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SUMMER 2006

PROPERTY & CONSTRUCTION LAW UPDATE

State Legislature Overhauls Eminent Domain Laws

By GINNY BELL

During this past session, the Minnesota State Legislature made sweeping changes to Minnesota's eminent domain law. These changes may be the most significant alterations to the law of eminent domain in the past 40 years.

The recent legal and political climate in Minnesota created the perfect storm for an overhaul of Minnesota's eminent domain laws. The 2005 U.S. Supreme Court, in *Kelo v. City of New London*, approved New London's taking of non-blighted private property for transfer to other private parties. That decision set off a firestorm of protest throughout the country. The storm raged with particular ferocity here in Minnesota where the Minnesota Supreme Court's split decision in *Walser v. City of Richfield HRA* let stand the approval of a taking of private property (a car dealership located along Interstate Highway 494) for redevelopment by other private parties. Fueled by this backlash, national property rights advocates joined forces with Minnesota business groups, farmers, and others to lobby for restrictions on the government's ability to take private property.

The result of that effort is a new law that limits the ability of local governments to take private property for economic development or redevelopment purposes. The new law also creates significant new rights for property owners and business owners in eminent domain cases.

Public Use and Public Purpose Redefined

The new law begins by redefining public use and public purpose to include only: a) public ownership of property, b) public utilities, and c) the elimination of blighted areas, remediation of environmental contamination, reduction of abandoned property, or removal of public nuisances. These last four areas noted in item (c) above are tightly defined.

For instance, a "blighted area" is defined under the new law as an area where more than 50 percent of the buildings are "structurally substandard." "Structurally substandard" is, in turn, defined under the new law to mean that the buildings have been inspected and cited for housing, maintenance or building code violations, the violations have not been remedied after two notices to cure, and the cost to cure the violations is more than 50 percent of the taxable market value for the building.

The new law also dramatically reduces the ability of condemning authorities to assemble property within a blighted area. Specifically, buildings that are not structurally substandard within a blighted area cannot be taken by eminent domain unless there is no feasible alternative to the taking of those buildings and all steps have been taken to avoid acquisition by condemnation.

The new law also requires that condemning authorities first conduct public hearings and engage in a cost/benefit analysis before taking blighted or contaminated property. If the taking is later challenged in court, the condemning authority must show that the taking is in fact for a public purpose. The net result of all of these changes is that local governments may find it much harder to use eminent domain as a tool in redeveloping their communities.

Compensation Expanded for Property Owners and Business Owners

For property owners and business owners, the most significant changes under the new law are the new compensation provisions. Specifically, the new law adds an explicit provision which compensates for loss of going concern (including good will and other benefits that accrue to a business or trade above the value of the real estate). Previously, it had been very difficult for

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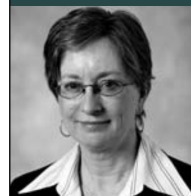

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WHEN IT MATTERS MOST.

Was Your Land Taken Without Your Knowledge?

Did the Minnesota Supreme Court Open The Door to Uncompensated Takings?

By ALLEN WHEELER

Imagine yourself as a real estate developer trying to evaluate whether to buy a golf course. It is located in a local city and zoned residential with the golf course as a conditional use. The city also has a comprehensive plan which allows the property to be used as a golf course but not for residential purposes. Fortunately, at the time of purchase, a Minnesota law provides that a city's zoning ordinance takes priority over conflicting comprehensive plan designations.

Because the zoning ordinance trumps the comprehensive plan, the dual-zoning status makes your investment appear foolproof. You can buy the property, run the golf course, and then make a determination whether the golf operation can make money. If it does, great. If it does not, then the property can be converted to a residential use in accordance with the zoning ordinance.

