New Construction Not Always Subject To Realty Transfer Tax

With residential new construction exploding throughout the Philadelphia region, many individuals may be unwittingly placing themselves on the hook for unwanted realty transfer taxes when they purchase an undeveloped parcel of land and construct the home of their dreams on that land.

In a rather informative pamphlet titled Commonly Asked Questions: PA Realty Transfer Tax & New Home Construction, the Pennsylvania Department of Revenue states that "[t]he value of a construction contract is subject to the Realty Transfer Tax when . . . an executory construction contract for building a house is effective prior to or contemporaneously with the transfer of the title to a building lot and . . . . the seller and the builder are affiliated in some way."

According to the Department of Revenue, an 'executory' construction contract is "when the purchase takes title to a lot" and "is legally bound to build a house with a specific builder." The Department of Revenue points out that an affiliation between the seller and contractor may be created by agreement or common ownership.

In the pamphlet, the Department of Revenue sets forth the following examples of an agreement between the seller and contractor causing an affiliation implicating the realty transfer tax:

- an existing contract for the construction of the house between the seller and the builder that is assigned to the buyer;
- options to purchase or buy a lot or lots given by the seller to the contractor;

- rights of first refusal to buy a lot or lots given by the seller to the contractor;
- agreements of sale for a lot or lots given by the seller to the contractor;
- written agreement designating the contractor as the only builder that can build houses on the lots;
- agency agreement whereby the seller acts as an agent for the contractor in selling a lot or lots to the buyer;
- an agency agreement whereby the contractor acts as an agent for the seller in selling a lot or lots the buyer; or
- a partnership agreement or joint venture agreement between the seller and contractor to develop the lots.

The Department of Revenue then lists the following examples where common ownership between the seller and the contractor may cause such an affiliation:

- seller or close relative is a shareholder or partner in the contractor;
- contractor or close relative is a shareholder of a partner in the seller; or
- seller and contractor are owned in whole or in part by the same individuals or entities.

Not all of the affiliations listed by the Department of Revenue may be readily apparent by a buyer. To illustrate, an unsuspecting buyer who purchases an undeveloped lot may use a builder recommended by the seller. Assuming the buyer pays the builder fair consideration for the construction work, if the seller or close relative is a shareholder or partner in the contractor, or vice versa, the buyer would still incur an additional tax burden, even if that buyer was unaware of that relationship when he made the decision to the use the builder.

In order to avoid paying for the value of the construction work, whenever a buyer purchases undeveloped land and constructs a new house onto the land, he should make sure he

fully understands the “affiliation”, if any, which may exist between the seller and contractor.

RECENT COURT DECISION

In *Harmon Homes, Inc. v. Commonwealth*, the Commonwealth Court recently rejected a seller’s attempt to use the “turnkey project” exemption of Pennsylvania’s Realty Transfer Tax Act in order to avoid paying realty transfer taxes for the value of the construction work.

On February 4, 2002, Harmon Homes filed a deed dated January 28, 2002 with the recorder’s office in Monroe County transferring two lots in a planned community to Gerald L. Robbins, Jr. According to the deed, the lots were purchased for $40,000. When the deed was recorded, a realty transfer tax of $400 was paid. On the day that the lots were conveyed to Robbins, he entered into a separate contract with P.P.F. Homes, Inc., an affiliate of Harmon Homes, for the construction on the lots of a home at a cost of $138,000.

On February 24, 2002, Robbins conveyed the lots to One Stop Realty, Inc. for nominal consideration. When the deed was recorded the following month, the parties presented a Statement of Value exempting the transfer from taxation as a “turnkey project”. Under the “turnkey project” exemption, “[a] transfer of realty to a developer or contractor who is required by contract to reconvey the realty to the grantor after making contracted-for improvements to the realty is not taxable if no beneficial interest is transferred to the developer or contractor. The reconveyance to the grantor is also not taxable.”

Upon completion of the home’s construction, One Stop Realty conveyed the lots back to Robbins for nominal consideration. At recording, the parties once again claimed that the transfer was a turnkey project and not taxable.

The Department of Revenue subsequently notified Harmon Homes

of its determination that it owed additional tax on the January 28, 2002 lot transfers to Robbins. The Department explained that the lots had a value of $178,000, not $40,000 as indicated in the State of Value, because Robbins also contracted for the construction of a home on the land received from Harmon Homes on the same day Robbins purchased the lots. After administrative appeals were rejected, Harmon Homes then appealed the Department's ruling to the Commonwealth Court.

Harmon Homes argued that the value of the building contract executed by Robbins was irrelevant to his purchase of the lots from Harmon Homes because Robbins did not own the lots while the home was being constructed and that Robbins' conveyance to One Stop Realty separated the value of the executory contract from the value of the real estate conveyed by Harmon Homes to Robbins.

In upholding the administrative ruling, the Commonwealth Court heavily relied on its previous decision in *Pennsylvania Builders Association v. Department of Revenue*. In *Pennsylvania Builders*, the Court flatly rejected taxpayers' argument that an agreement to make future improvements to land does not convey an interest in real estate and, thus, should not be subject to the transfer and instead concluded that Pennsylvania's Realty Transfer Act "was intended to tax 'all new home sales uniformly on the full monetary worth of the interest in real estate conveyed.'"

Although the transfers from Robbins to One Stop and back to Robbins were obviously exempted from taxation as a turnkey project, the Commonwealth Court emphasized that it did "not follow that because one part of the transaction by which Robbins acquired his home and land fit the exemption for a turnkey project, that the entire transaction can be considered a turnkey project."

The Commonwealth Court rather determined that "[t]he intervening transfer to One Stop Realty had no effect on the

value of the transaction between Harmon Homes and Robbins that took place on January 28, 2002. When the deed for the transfer from Harmon Homes to Robbins was recorded, the executory building contract was in effect and, thus, the value of the realty subject to the recording included both the combined value of the newly constructed home and the lots."

LESSON LEARNED

Purchasers of undeveloped land who construct the house of their dreams on that land must be wary of creating the ultimate nightmare of owing realty transfer taxes on the value of their newly constructed home. Only through due diligence and proper planning can these purchasers reap the benefits of the increase in the fair market value of their newly constructed house and adjoining land without giving the state government an unnecessary windfall.

