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WHAT'S INSIDE

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A BRIEF OVERVIEW OF COST SEGREGATION STUDIES

By Jay L. Buck, Barbara Ericks, Jon W. Mitchell and Tom Holcombe

INTRODUCTION

A cost segregation study (CSS) is an accounting and engineering analysis performed to allocate the cost of real property among the various allowable depreciation recovery periods. Generally, without a good CSS, an unnecessarily large portion of the cost of real property is allocated to the 27.5-year (residential) or 39-year (commercial) recovery periods rather than the shorter recovery periods available to tangible personal property. During the initial years of ownership, this results in much smaller depreciation deductions than might otherwise be available. A CSS can be performed on new construction, most existing property purchased within the past ten years, or improvements to existing property.

AUTHORITY

While there are a large number of cases that are used to justify the application of certain depreciation treatment to particular types of assets, the most heavily relied upon case for performing a CSS is Hospital Corporation of America (HCA) v. Commissioner, 109 TC 21 (1997). In HCA, the IRS challenged the taxpayer's classification of certain assets as tangible personal property rather than as part of the hospital buildings. For example, HCA classified portions of the primary, secondary, and branch electrical systems, carpeting, wiring and other property items related to equipment, vinyl floor coverings, special plumbing connections for X-ray equipment, patient handrails, accordion doors, and many other items associated with the hospital facilities as non-structural assets. The IRS challenged these classifications arguing that, among other things, component depreciation is not allowed under the current depreciation rules (MACRS).

The Tax Court in HCA held that if an asset is tangible personal property for purposes of the pre-1981 law regarding the investment tax credit (ITC), then it is also tangible personal property for purposes of MACRS. The IRS acquiesced to the use of the tests developed under the ITC, but non-acquiesced as to how the tests were applied to specific assets. Acceptance by the IRS of the CSS as a valid technique for allocating the cost of real property is evidenced by the existence of its Audit Guide for use by IRS field agents, geared specifically for an examination of a CSS.

ADVANTAGES

Cash flow: By reallocating the cost of real estate from structural components to tangible personal property, depreciation deductions are dramatically increased in the early years of ownership, resulting in a decreased tax liability. The reduced tax liability translates to increased cash flows during the early years of the project when cash resources are most likely to be strained. Moreover, because of the tax savings and the effects of the time value of money, acceleration of deductions will result in a higher net present value of the overall project.

One time adjustment: For properties placed in service in a year prior to the year in which the CSS is conducted, there are provisions under Rev. Proc. 2002-9, 2002-1 C.B. 327 and Rev. Proc. 2002-19, 2002-1 C.B. 696 that allow for a one-time "catch-up" adjustment (§481(a) adjustment). This adjustment allows the taxpayer to take an additional depreciation deduction equal to the difference between the amount of depreciation actually taken on previous tax returns and the amount of depreciation allowable as a result of

the CSS. The §481(a) adjustment is usually a significant deduction and can result in considerable tax savings, particularly if timed to coincide with a year in which income is higher than usual. The amount of the §481(a) adjustment is generally included as part of the CSS report. Example nine under Treas. Reg. §1.446-1T(e)(5)(iii) contains a basic example of how the §481(a) adjustment would work where the taxpayer had a CSS performed three years after the property was acquired.

Asset Detail: Having a list of the various assets that comprise certain real property allows the taxpayer to write off those assets that are replaced prior to the end of their depreciable lives. For example, if a tenant in an office building or retail space vacates its leased space one year after a new owner purchases the property, and the space was not suitable for a new tenant, the remaining depreciable basis of the non-structural portion of that space could be written off. Without a CSS to segregate the non-structural portion from the structural portion of that space, that portion of the building would likely continue to be written off over the original 39 years. An attempt to write off the non-structural portion of the building without a CSS could be challenged by the IRS.

Tax planning for prior year: A CSS is not required to be completed by the end of the calendar year to which it relates. Therefore, a CSS completed prior to the filing of the previous year's tax return (including extensions) may still be beneficial with respect to that previous year's tax liability. This allows the taxpayer to do some tax planning after the close of the taxable year.

Convert ordinary income to capital gain: In many cases, the increased depreciation deductions afforded by the CSS will serve to offset ordinary income (federally taxed as high as 35%) of the taxpayer. However, upon disposition of the property, the income will be subject to §1245 recapture (also taxed as ordinary income), unrecaptured §1250 gain (federally taxed at 25% for most taxpayers), and/or capital gain (federally taxed at 15% for most taxpayers).

As a practical matter, assuming the property is not sold shortly after having the CSS performed, most of the §1245 property will be valued at or near its depreciable basis upon disposition due to wear and tear or obsolescence. Under those circumstances, the amount of the §1245 recapture should be minimal. Where there is no §1245 recapture, the gain on sale of the property will be either unrecaptured §1250 gain or capital gain. Therefore, the accelerated depreciation deductions have the effect of reducing current-year ordinary income in favor of future income taxed at lower capital gains rates.

