (from which Arizona's notary statutes were taken) does not *require* a seal when an in-state notary properly takes and certifies an acknowledgment within the state. Therefore, the absence of a seal on a deed in which an Arizona notary takes an acknowledgment and certifies it is not a fatal defect if URAA requirements are otherwise satisfied. Therefore, the Court of Appeals held that Chauncey had duly acknowledged the deed and it was valid.

Lender takeaway. If you are notarizing a document, or having one notarized, whether in Arizona or outside of Arizona, have the notary use the **ink stamp** rather than an embossing seal, as you will otherwise have great difficulty recording it, particularly in a title-insured transaction.

Canadian Income Tax Issue

In mid-2016, the Canada Revenue Agency (CRA) announced that it will treat U.S. limited liability partnerships (LLPs) and U.S. limited liability limited partnerships (LLLPs) as corporations for Canadian tax purposes, as those U.S. "hybrid" entities resemble Canadian corporations. While the interest held by a Canadian taxpayer in such an entity will now be treated as an interest in a corporation, U.S. tax authorities will continue to consider those entities to be pass-through entities. The differing U.S. and Canadian tax treatment will create the potential for negative tax consequences,[6] especially if the entity earns passive income. LLPs or LLLPs may therefore need to be changed to ordinary limited partnerships to avoid triggering adverse Canadian tax consequences.

The CRA's short-term grandfathering provisions will allow Canadian taxpayers to administratively treat the hybrid U.S. entities as partnerships for Canadian tax purposes and avoid triggering adverse Canadian tax consequences if: (a) neither the entity nor any of its partners have taken the position that the entity is not a partnership for Canadian income tax purposes; (b) the entity must have been formed, and must have carried on business, prior to July 2016; (c) the partners must have intended the entity to be treated as a partnership for Canadian tax purposes from the time of its formation; **and** (d) the entity is converted before January 1, 2018, to a form of ownership that the CRA recognizes as a partnership. Owners (LLPs and

LLLPs) and their lenders should also confirm with their title insurers that the foregoing change in entity form will not impair any existing title policies.

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[1] The Goldwater Institute contends, among other things, that the proposed GPLET transaction violates the following clauses of the Arizona Constitution: (a) the **gift clause**, which provides that neither the state nor any city may give or loan its credit in the aid of, or make any donation or grant, by subsidy or otherwise, to any individual, association or corporation; (b) the **uniformity clause**, which requires the government to uniformly tax all properties within the same class of property in the territorial limits of the taxing authority; (c) the **special law** clause, which prohibits a city from enacting any local or special laws in cases involving the assessment and collection of taxes, or granting any special or exclusive privileges, immunities or franchises, if a general law can be made applicable; and (d) the **conveyance clause**, which provides that no property that has been conveyed to evade taxation shall be exempt. The suit also contends that the property is not located in a "Central Business District" as required by the current GPLET statute and is not located in an area that has recently been determined to be *slum* or *blighted* (the City allegedly relied on a 1979 declaration to that effect). Finally, the Goldwater Institute contends that the City did not publish an invitation for bids or post notices as required by Arizona's competitive bidding statute in entering into the Development Agreement and the GPLET lease with the developer.

[2] **Section 2** of the ALTA Loan Policy provides, among other things, that the title policy coverage continues in force as of the date of the policy in favor of an insured that acquires the property by foreclosure or other means, and that the amount of insurance following the acquisition shall not exceed the lesser of the amount of insurance stated in the policy or the principal of the loan secured by the insured mortgage as of the date of the policy, interest thereon, expenses of foreclosure and protective advances, *reduced by the amount of all payments made*. **Section 9** of the ALTA Loan Policy provides, among other things, that all payments under the policy, except those made for costs, attorneys' fees and expenses, reduce the amount of the insurance, and that payment in part by any person of the principal of the loan or any voluntary partial satisfaction or relief of the insured mortgage, will reduce the amount of insurance to such extent, and that payment in full by any person or the voluntary satisfaction or release of the insured mortgage terminates all liability of the title company except as provided in Section 2(a).

[3] **Section 7** of the ALTA Loan Policy provides, among other things, that the policy is a contract of indemnity against actual monetary loss or damage sustained or incurred by the insured by reason of matters insured against by the policy, and that, in the event the insured has acquired the land in the manner described in Section 2(a) or has conveyed the title, the title insurer's liability continues as set forth in Section 7(a).

[4] Helvetica indicated in a motion it filed with the court that it deliberately chose not to name any junior lienholders in the hopes of inviting one to redeem.

[5] A.R.S. §12-1566(C) provides in part that the redemption price "shall be calculated on the sales price of the real property." A.R.S. §12-1282(C) provides in part that a junior creditor may redeem by paying the amount for which the property was sold and all liens prior to his own held by the person from whom

redemption is made, together with the 8% commission. A.R.S. §12-1285 provides in part that any junior redemptioner must pay the purchase price with 8% added thereto, together with any taxes or assessments the purchaser has lawfully paid after purchase, plus the amount of the lien of redemptioners who may have previously redeemed the property, plus the amount of a prior creditor's lien with interest.

[6] Negative consequences include confusion regarding the residency status of the entity, eligibility for foreign tax credits, application of Canada-U.S. treaty tax rulings and double taxation (with combined U.S. and Canadian tax rates capable of exceeding 65% for individuals and 100% for corporations on income earned in the LLP/LLLP).