Alan Nochumson

Vertical Position 100%

Sellers Prevented From Exercising Mortgage

Contingency Clause

Agreements of sale generally contain a laundry list of contingencies which must be satisfied before the settlement date. Most, if not all, of these contingencies allow the buyer to escape from an otherwise unfavorable real estate transaction.

In *Watson v. Gerace*, the United States Court of Appeals for the Third Circuit recently prevented homeowners from exploiting a mortgage contingency clause contained in an agreement of sale.

SELLERS CANCEL SALE

J. Scott Watson and Laura Watson, who owned the second floor apartment in a duplex in Ocean City, New Jersey, executed a written agreement to sell their apartment to Joseph and Donna Gerace for $665,000. Under the terms of the contract, the Geraces placed $15,000 in escrow and agreed to pay the balance with cash and a $532,000 mortgage.

The contact was a standard form prepared by a real estate company which represented the parties involved through separate agents.

Clause 6 of the contract contained a provision entitled "Mortgage Contingency." According to Clause 6, "[t]he Buyer's obligation to complete this contract depends on the Buyer getting a written commitment of an established mortgage lender, or the Seller, as the case may be, to make a first mortgage loan on the property in the principal amount of $ 532,000.00. . . . The Buyer shall supply all necessary information and fees asked for by the lender. The commitment must be received by the Buyer on or before March 22, 2004. . . . Should the buyer not receive the written commitment by the above date then this Contract shall be null and void and all deposit money will be returned to the Buyer; unless the

commitment date is extended by Buyer and Seller. The Buyer, at his option, can waive this mortgage contingency at any time. . . . Any mortgage commitment signed by the BUYER will satisfy this mortgage contingency."

On March 10, 2004, the Geraces obtained a "Credit Approval Letter" from Wells Fargo Home Mortgage, which they signed on March 13, 2004. The letter stated "Congratulations! Your loan application has been approved subject to the terms and conditions included on this credit approval letter. A commitment letter will be forwarded to you by your Mortgage Specialist, once an appraisal report has been reviewed by the Lender."

The letter contained a number of conditions, including: a verification of the Geraces' financial status; an appraisal of the property indicating a market value of the agreed upon purchase price; and documentation approving a second mortgage of $33,250.

On March 23, 2004, the Watsons contacted their agent to inquire about the status of the mortgage commitment. They advised him to inform the Geraces that the contract would be considered null and void unless the commitment had been received by him. The following day, the agent faxed a copy of the Credit Approval Letter to the Watsons. Afterwards, the Watsons stated that the letter was unacceptable to them and that the contract was null and void. They then requested that their agent re-list the property for sale.

The Geraces nevertheless appeared at the originally scheduled closing. The Watsons, instead of appearing at the closing themselves, filed a complaint in federal court. In their complaint, they requested a declaratory judgment that the contract was null and void.

In response, the Geraces filed an action in the Superior Court of New Jersey for breach of contract, requesting damages and

specific performance. The state court case was eventually removed to federal court and consolidated with the Watsons' declaratory judgment action. Both parties eventually moved for summary judgment. The district court granted summary judgment for the Geraces primarily on the finding that the Credit Approval Letter satisfied the mortgage contingency clause.

THIRD CIRCUIT SIDES WITH BUYERS

On appeal, the Third Circuit upheld the district court's ruling strongly stating that "[i]t was in writing, it was received by the Buyers before the deadline, and the loan it approved met the stated financial criteria."

The Third Circuit summarily rejected the Watsons' argument that the Credit Approval Letter was not a "mortgage commitment" because it did not definitely bind Wells Fargo to fund the mortgage. Instead, the Third Circuit found that, "[w]hile the Credit Approval Letter does refer to a separate 'commitment letter', it is clear from its language that it binds Wells Fargo, subject only to specified conditions."

The Third Circuit also found the Watsons' reliance on a line of cases standing for the proposition that a conditional commitment cannot satisfy a mortgage contingency clause as misguided, to say the very least. The Watsons argued that, because the second mortgage and the appraisal were outside the control of the Geraces, the commitment was too uncertain. The Third Circuit found the cited cases as inapposite because, in those cases, the mortgage contingency clauses were conditional on the successful sale of the buyers' previous homes.

The Third Circuit noted that "[t]here, unlike here, the conditions not only had a substantial likelihood of nonfulfillment through no fault of the buyers, but actually failed before the deadline in the mortgage contingency clause. In contrast, the conditions were both likely to be and actually were fulfilled. The second mortgage was also issued

by Wells Fargo; the Credit Approval Letter refers to it as ‘a component of this transaction.’ There is no evidence in the record that there was any genuine risk that the second mortgage would not be available. The appraisal could have blocked the mortgage commitment only if it had been for a value beneath the agreed sales price.”

In all, the Third Circuit emphasized that the Geraces “had the undisputed ability to comply with the remaining conditions, were under a good-faith duty to do so, and did comply with them.”

The Third Circuit also seemed perplexed as to why the Watsons had any right to cancel the agreement of sale per the mortgage contingency clause. The Third Circuit first stated that the Geraces, under the contract itself “had sole and unfettered discretion to determine whether the mortgage contingency they received was sufficient.” The Third Circuit pointed out that the contract specifically provided that “[a]ny mortgage commitment signed by the BUYER will satisfy this mortgage contingency.”

In a forcefully worded rebuke to the Watsons, the Third Circuit ruled that “[t]he Buyers found the Credit Approval Letter sufficient and signed it. The Buyers had the option to waive the mortgage commitment entirely, strongly suggesting that they could waive it to whatever extent the mortgage commitment was insufficient. Further, the mortgage contingency clause makes the mortgage commitment a condition precedent to the Buyer’s ‘obligation to complete this contract,’ indicating that the mortgage contingency clause operates for the Buyers’ benefit.”

PENNSYLVANIA LAW

The standard forms approved by the Pennsylvania Association of Realtor (PAR) are used for most residential real estate transactions in Pennsylvania. Paragraph 6 of the standard

agreement contains the mortgage contingency clause. If the parties elect to include the mortgage contingency clause as part of the agreement, the buyer must list, among other things:

1. The loan amount of the mortgage(s);
2. The minimum term of the mortgages(s);
3. The type of the mortgage(s);
4. The mortgage lender(s); and
5. The maximum acceptable interest rate of the mortgage(s).

Under the terms of the agreement, the buyer is required to complete a mortgage application within an agreed upon period of time from the date of the agreement is fully executed by the parties.