Not long after you buy the property, however, a new law is passed providing that the comprehensive plan now overrides a conflicting zoning ordinance. The new law orders cities to reconcile conflicts between comprehensive plans and zoning ordinances but your city fails to reconcile its conflict. When your golf course fails financially, you apply to the city to convert it to residential use. Surprisingly, the city denies your request because the city's comprehensive plan designates that area as a golf course only. You ask the city to reconcile the conflict between the comprehensive plan and the zoning ordinance by making the comprehensive plan consistent with the zoning ordinance. The city can do this by including residential development in the comprehensive plan. The city refuses and tells you that the only use for your property is to continue to operate it as a golf course. Your worst nightmare has been realized: you own a golf course which cannot be operated profitably and you cannot change its use. Can the city force you to continue to use the property as a golf course?

The Comprehensive Plan Trumps the Zoning Ordinance

This was the scenario faced by the landowners in the recent case of *Mendota Golf, LLP v. City of Mendota Heights*. In that case, the landowners sued the city and won. On appeal, the Minnesota Supreme Court held that the city did not have to reconcile its comprehensive plan to make it consistent with the zoning ordinance.

The court held that the city had broad discretion in deciding how to reconcile the zoning ordinance and comprehensive plan because land use planning is within the city's legislative prerogative. The court noted that even if the city's decision on how to reconcile these differences was debatable, courts do not interfere so long as there is a rational basis for the city's decision. Here, the court found such a rational basis in the city's interest in open and recreational areas for its residents, which in turn promoted the citizens' "health, safety, morals and general welfare."

The court also said that while zoning ordinances are intended to carry out the policies of the city's comprehensive plan, the comprehensive plan is the primary land control document and it supersedes all other municipal regulations. The court held that it lacks the statutory power to order the city to amend its comprehensive plan to conform to its zoning ordinance because that would undermine the supremacy of the comprehensive plan.

Finally, the court noted that the city's comprehensive plan was a piece of a larger comprehensive plan controlled by the Metropolitan Council. The Metropolitan Council retains the ultimate power to review and order modifications of city comprehensive plans which fall within its jurisdiction.

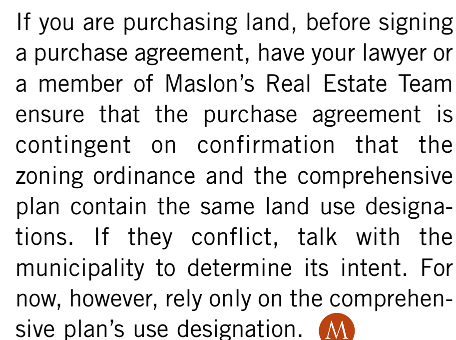
Where Does This Leave the Landowner?

When Mendota Golf purchased the property, it could be used either for residential or golf course purposes. Now, because the comprehensive plan limits its use to golf course purposes only and the comprehensive plan takes priority over the previously existing zoning ordinance, Mendota Golf can only use the land for golf course purposes. It has already been demonstrated that the golf course is not a financially self-sufficient operation. Many believe that this constitutes an effective taking by regulation without compensation, and as a matter of constitutional law, the property owner should be compensated. Unfortunately, because Mendota Golf did not specifically raise this issue, the court did not consider it. Whether Mendota Golf will be able to return to court and seek just compensation for the city's taking is unclear.

Where Does This Leave Other Landowners?

If you have already purchased land and the zoning designation and comprehensive plan designation differ, contact your lawyer or a member of Maslon's Real Estate Team to help you steer through the veritable maze of statutory land use controls or to pursue a claim against the local government for just compensation.

If you are purchasing land, before signing a purchase agreement, have your lawyer or a member of Maslon's Real Estate Team ensure that the purchase agreement is contingent on confirmation that the zoning ordinance and the comprehensive plan contain the same land use designations. If they conflict, talk with the municipality to determine its intent. For now, however, rely only on the comprehensive plan's use designation.



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The Minnesota Court of Appeals' recent decision in *In re Collier* confirms that that the Torrens land registration system remains alive and well in Minnesota. It also illustrates that a failure to recognize the distinction between abstract and registered property can have dramatic consequences.

The Torrens System: *Alive and Well*

By ANDY JACOBSON

The Torrens land registration system was developed by Sir Robert Torrens, a 19th century Australian land registrar. Torrens' system was based on the English system used for ship registration. Under that system a local registrar kept a registry book of all ships based from the local port. Each ship had its own page in the registry on which all liens against that ship were registered. In turn, the owner of the ship kept a duplicate original of the registry page which served as proof of ownership. To check the ownership status of and liens on a specific ship, a lender or buyer merely needed to check the appropriate registry.