If the buyer fails to apply for a mortgage within the agreed upon time period, he is in default of the agreement. The buyer is also in default of the agreement if he furnishes false or incomplete information concerning his legal or financial status or fails to cooperate in good faith in processing the mortgage loan application which results in the mortgage lender refusing to approve a mortgage commitment.

1. After receiving the mortgage commitment, the seller may only terminate the agreement if:
2. the commitment is not valid until the date of settlement;
3. the commitment is conditioned upon the sale and settlement of any other property;
4. the commitment does not contain the mortgage financing terms agreed by the buyer in the agreement itself; or
5. the commitment contains other conditions not specified in the agreement other than those conditions that are customarily satisfied at or near settlement, such as obtaining insurance and confirming employment status.

LESSONS LEARNED

In Pennsylvania, a seller, under the PAR form agreement of sale, clearly has the right to terminate the agreement if the buyer fails to obtain the mortgage commitment as set forth in the agreement. As such, buyers in Pennsylvania should be wary of a homeowner who suddenly succumbs to seller's remorse.

To illustrate, if the parties in *Watson* had used the PAR form agreement of sale, the sellers would likely have been allowed to cancel the agreement per the mortgage contingency clause.

The Watsons attempted to terminate the agreement because the mortgage commitment was conditioned upon the Geraces receiving a second mortgage, among other things. Under the PAR form agreement of sale, the Geraces would have been required to reveal whether they intended to finance the sale through a single mortgage or two separate mortgages. If the buyers had not decided on applying for two separate mortgages, the sellers would have been able to cancel the agreement because the buyers could not admittedly have financed the sale without obtaining a second mortgage.

Unlike the agreement in *Watson*, the PAR form agreement of sale does not allow a buyer to waive the mortgage contingency once the provision is included in the executed agreement. Under the plain and unambiguous terms of the agreement, the Geraces could not have simply waived the contingency (which they ultimately did) after failing to obtain the agreed upon financing, placing them in default of the agreement and, therefore, giving the Watsons the ability to simply cancel the sale without judicial intervention.

Alan Nochumson

Vertical Position 100%

Commonwealth Court Trashes Landlord’s Attempt To Avoid Borough Fees

Local governments are given wide latitude in outsourcing their government services to private independent contractors. Pennsylvania courts generally shy away from challenges by the citizenry with respect to the amounts paid on government contracts.

In a prime example, the Commonwealth Court of Pennsylvania in *M&D Properties, Inc. v. The Borough of Port Vue* recently rejected a landlord’s constitutional challenge to garbage collection fees assessed by the Borough against its apartment complex.

Under the Borough ordinance, all domestic refuse accumulated upon any property within the Borough had to be collected and removed either by the Borough or an approved independent contractor. Since the early 1990s, the Borough contracted with a private contractor to perform that function by through a public bidding process and selecting the lowest bidder from interested trash collection companies. The annual fee charged by the Borough to owners of real estate for trash collection was $105 per dwelling unit.

M&D owned and operated an apartment complex located in the Borough consisting of 72 single-family units. The apartment residents were responsible for depositing their trash into the dumpsters located within the complex. In accordance with the

ordinance, the Borough levied, and M&D paid, the annual trash collection fee of $105 for each of the 72 units in the apartment complex.

TRIAL COURT'S RULING

In 1993, M&D filed a complaint challenged the ordinance on the grounds that the Borough's annual garbage collection fee was "arbitrary, irrational, unreasonable, confiscatory, and not related to the Borough's incurred costs of collection of trash." In support of its claim, M&D offered bids it obtained from two private trash haulers for collection of garbage at the apartment complex. Both bids were for less than half of the $105 per dwelling unit.

After judgment was entered in M&D's favor, the Borough filed a motion for post-trial relief, which was granted, and the case was retried as a de novo non-jury trial. At the new trial, the judge found that M&D failed to sustain its burden of proof that the Borough's trash collection fee was unreasonable.

On appeal, the Commonwealth Court directly confronted the reasonableness of the assessed trash collection fees.

Under Pennsylvania law, "fees charged by a municipality for services rendered are proper if they are reasonably proportional to the costs of the regulation or the services performed. A municipality may not use its power to collect fees for a service as a means of raising revenue for other purposes. The party challenging the reasonableness of a fee bears the burden of proving it is unreasonable."

The Commonwealth Court first addressed M&D's argument that the Borough's annual fee of $105 dwelling unit is unreasonable when compared to the proposals from two independent contractors to provide trash collection service to the apartment complex for half of the fee.

Agreeing with the trial court's determination that the

evidence submitted did not support M&D's conclusion that the Borough's fees was unreasonable, the Commonwealth Court pointed out that the "fees cover[ed] more than just the contractual payments to its designated trash hauler" and that "[t]he fee also include[d] overhead expenses borne by the Borough for personnel, billing, collection, regulation, inspection and enforcement costs." The Commonwealth Court emphasized that "[a]ny assessment of the reasonableness of the Borough's $105 fee must take into account whether the fee is 'reasonably proportional' to all of the costs associated with trash collection, not just one part of those costs."

The Commonwealth Court also rejected M&D's heavy reliance on the Supreme Court of Pennsylvania's decision in *Ridley Arms, Inc. v. Township of Ridley*. In *Ridley Arms, Inc.*, the Supreme Court found "that the payment of approximately $58,000 to a municipality for the performance of services which can be, and actually were provided by the private sector for approximately $23,000, less than half the amount charged by government, [wa]s" unreasonable.

The Commonwealth Court found the facts and circumstances in *Ridley Arms, Inc.* to be distinguishable.

The Commonwealth Court first pointed out that the Township of Ridley conceded that its actual cost per unit for collecting refuse from apartment complexes ranged from "$19.99 to $ 30.00 during the relevant time period, whereas it charged a refuse collection fee of $ 70.00 per unit." In contrast, the Commonwealth Court noted that the Borough was not "levying a revenue-generating surcharge."

The Commonwealth also highlighted that the landlord in *Ridley Arms, Inc.* paid a private contractor for trash removal in addition to paying the township in fees pursuant to the trash collection ordinance. Since "M&D did not pay a fee to the Borough for services which 'actually were provided by the private sector' for half the cost", the Commonwealth Court

believed that the trash collection fees were not per se unreasonable.