Minnesota was one of 21 states that enacted the voluntary Torrens land registration systems in the late 1800s and early 1900s. While adopted by a number of states, the voluntary Torrens systems have only been used extensively in limited areas of the country, including Cook County, Illinois; Massachusetts, and Minnesota. Because of the availability of Torrens land registration in Minnesota, each county is required to maintain two distinct systems of real property records. Land records for abstract properties are maintained in the county recorder's office while records for registered property are kept by the county registrar.

While adopted by a number of states, the voluntary Torrens systems have only been used estensively in limited areas of the country.

In re Collier, No. A05-1178 (Minn. Ct. App. 4/04/06), the owner of a Torrens registered property took out a loan secured by a mortgage from a major institutional bank. The bank recorded its mortgage on the registered property with the county recorder (abstract records) but failed to register the mortgage with the county registrar (Torrens records). As a result of this error, the bank's mortgage did not appear as an encumbrance on the "Certificate of Title" for the property. The landowner subsequently defaulted on the bank's loan, resulting in the bank foreclosing on its mortgage and the bank purchasing the property at the foreclosure auction.

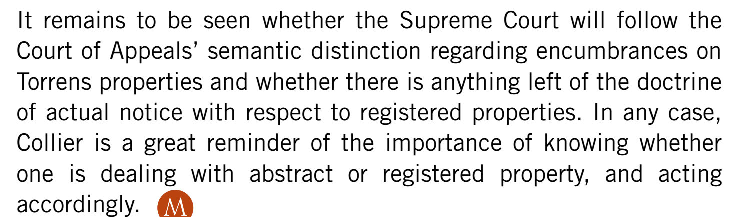
Following the foreclosure sale the bank compounded its initial error by recording (but failing to register) its certificate of sale. During the statutory redemption period following the foreclosure sale, Collier approached the bank with an offer to purchase the bank's interest in the property. After being turned down by the bank, Collier did some research and discovered that the bank had recorded, but not registered, its interest in the property. Collier then contacted the foreclosed landowner and purchased the property for $5,000. At the time of purchase, Collier executed a new mortgage on the property to a third-party lender and then promptly registered both his deed and the new mortgage with the county registrar (Torrens records).

Several months after Collier's purchase, Collier brought an action against the bank to determine their respective rights and priority. The priority issue would dictate whether Collier owned the property free and clear of the bank's interest. The trial court determined that Collier was subject to the bank's interest, because he had actual notice and knowledge of the bank's interest at the time he purchased the property. This prevented him from qualifying as a "good faith" purchaser under Minnesota Statute Section 508.25.

The Court of Appeals reversed the lower court, holding that the bank's mortgage could not constitute an "encumbrance" against the property or an interest adverse to Collier's interest in the property, because the mortgage and certificate of sale were never registered on the Certificate of Title. Until such registration, the bank's interest was merely a private contract between Collier's predecessor and the bank and thus did not burden the property or bind third-party purchasers, such as Collier.

Consequently, under the Torrens system, Collier's actual knowledge of the bank's mortgage was insufficient to prevent Collier from being a "good faith" purchaser of the property. The appeals court justified its decision, in part, on one of the underlying principles of Torrens law: a purchaser need look no further than the "Certificate of Title" to determine the existence of any adverse interests for a property. On June 20, 2006, the Minnesota Supreme Court granted the petition to hear a further appeal of this case.

It remains to be seen whether the Supreme Court will follow the Court of Appeals' semantic distinction regarding encumbrances on Torrens properties and whether there is anything left of the doctrine of actual notice with respect to registered properties. In any case, Collier is a great reminder of the importance of knowing whether one is dealing with abstract or registered property, and acting accordingly.



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Want To Invest In Real Estate? *As of Now the Clock is TICking*

By ALLEN WHEELER

Right now, there is more money seeking property than at any time in recent history. With most institutional investors actively purchasing property, how can a small business or a single investor with limited financial assets acquire quality real estate investments? One method is to purchase an interest in a Tenancy In Common, more commonly known as a TIC. Local papers and trade magazines have recently heralded the potential allure of this investment vehicle, but its mechanics and limitations can be complicated.

What Is a TIC?

TIC ownership, though recently fashionable, particularly for 1031 investors, is actually centuries old. A TIC is a collection of two or more parties who each own an undivided fractional interest in a single piece of property. That is, each owns a percentage of the whole rather than a specifically described portion of the property. This is to be contrasted with a condominium, in which each owner owns a specifically described piece of the property (their residence or office) plus an undivided interest in the common areas.

ADVANTAGES

If created correctly, owners can buy into and sell out of TICs and qualify for "like kind" treatment under Section 1031 of the Internal Revenue Code. Thus, transfers that would normally be taxable are not taxable and gains otherwise recognized on sales are deferred as long as the investor reinvests those gains properly. Also, TIC ownerships are usually structured as passive investments so the owners don't have to worry about operational responsibilities.

TYPICAL STRUCTURE

In one of the most common TIC structures, a "sponsor" buys a property, drafts a TIC Agreement (or Co-Owners Agreement) that is signed by all the TIC owners, secures strong anchor tenant(s) for the property, arranges for the property's long-term management, and begins to sell TIC shares. After all the co-ownership interests are sold, the newly formed TIC owns the property, a property management firm is retained to manage the property on behalf of the TIC, the tenant(s) pay their rents directly to the management company, and the management company pays the owners their proportionate share of revenues (or bills them proportionately for any losses).

Partnership or TIC?

In 2002, the IRS issued Revenue Procedure 2002-22, which identifies the differences between TICs and partnerships. This distinction is critical because if a partnership is created rather than a TIC, the investor will not qualify for "like kind" treatment under Section 1031.

...transfers that would normally be taxable are not taxable and gains otherwise recognized on sales are deferred as long as the investor reinvests those gains properly.

Revenue Procedure 2002-22 describes 15 distinguishing features of a TIC. Some of the more important features of a TIC are:

1) **NUMBER OF CO-OWNERS:**
   Limited to no more than 35 persons.

2) **CO-OWNERSHIP AGREEMENT:**
   There must be a co-ownership (or TIC) agreement that establishes the rights and obligations of the co-owners with respect to each other.

3) **VOTING:**
   The co-owners must retain the ability to make all major decisions affecting the property, such as: (i) hiring a property manager; (ii) entering into leases; (iii) selling the property; and (iv) mortgaging the property. In addition, certain decisions must be authorized by a unanimous vote of the co-owners.

4) **RESTRICTIONS ON TRANSFER:**
   In general, each co-owner must have the right to dispose of its undivided interest in the property without the approval of any party.

5) **PROPORTIONATE SHARING OF PROFITS AND LOSSES:**
   Each co-owner must share in all revenues generated by the property and all costs associated with the property in proportion to the co-owner's interest in the property.

6) **PROPORTIONATE SHARING OF DEBT:**
   The co-owners must be liable for any indebtedness secured by a blanket lien in proportion to their undivided interests.

7) **MANAGEMENT AND BROKERAGE AGREEMENTS:**
   The co-owners may enter into management or brokerage agreements, which must be renewable no less frequently than annually, with an agent who may be the sponsor or a co-owner but who may not be a tenant.

8) **PAYMENTS TO THE SPONSOR:**
   In general, the amount paid to the sponsor for the acquisition of the TIC interest (and the amount of any fees paid to the sponsor for services) must reflect the fair market value of the acquired interest (or the services rendered) and may not depend, in whole or in part, on the income or profits derived by any person from the property.

Concluding Considerations

Potential investors should consider several factors when evaluating a TIC:

- **LOOK FOR AN IRS APPROVED TIC.**
  That is, make sure the TIC satisfies the requirements of Revenue Procedure 2002-22 and is a TIC rather than a partnership.

- **EVALUATE THE SPONSOR.**
  Investigate the sponsor's track-record. How many other deals has the sponsor completed? Talk with co-owners of those deals if possible to see if they are satisfied with the sponsor.