LESSONS LEARNED

As illustrated by the Commonwealth Court's ruling in *M&D Properties, Inc.*, the judiciary refuses to second guess decisions made local governments. This foolhardy approach allows local governments to either intentionally or negligently overcharge their residents for government services. Based upon the language of the court opinion, such challenges are better handled through the electoral process rather than the judicial system.

Alan Nochumson

Vertical Position 100%

Nochumson Examines What Could Happen When Natural Disasters Strike

Alan Nochumson was a faculty speaker at the Continuing Legal Education (CLE) seminar sponsored by Pennsylvania Bar Institute entitled "Disasters: Planning Ahead to Avoid the Worst" which took place in Philadelphia, Pennsylvania.

During the seminar, Nochumson discussed what sellers, buyers, and even contractors should know when natural disasters strike.

Landowner Prevented From Changing The Use Of His Property

Wilson v. Plumstead Township Zoning Hearing Board is a cautionary tale on why landowners should not downplay zoning restrictions encumbering their property prior purchase.

In *Wilson*, the landowner purchased a single-family residence located on the heavily traveled Route 611. The property was zoned as R-2 Residential. Under local zoning regulations, a R-2 Residential property could be used as a "Home Occupation" or, in other words, a use "conducted within an existing dwelling which is the bona fide residence of the principal practitioner." Unlike a R-2 Residential property, zoning regulations designates a F3 Professional Office property as allowing landowners who do not reside on the property to maintain "business, professional or governmental offices other than [a medical or veterinary office]."

After purchasing the property, the landowner in *Wilson* immediately started renovations on his "residence." As the landowner proceeded with the renovations, the township's zoning officer noticed work throughout the residence typical of an office, but was assured by the landowner that the renovations were only for a residence with a "Home Occupation". After the renovations were completed, the zoning officer discovered that the landowner was not residing at the

property and that the property was being used solely as an office. The zoning officer thereafter issued an enforcement notice for operating an impermissible F3 Professional Office.

OWNER SEEKS VARIANCE

Instead of appealing the enforcement notice, the landowner filed a variance application with the zoning board seeking to utilize the property as an F3 Professional Office.

The zoning board subsequently denied the landowner's application. Among other things, the zoning board noted that the landowner bought the property with knowledge that he could not conduct his business as an F3 Professional Office, so any hardship created was self-inflicted. The landowner appealed the zoning board's decision to the trial court.

Taking additional evidence of the commercial uses of neighboring properties, the trial court reversed the zoning board's decision and granted the variance. The trial court found that an "overwhelming majority" of the neighboring properties contained a "commercial use." The trial court also reasoned that "the non-residential and commercial nature of the area near the Property renders it largely unusable for traditional residential purposes." The township then appealed that decision to the Commonwealth Court.

MAJORITY OPINION

According to the Commonwealth Court in *Wilson*, in municipalities governed by the Municipalities Planning Code (MPC), an applicant for a variance has the 'heavy burden' of establishing: "an unnecessary hardship will result if the variance is denied, due to the unique physical circumstances or conditions of the property; because of such physical circumstances or conditions the property cannot be developed in strict conformity with the provisions of the zoning ordinance and a variance is necessary to enable the reasonable use of the property; the hardship is not self-inflicted;

granting the variance will not alter the essential character of the neighborhood nor be detrimental to the public welfare; and the variance sought is the minimum variance that will afford relief."

In reversing the trial court's decision, a divided Commonwealth Court concluded that the "trial court committed an error of law by not addressing the MPC's requirement that the hardship justifying the variance not be self-inflicted."

The majority, agreeing with the zoning board, found that any hardship resulting from the denial of the variance was self-inflicted because the landowner purchased the property knowing the applicable zoning regulations.

The majority heavily criticized the landowner's reliance on the Commonwealth Court's previous decisions in *In re Appeal of Grace* and *Vacca v. Zoning Hearing Board of Borough of Dormont*.

In *Grace*, the Commonwealth Court vacated the denial of a variance request to allow the construction of a single-family dwelling in a residential district on a pre-existing nonconforming lot that did not meet the township's dimensional requirements. Due to new size and set back requirements of subsequently enacted zoning regulations, the property in *Grace* became nonconforming. The hardship in *Grace* was that the zoning ordinance's dimensional and set back requirements prohibited the construction of a single-family dwelling on a residentially zoned lot because of the lot's size, which pre-dated the zoning ordinance.

Unlike *Grace*, the majority believed that the hardship in *Wilson* was created by the purchase itself, not by the characteristics of the property. The majority reasoned that: the "hardship, which derives from [the] [l]andowner's inability to utilize the [p]roperty solely as an office, was known or knowable at the time of purchase and prior to the renovations. In *Grace*, it was not just the current property

owner, but also every subsequent owner of the property, that would not be able to construct a residence within the restrictions of that residential district. Here, the evidence of record reveals that, not only can [the] [l]andowner utilize the [p]roperty for a permissible Home Occupation, but also he and other neighboring landowners are currently operating permissible Home Occupations. Thus, the facts of this case are distinguishable from *Grace* because, here, [the] [l]andowner's claimed hardship does not derive from the inherent characteristics of the [p]roperty but, rather, from his personal desire to gain a greater use of the [p]roperty from the permissible and currently viable uses allowed in the R-2 District."

Moreover, the majority noted that *Vacca* actually supported a denial of the landowner's requested variance. In *Vacca*, the landowner sought a variance to allow the commercial use of his residentially zoned property presenting evidence of the commercial uses of surrounding property and his property's placement on a heavily traveled road. Affirming the denial of the requested variance, the Commonwealth Court in *Vacca* concluded that "the property's current use, as a single-family rental property, established that it was, in fact, being put to a reasonable use as zoned and, thus, did not justify the grant of a variance" and "further reasoned that the claimed hardship was self-inflicted because the landowner had recently paid a high price for the property under the false assumption that he would receive a variance."

In *Wilson*, the majority pointed out that, similar to *Vacca*, the landowner purchased "the [p]roperty under a false assumption, or with prior knowledge, that he could not use his [p]roperty solely as an office."

DISSENT

In a passionate dissent opinion, Judge Robert Simpson disagreed with the majority's discussion of self-imposed

hardship. The judge pointed out that the majority twisted the hardship at stake in *Wilson*. The judge noted that the trial court identified the hardship as "the surrounding parcels of land are dissimilar and disharmonious" and "the non-residential and commercial nature of the area near the property renders it largely [unusable] for traditional residential purposes." In contrast, the judge believed that the majority unreasonably redefined the hardship as the "[l]andowner's inability to utilize the [p]roperty solely as an office."

The dissenting judgment then could not fathom "how the dissimilar and disharmonious situation found by the trial court could possibly be created by the landowner's purchase." The judge believed that "[t]hese conditions existed independent of any action of or any thought by the landowner. Whether or not these conditions constitute unnecessary hardship (which is a different question), they were not created by and existing for the first time when the property was purchased."

LESSONS LEARNED

Since Philadelphia is exempt from the MPC, the majority's decision in *Wilson* will likely have no direct impact on variance applications made on properties located within the city limits. Landowners in Philadelphia and throughout the Commonwealth, however, should not downplay the potential risk associated with ignoring the use restrictions imposed by applicable zoning regulations; otherwise, they could be prevented from using the property for its anticipated purpose.

Alan Nochumson

Vertical Position 100%

Landlord Attempt To Terminate Option Contract 'Invalid'

Drafting a lease agreement is no easy task. Although most landlords possess an upper hand in lease negotiations, they do not always protect themselves from a defaulting tenant.

In *Jones v. Battista*, a landlord recently found himself relying upon a lease which had more holes in it than a piece of Swiss cheese.

In *Jones*, Sherry Mennett sold a property located near Rittenhouse Square to Anthony Battista. As part of the transaction, Battista leased the property to Mennett. Under the lease, Mennett was obligated to pay monthly rent in an amount equal to the monthly mortgage payment due on the property. The lease also contained a clause giving Mennett the option to purchase back half of the property.

Although Mennett made some rental payments initially, she eventually ceased to do so. Soon thereafter, Battista informed Mennett in writing that he was terminating the lease due to her nonpayment of rent and her failure to maintain liability insurance as required under the lease. Several months later, Mennett exercised her option to purchase half of the property.

Mennett then filed an action in the Philadelphia County Court of Common Pleas, requesting, among other things, specific performance of the option provision contained in the lease.

In response, Battista filed counterclaims for the amount allegedly due by Mennett under the lease.

Since Mennett did not dispute her failure to make the rental payments, Battista moved for summary judgment arguing that she no longer has any right to exercise the option provision due to her admitted default in payment of the rent. Mennett then filed a cross-motion for summary judgment on her claim for specific performance of the option provision.

FAILURE TO TERMINATE LEASE

The trial court first concluded that Battista did not properly terminate the lease. The trial court relied upon the lease provision entitled "Term of Lease," which provides that: "[t]he lease term shall expire in 10 years from the date of this agreement, or upon the delivery of a deed conveying one-half interest in the premises pursuant to the option to purchase set forth in paragraph."

The trial court emphasized that "[n]owhere does the [l]ease state that Battista has the right to call a default, terminate the [l]ease, or otherwise extinguish Mennett's rights under the [l]ease due to her failure to fulfill her obligations under the [l]ease. At most, the [l]ease provides that Mennett covenants and agrees with Battista that in consideration of Battista paying rent when due, she shall peaceably and quietly use, occupy and possess the premises for the full term of this lease."

Since the lease did not expressly provide a remedy to Battista in the event of Mennett's failure to pay rent, the trial court stated that he "[wa]s left with only those remedies provided at law."

In a commercial lease situation, Pennsylvania courts have consistently followed the strict common law rule that, unless a demand for rent is expressly waived by the terms of the lease, a demand by the landlord is absolutely essential to

terminate the lease as a result of nonpayment of rent.

The trial court noted that "Battista . . . proffered no evidence that he made any demand upon Mennett to cure her alleged breach in payment of the rent, or that she expressly waived her right to receive a demand to cure before her rights under the [l]ease were forfeited."

As a result, the trial court reasoned that "[u]ntil Battista made such a demand (and Mennett failed to comply with it), Battista was not entitled to terminate the [l]ease. Therefore, his attempt to do so was invalid."

The trial court was also not persuaded by the following lease provision: rent "shall be payable without demand on the 15th day of each month." The trial court reasoned that "this waiver of demand before the rent comes due does not act as a waiver of a subsequent demand to cure a default in payment of rent, which is required before a forfeiture can be had."

In dicta, the trial court also discussed Battista's failure to properly terminate the lease based upon the lack of liability insurance. The trial court pointed out that the lease required Battista to first request that the Mennett cure the default prior to terminating the lease. Since Battista failed to do so, the trial court obviously believed that the lease was not terminated on these grounds as well.

OPTION PROPERLY EXERCISED

The trial court next discussed whether Mennett's option rights were contingent upon the performance of her contractual obligations.

The option provision of the lease specifically provided that: "[Battista] hereby gives and grants to [Mennett] the exclusive option of purchasing a one-half fee simple interest in the [Property] for the payment of $1 and the assumption of one-half of the balance of principal and interest remaining on the

mortgage and mortgage note with Worlds Savings dated June 14, 2000, as of the time [Battista], at his cost and expense, delivers to [Mennett] a duly executed and acknowledged fee simple deed as tenants in common in proper statutory form for recording."

Pennsylvania courts generally treat an option to purchase leased premises as an entirely separate agreement. Unless the lease contains language extinguishing the tenant's right to exercise the option upon a lease default, the tenant will not be barred from exercising the option. In fact, "[w]here an act or event mentioned in a contract is not expressly made a condition precedent, it will not be so construed unless such clearly appears to be the intention of the parties."

After reviewing the option provision contained in the lease, the trial court concluded that, since the lease was not validly terminated by Battista, Mennett was in a position to exercise the provision to repurchase half of the property.

The trial court rejected Battista's reliance of *Gateway Trading Co., Inc. v. Children's Hospital of Pittsburgh*. In *Gateway*, the lease expressly stated that the tenant's right of first refusal could be exercised only "if the Tenant be not in default under the terms of this Lease."

The trial court found the Pennsylvania Supreme Court's ruling in *Gateway* was not applicable because the lease in *Jones* did not contain any such condition precedent. Unlike *Gateway*, there was no express language in the lease making Mennett's option rights contingent upon her performance of her obligations as tenant under the lease.

LEASONS LEARNED

Jones illustrates the importance of drafting a lease which adequately protects landlords from defaulting tenants. The landlord in *Jones* did not properly terminate the lease most likely because he assumed the lease contained a clause waiving

his obligation to demand rent from the tenant.