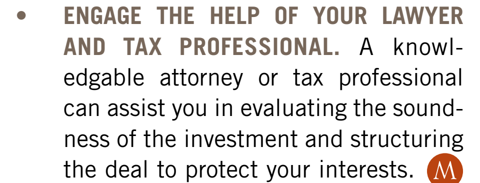
- **EVALUATE THE FINANCIAL STABILITY OF ANCHOR TENANTS.**
  Can you depend on these tenants for a steady, predictable cash flow? If there is a large vacancy or if the lease of any major tenant will expire in the near future, scrutinize the sponsor's (or management company's) assumptions regarding when another tenant (or tenants) will be secured. Are these assumptions reasonable given the condition of the local real estate market?

- **REALIZE THAT THE MORE CO-OWNERS THERE ARE, THE MORE DIFFICULT DECISION-MAKING WILL BE.**
  Make sure you are comfortable with the methods described in the TIC Agreement for making decisions and resolving conflicts.

- **LOOK FOR CONFLICTS OF INTEREST.**
  Is one of the co-owners the sponsor? Is the management and/or brokerage company an affiliate of the sponsor or another co-owner? These types of arrangements are not necessarily bad. If they exist, however, make sure the TIC Agreement is drafted to mitigate against any overreaching by these potentially conflicted entities or persons.

- **MAKE SURE THAT THE TIC AGREEMENT PROVIDES FLEXIBILITY.** At some point, you may need an exit strategy; make sure you review the applicable terms of the TIC Agreement to be sure you have the flexibility you need.

- **UNDERSTAND THE COSTS.** The TIC Agreement should define the costs, fee structure and annual equity disbursement procedures. Make sure you've looked at these provisions closely.



- **ENGAGE THE HELP OF YOUR LAWYER AND TAX PROFESSIONAL.** A knowledgable attorney or tax professional can assist you in evaluating the soundness of the investment and structuring the deal to protect your interests.

If you have any questions about TIC entities, feel free to contact ***ALLEN WHEELER*** *at allen.wheeler@maslon.com or another member of Maslon's Real Estate Practice Team.*

All of you real estate developers and corporations on the receiving end of tax increment financing (TIF) can let out a sigh of relief...at least for the moment. On May 15, 2006, the U.S. Supreme Court tossed out a case that had most real estate insiders wondering whether TIF would remain constitutional.

Tax Increment Financing Unconstitutional? … *Not Just Yet.*

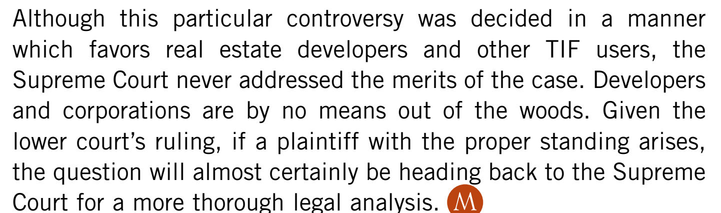
By ALLEN WHEELER

In March, the Supreme Court heard *DaimlerChrysler v. Cuno*, a case that involved the constitutionality of an Ohio statute that provides lucrative tax breaks to businesses investing in new business in Ohio. DaimlerChrysler and the City of Toledo entered into an agreement under which the car manufacturer would build a $1.2 billion Jeep plant. In return, the Ohio government promised an investment tax credit of approximately $280 million.

In a lower court ruling, the Sixth Circuit Court of Appeals declared Ohio's investment tax credit unconstitutional. The court reasoned that the investment tax credit violated the Commerce Clause of the U.S. Constitution because it encouraged investment in Ohio at the expense of development in other states, thereby hindering free trade among the states.

If the Supreme Court affirmed the lower court ruling, the national ripple effect could have been severe. Forty-six states use some form of tax subsidy to motivate and assist businesses to remain, relocate, and expand in their respective states.