Even worse, the lease did not prevent the defaulting tenant from otherwise purchasing an interest in the property. If the lease contained such restrictive language, the tenant in *Jones* would have been foreclosed from repurchasing the property back from the landlord.

Alan Nochumson

Vertical Position 100%

Nochumson P.C. And Bear Abstract Services Open Their Doors

Nochumson P.C. and Bear Abstract Services opened their doors for business at 1616 Walnut Street, Suite 705, Philadelphia, Pennsylvania 19103.

Nochumson P.C. provides superior legal representation to businesses, individuals, and professionals throughout Pennsylvania and New Jersey. Bear Abstract Services offers comprehensive title insurance, title examination, and closing services for transactions ranging from simple residential agreements of sale to complex commercial projects.

Subcontractor Prohibited From Filing Mechanics' Lien

If the real estate market slows down as some experts are predicting, Pennsylvania courts will likely be inundated with an influx of mechanics' lien actions filed by contractors who are left holding the proverbial bag on real estate projects mired in cost overruns and unrealized profits.

In *Wentzel-Applewood Joint Venture v. 801 Market Street Associates*, a subcontractor learned a rather costly lesson when the Superior Court of Pennsylvania recently dismissed its mechanics' lien because the subcontractor failed to issue the requisite notice under Pennsylvania law.

CONSTRUCTION WORK

In *Wentzel-Applewood*, Citizens Bank, occupying several upper floors in a building located in center city, entered into an agreement with a contractor to convert the floors from their previous use as retail and storage space for the Strawbridge and Clothier department store into an "item processing center" on two of the floors with office space on the third floor. The contractor then retained the services of a subcontractor who provided and installed the drywall, studs, doors, windows, ceilings and millwork required in building the item processing center.

After the subcontractor completed the work, the contractor was paid in full by Citizens Bank. The contractor then filed for bankruptcy protection and did not pay the subcontractor for the work performed. The unpaid portion to the subcontractor was in the amount of $257,286.31. The subcontractor then provided formal written notice of its intent to file a

mechanics’ lien.

TRIAL COURT DECISION

After the subcontractor filed the mechanics’ lien in state court, Citizens Bank and the other named parties filed preliminary objections asserting that the subcontractor failed to give, prior to completion of its work, the required preliminary written notice of its intent to file the lien.

The trial court initially overruled the preliminary objections, but subsequently granted reconsideration and directed that discovery and depositions take place. Upon review of the evidence produced, the trial court, without further evidentiary proceedings, sustained the preliminary objections, dismissed the mechanics’ lien claim, and struck the lien. The subcontractor then appealed the decision.

APPELLATE OPINION

The subcontractor first argued that the trial court erred when it sustained the preliminary objections by reason of the subcontractor’s failure to give preliminary notice of its intent to file a lien.

Under Pennsylvania’s Mechanic’s Lien Law, the type of notice required of a subcontractor in order to properly file a mechanics’ lien rests with whether the work performed qualifies as “erection and construction” or “alteration and repair”. If the work is deemed ‘alterations and repairs’, a subcontractor must give “the owner, on or before the date of completion of his work, a written preliminary notice of his intention to file a claim if the amount due or to become due is not paid.” Additionally, “no claim by a subcontractor, whether for erection or construction or for alterations or repairs, shall be valid unless, at least thirty . . . days before the same is filed, he shall have given to the owner a formal written notice of his intention to file a claim.”

Since there was no dispute that the subcontractor in *Wentzel-Applewood* failed to give preliminary notice, the validity of the subcontractor's mechanics' lien hinged upon its insistence that the work qualified as "erection and construction".

The Superior Court examined how the Mechanic's Lien Law defined the terms "improvement", "erection and construction", and "alteration and repair". According to the Mechanic's Lien Law:

"Improvement" includes any building, structure or other improvement of whatsoever kind or character erected or constructed on land, together with the fixtures and other personal property used in fitting up and equipping the same for the purpose for which it is intended.

"Erection and construction" means the erection and construction of a new improvement or of a substantial addition to an existing improvement or any adaptation of an existing improvement rendering the same fit for a new or distinct use and effecting a material change in the interior or exterior thereof.

"Alteration and repair" means any alteration or repair of an existing improvement which does not constitute erection or construction as defined herein.

The Superior Court pointed out that Pennsylvania courts deem improvement of real estate as 'erection and construction' "where the adaptation (1) is substantial enough in its own right to constitute a new structure, or (2) creates a significant change in the use of the existing structure."

The Superior Court in *Wentzel-Applewood* did not believe that the renovations were substantial enough in their own right to constitute a new structure. The Superior Court relied on the subcontractor's principal own deposition testimony. During the deposition, the principal noted that, "after those three floors had been 'gutted' by another party, the subcontractor

‘performed drywall, metal studs, acoustical, door frames and hardware, millwork, specialty metal ceilings to create computer rooms, electrical rooms, sprinkler rooms, office space, [and] bathrooms.’” The Superior Court reasoned that the renovations performed by the subcontractor “were alterations of the existing building and, extensive though they were, did not constitute the erection of a ‘new improvement’ or a ‘substantial addition’ to the . . . building.”

Moreover, the Superior Court concluded that the improvements did not significantly change the use of the renovated floors. In doing so, the Superior Court continued its reliance upon the deposition testimony of the subcontractor’s own principal. During the deposition, he “established that prior to the alterations, the renovated floors were ‘retail, old space’ used as storage in the commercial operations of Strawbridge and Clothier, and that after the construction the floors were used in the commercial operations of Citizens Bank as ‘office space’ and ‘processing areas’.” The Superior Court found that, “while the specific activities carried out on the pertinent floors changed, the character of the use of the floors remained the same, namely, a use attendant to the commercial operations of first, Strawbridge and Clothier and subsequently, Citizens Bank.”

As a result, the Superior Court ultimately agreed with the trial court’s ruling that the renovations performed by the subcontractor did not meet the definition of “erection and construction” but rather “alteration and repair” and that the subcontractor was thus obligated under the plain language of Pennsylvania’s Mechanic’s Lien Law to have provided, prior to completion of its work, a written preliminary notice of its intention to file a mechanics’ lien.

The Superior Court also rejected the subcontractor’s attempt to overturn the trial court’s ruling on procedural grounds. In its appeal, the subcontractor argued that the trial court erred when it sustained the preliminary objections without

conducting a hearing.

In Pennsylvania, "[w]hen issues of fact are raised by preliminary objections, the trial court may receive evidence by depositions or otherwise." The Superior Court concluded that the trial court bent over backwards in this regard by allowing the presentation of evidence through depositions. The Superior Court specifically pointed out that the depositions "provided full clarification of the determinative issues of . . . the extent of the work done by [the subcontractor], and . . . the uses of the renovated floors before and after the alterations, thereby, affording an ample evidentiary basis for the rulings of the trial court. Thus, there was no need for the trial court to undertake further evidentiary proceedings."

LESSONS LEARNED

The recent opinion handed down by the Superior Court clearly illustrates the importance of following the technical requirements imposed on contractors and subcontractors alike when placing a mechanics' lien on a property. By failing to fulfill these requirements, the subcontractor in *Wentzel-Applewood*, faced with a bankrupt contractor, may now lose its ability to collect from otherwise deep pockets.

Alan Nochumson

Vertical Position 100%

Common Pleas Court Rules On Partition Actions In Pa.

In *Bernstein v. Sherman*, the Philadelphia County Court of Common Pleas recently provided a glimpse into the esoteric world of litigating a partition action in Pennsylvania.

The procedures for a partition of real estate are dictated by the Pennsylvania Rules of Civil Procedure. The action must be commenced in the county in which the property is located. The action may be brought by any of the co-tenants. All the other co-tenants must be joined as defendants. The complaint must include a description of the property and a statement of the nature and extent of the interest of each party in the property.

If the court ultimately decides there are sufficient grounds to partition the property, the court must enter an order setting forth the nature and extent of the property interests of the respective parties.

APPOINTMENT OF MASTER

After issuance of the partition order, a preliminary conference is held for the parties to, among other things, consider whether they can agree upon a plan of partition or sale, simplification of any outstanding issues, and whether any issues or matters relating to the implementation of the order should be referred to a master.

A master may be appointed to hear the entire matter or to conduct any sale, or to act upon only specified issues or matters relating to the execution of the partition order. The master is empowered to hold hearings and employ appraisers and other experts. Afterwards, the master is required to file a written report and issue a proposed order.

The written report must include the following findings of fact: “whether the property is capable of division, without prejudice to or spoiling the whole, into purparts proportionate in value to the interests of the co-tenants; the number of purparts into which the property can be most advantageously divided, if partition proportionate in value to the interests of the parties cannot be made; the value of the entire property and of the purparts; the mortgages, liens, and other encumbrances or charges which affect the whole or any part of the property and the amount due thereon; the credit which should be allowed or the charge which should be made, in favor of or against any party because of use and occupancy of the property, taxes, rents or other amounts paid, services rendered, liabilities incurred or benefits derived in connection therewith and therefrom; whether the interests of persons who have not appeared in the action, or of defendants who have elected to retain their shares together shall remain undivided; whether the parties have accepted or rejected the allocation of the purparts or bid therefor at private sale confined to the parties; and whether a sale of the property or any purpart not confined to the parties is required and if so, whether a private or public sale will in its opinion yield the better price.”

The proposed order issued by the master must include the following: “an appropriate award of the property or purparts to the parties subject to owelty where required; if owelty is required, the amount of the awards and charges which shall be necessary to preserve the respective interests of the parties, the purparts and parties for or against which the same shall be charged, the time of payment and the manner of securing the payments; the protection required for life tenants, unborn and unascertained remaindermen, persons whose whereabouts are unknown or other persons in interest with respect to the receipt of any interest; and a public or private sale of the property or part thereof where required.”

After receiving the master's written report and proposed order, any party may file exceptions "to rulings on evidence, to findings of fact, to conclusions of law, or to the proposed order." "The court may, with or without taking testimony, remand the report or enter an adjudication . . . which may incorporate by reference the findings and conclusions of the master in whole or in part."

SALE OF PROPERTY

If the property is incapable of division without prejudice to or spoiling the whole, the property must be offered for private sale confined to the parties. If any defendant owns a majority in value of the property, he may object to any sale and instead request an award of the property at a price fixed by the court.

If division of the property can be made without prejudice to or spoiling the whole, the property may be divided in one of the following manners: proportionately in value to the interests of the parties; in as many purparts as there are parties entitled to the property; or in the most advantageous and convenient manner.

Unless the property may be divided proportionately in value to the interests of the parties, notice of the proposed partition must be served on all parties. The notice in the case of inability to partition must state that the property will be sold unless objection is made by the defendant owning a majority in value of the property.

The notice must also include "a description of the property and the proposed partition, the valuation of the property as a whole and of the purparts, if any, into which it is proposed to be divided, the mortgages, liens, encumbrances or charges which affect the whole or any part of the property and the amounts due on account of the property. A plan or map of the proposed division of the property may be attached to the

notice.” In the alternative, the notice may specify a place where the proposed plan and information may be examined.

If any party rejects the proposed partition, the property must be offered for private sale by open bidding confined to the parties.

In any private sale confined to the parties, the property must be offered for sale both in purparts and as a whole to determine which will bring the greater price. No sale of the whole or purpart will be confirmed unless the amount bid equals or exceeds the valuation as fixed by the court.

If the private sale of the property is not confirmed, the property will be sold at public sale or at private sale not confined to the parties. The sale is subject to the power of the court to order a resale because of inadequacy of price.

RECENT DECISION IN BERNSTEIN

In *Bernstein*, the defendant appealed the trial court’s ruling to grant exceptions filed by the plaintiff to the master’s written report and proposed order. In the report, the master recommended that four properties be each conveyed to the plaintiff and defendant. The properties were assigned a value by the master. Since the cumulative values of the properties were uneven, the master ordered that the plaintiff, the party receiving the higher value, pay a sum of money to effect an even division. The master noted that his decree was subject to credits due to maintain the properties and refinancing of existing mortgages.

In his filed exceptions, the plaintiff in *Bernstein* contended that, due to the mixed nature and values of the properties, he did not believe it was not possible to divide the properties evenly.

In granting the exceptions, the trial court found that, “because the properties owned between the parties could not be

divided without assignment of credit to equalize the value, this method of partition would not lead to an equal division of the property." Further, the trial court "found that this method would require unnecessary court intervention (to ascertain the actual credits to which the parties would be entitled) and would only foster continued litigation."