The Supreme Court dismissed the case, however, on the grounds that the plaintiffs lacked "standing" to challenge the constitutionality of the Ohio tax incentives. The high court held that the lower court should never have heard the case because the plaintiffs, as individual taxpayers with a grievance over state policy, could not force the courts to intervene in an essentially political controversy; the plaintiffs needed to take such matters up with their state legislature.



Although this particular controversy was decided in a manner which favors real estate developers and other TIF users, the Supreme Court never addressed the merits of the case. Developers and corporations are by no means out of the woods. Given the lower court's ruling, if a plaintiff with the proper standing arises, the question will almost certainly be heading back to the Supreme Court for a more thorough legal analysis.

If you have any questions, feel free to contact ***ALLEN WHEELER*** *at allen.wheeler@maslon.com or another member of Maslon's Real Estate Practice Team.*

owners and tenants to obtain compensation for losses above the lost market value of the real estate. Under the new law, owners and tenants are entitled to compensation for loss of going concern if their business or trade is "destroyed" by a taking and they could not have reasonably prevented the loss. Another important provision provides that property owners who are forced to relocate because of a government taking must be paid, at a minimum, an amount sufficient to acquire a comparable property in the community.

Government Required to Reimburse Property Owners for Attorneys' Fees in Certain Cases

The new law also permits, and in certain cases mandates, the recovery of attorneys' fees and litigation expenses by owners. The new law provides that reasonable attorneys' fees and expenses must be awarded by the court if the final judgment or condemnation award is more than 40 percent greater than the condemning authority's last written offer. If the final judgment or award is at least 20 but not more than 40 percent greater than the last offer, the court may still award the fees and expenses. In addition, the owners are entitled to be reimbursed for the reasonable costs of an appraisal, up to $5,000 for most takings, regardless of the amount of the judgment or award.

The cap on re-establishment expenses also has been raised from $10,000 to $50,000. These expenses are part of the package of relocation benefits paid to businesses that are forced to relocate because of condemnation. In addition, under the new law appeals of relocation decisions must be heard by an administrative law judge (as opposed to an entity chosen by the condemning authority) to ensure fairness.

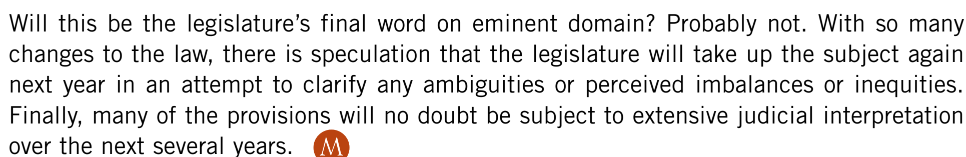
The New Law Takes Effect Immediately but Certain Takings are Exempt

Effective on May 20, 2006, the new law applies to eminent domain actions commenced after that date. There are certain exceptions, however; utilities and certain other "public service corporations" are exempt from many of the provisions of the law. The new law does not apply to takings for drainage purposes or for town roads. It also includes a complicated set of phase-in provisions for property included within Tax Increment Financing (TIF) Districts.

Is the New Law a Good Thing?

Those connected with municipal government believe that the new law will probably result in fewer takings by local governments for redevelopment purposes. Whether this is a good or a bad thing depends on your perspective. If you believe that government-sponsored redevelopment has helped to breathe new life into inner-ring suburbs and cities, then you probably view the new law as a step backward. If you view such government-sponsored redevelopment as state overreaching and a violation of individual property rights, then you will likely see the new law as a welcome change.

The new law is also expected to make it easier for property owners and business owners to obtain just compensation. For instance, a case can be made that, by tying the availability of attorneys' fees to the amount of the condemning authorities' last written offer, condemning authorities will be motivated to make reasonable and fair offers that will reduce the need for expensive litigation.



Will this be the legislature's final word on eminent domain? Probably not. With so many changes to the law, there is speculation that the legislature will take up the subject again next year in an attempt to clarify any ambiguities or perceived imbalances or inequities. Finally, many of the provisions will no doubt be subject to extensive judicial interpretation over the next several years.

If you have any questions about the new law and how it impacts you, feel free to contact ***GINNY BELL*** *at ginny.bell@maslon.com or another member of Maslon's Real Estate Litigation Team.*

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