The trial court ultimately believed that, "[a]lthough the resolution the master proposed is not unreasonable, because one of the parties filed exceptions . . ., [it] was required to order the properties be sold between the parties."

LESSONS LEARNED

As illustrated in *Bernstein*, a partition order just marks the beginning of the property dispute. The property must still be sold either by agreement or per court order.

Alan Nochumson

Appealing Party Must File Bond To Protect Property Interest

In two recent decisions, Pennsylvania courts have cautioned litigants who have failed to protect their property interests during the appeal process.

In *Detusche Bank National Company v. Butler*, the Superior Court of Pennsylvania dismissed an appeal of a trial court order setting aside a sheriff's sale based upon mootness because the property was sold at a subsequently scheduled sale.

In *Butler*, the bank foreclosed on the property after its borrowers failed to make the monthly payments due under the promissory note. The bank then scheduled the property for sheriff's sale. At the time of the sheriff's sale, the bank instructed its attorney to bid up to $240,600, an amount equal to the upset price (total amount of judgment and costs), for the property.

At the sheriff's sale, a third party bid $25,000 for the property. Since the bank's attorney mistakenly failed to increase the bid, the property was sold to the bidder. Later that day, the bank's attorney filed a motion to set aside the sheriff's sale. Afterwards, the trial court entered an order granting the motion and scheduled the property for another sheriff's sale.

After appealing the trial court's ruling, the bidder petitioned the trial court to stay the rescheduled sheriff sale. In his petition, the bidder offered to post a bond in the amount of $25,000, the amount of his original bid, to operate as a supersedeas. The trial court granted the supersedeas on the condition the bidder posted a bond in the amount of $255,000. Since the bidder never posted the bond, the sheriff's sale was not stayed. The bank purchased the property at the second sale. Subsequently thereafter, the sheriff delivered the deed to the bank.

The bank then filed a motion to dismiss the appeal on the ground of mootness. In granting the motion, the Superior Court found that, since the property was sold at the second sale, an order declaring the first sale valid would have no effect.

The Superior Court believed the bidder did not exhaust his remedies in preventing the issue from becoming moot. The Superior Court pointed out that, "while the b[idder] now complains that the trial court erred in setting the amount of the supersedeas at $255,000, he never filed a motion with the trial court or the Superior Court . . . objecting to the amount of the security. Instead, the b[idder] chose not to file the bond or a motion, and the property was sold."

In a footnote, the Superior Court distinguished Butler from its ruling in *Jefferson Bank v. Newton Associates* where it previously denied a claim of mootness where a sheriff's deed was delivered after the appeal was filed.

In *Jefferson Bank*, a condominium association attempted to collect on a judgment for common maintenance expenses by suing the mortgage holder of the delinquent condominium units. In order to extinguish the condominium liens on the units, the mortgage holder filed foreclosure actions against the defaulting unit owners, obtained judgments against the unit owners, and assigned the judgments to third parties, who agreed to resell the units and pay off the mortgage loans with the proceeds. When the third parties purchased the units at the sheriff's sale, the condominium liens were extinguished by operation of law. The condominium association then filed petitions to set aside the sheriff's sale on the basis of fraud. The trial court struck some petitions, and after a hearing, denied others. The condominium association appealed the denied petitions.

The mortgage holder in *Jefferson Bank* then argued the appeal was moot because titles to all of the condominium units at issue were transferred to third parties subsequent to the filing of the appeal. The Superior Court found "[t]his is a specious argument, for it ignores the essential fact that, in the present appeal, it was appellees who transferred the properties after appellant took its appeal. This is a distinction with a difference, because our courts have never

held that an adverse party may create mootness through deliberate factual manipulation."

Distinguishing its ruling in *Jefferson Bank*, the Superior Court in Butler noted that, in *Jefferson Bank*, it "did not consider the issue of how an appellant's failure to obtain a supersedeas impacts a determination of whether an issue has become moot due to the subsequent enforcement of the trial court's order." From the language contained in the footnote, it is now clear the Superior Court expects appellants to post a bond in order to protect their property interests.

Notably, the Superior Court in *Butler* did not expressly overrule *Jefferson Bank*. Unlike *Jefferson Bank*, the property transfer in Butler was not part of a scheme to defraud the appellant out of his interest in the property. The Superior Court in *Butler* may have thus left the door open in situations involving fraudulent conduct.

In *Federal Home Loan Mortgage Corporation v. Oppong*, the Philadelphia County Court of Common Pleas rejected a plea by a former property owner to set aside a sheriff's sale because he failed to seek and obtain a supersedeas.

In *Oppong*, the property was purchased by the Federal Home Loan Mortgage Corporation (FHLMC) at a sheriff's sale pursuant to a foreclosure proceeding. After the sheriff's sale, the former owner of the property filed a petition to set aside the sale. The petition was denied by the trial court. The former owner then filed a notice of appeal with the Superior Court.

During the pendency of the appeal, FHLMC received the sheriff's deed for the property. FHLMC then filed an ejectment action against the former property owner and then moved for summary judgment. FHLMC offered the sheriff's deed in support of the motion. In his response, the former property owner did not contest that FHLMC had completed settlement of its bid or that the sheriff had delivered the deed to FHLMC pursuant to

that settlement. Instead, the former property owner argued that the deed was a nullity solely because it was delivered during the pendency of the appeal of the trial court's denial of the petition to set aside.

After the trial court granted the motion for summary judgment, the former property owner appealed that ruling as well to the Superior Court.

Issuing a written opinion recommending affirmance of its order, the trial court emphasized that the former property owner did not file appropriate security with the court or make any attempt to obtain a supersedeas after his petition to set aside was denied. Because the former property owner failed to obtain a supersedeas, the trial court believed granting the motion for summary judgment was appropriate. The trial court also relied on the fact that ownership of the property had already been transferred.

A potentially interesting battle may ensue in *Oppong* based upon the Superior Court's recent ruling in *Butler*. If the former property owner fails to obtain a supersedeas preventing his eviction from the property, the bank in *Oppong* could presumably attempt to dismiss both appeals based upon mootness.

LESSONS LEARNED

Oppong and *Butler* illustrate the importance of obtaining a bond while the appeal is pending in a property dispute. By failing to do so, the appealing party could very well lose his interest in the property.

Alan Nochumson

Vertical Position 100%