DISADVANTAGES

Cost: The cost of a CSS will depend on the unique characteristics of each property, but one can expect to pay from $8,000 up to as much as one percent of the cost of the property. While this expense is a deductible business expense, it generally does not make economic sense to perform a CSS on a property with a depreciable basis of less than $1 million. A reasonable estimate of the cost and the potential tax savings should be obtained prior to beginning the CSS.

Expense election (§179): In 2005, a taxpayer may elect to expense up to $105,000 ($108,000 in 2006) of tangible personal property acquired for use in a trade or business during the year. However, this amount is reduced or eliminated if total tangible personal property acquired for use in a trade or business during the year exceeds $420,000 ($430,000 in 2006). A CSS could avail the taxpayer of additional deductions resulting from a §179 election or, more likely, could put the taxpayer over the $420,000 limit and reduce or eliminate other §179 deductions which may have been generated by another activity. Keep in mind that if the tangible personal property is related to a real estate rental activity, it is not considered to be from a trade or business and it would not have any effect on a §179 election.

Passive activity rules (§469): Losses generated by passive activities are not deductible except to the extent of passive activity income. Therefore, if passive activity losses are created by the acceleration of depreciation deductions, the losses may be carried forward until there is offsetting income or until the disposition of the activity. If the taxpayer is unable to use the deduction in the current year, the cash flow benefit of the CSS is reduced or eliminated. To the extent that the taxpayer's ownership of real estate is not a passive activity, §469 has no effect.

EXAMPLES

Taxpayer purchases an office building for $10 million on 01/01/2005. Assuming the land is worth $2 million and the building is worth $8 million, the first year depreciation deduction is $196,581. If a CSS reallocates 5% of the depreciable basis to land improvements (15-year asset) and 10% of the depreciable basis to personal property with a class life of five years, the first year depreciation deduction jumps to $347,094. In the second year, the depreciation deduction before the CSS is $205,128 and the post-CSS depreciation is $468,359. Based on a blended (state and federal) tax rate of 38.25% and an assumed discount rate of 6%, if the building is held for the entire 39 year depreciable life, the net present value of the tax savings from the CSS is $196,716. Since the benefits of a CSS are recognized in the early years of the project, the net present value will be higher if the project is sold before the building is fully depreciated.

Assume the same facts as in the above example except that the property was purchased 01/01/2003. In that case, following a CSS, the taxpayer would be able to take a one-time §481(a) adjustment to "catch up" on the depreciation deductions not taken in 2003 and 2004. Using the above figures and ignoring bonus depreciation, the taxpayer would be entitled to a one-time §481(a) adjustment (deduction) of $413,744 and would also be entitled to the current year depreciation deduction, as determined by the CSS, for future years. The tax savings on the "catch up" deduction would be just over $158,000 at the above blended tax rate.

LOGISTICS

To complete a CSS, information is gathered from actual invoices or other source data, engineering studies, or a combination of both. The review of blueprints, inspection of the building and other detailed analysis is important to maximize the benefit of the CSS. Whether the study is being performed on an older property or a property that is under construction, there are accepted methods for determining the depreciable cost of various assets. Companies that do a significant number of these studies are likely to have engineers on staff to perform this type of work. Use of an engineer or similar expert is important given Chief Counsel Advice 199921045

issued by the IRS which said the CSS can not be based on "non-contemporaneous records, reconstructed data, or taxpayer's estimates or assumptions that have no supporting records."

REPORT

At the conclusion of the work, a CSS report is issued. A complete report should contain a summary of the allocation of costs and supporting documentation, a detailed listing of assets with shorter lives (i.e., those that are not considered to be part of the structure), pictures of the property, and terms and definitions used in the study, including legal authority on which the study relies to justify treatment of specific types of assets and to justify the study itself.

SUMMARY

Every taxpayer's situation is unique and therefore each taxpayer requires individual analysis to determine if a CSS would be beneficial. Taxpayers are encouraged to consult their tax advisors to help them to make that determination. In many cases, conducting a cost segregation study will provide a welcome infusion of cash through current and future tax savings.

Clifton Gunderson LLP is the nation's 12th largest accounting firm with offices in 14 states, including offices in both Tucson and Phoenix. They are a full service accounting firm and have a full-time staff dedicated solely to conducting cost segregation studies anywhere in the United States. For more information, please visit Clifton Gunderson's website at www.cliftoncpa.com or contact one of the authors in the Tucson office at 520-790-3500.

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Construction Defects and the Implied Warranty of Fitness and Habitability

By Christopher A. Combs and Lincoln Combs

The explosion of residential real estate development in Arizona in the last five years has given a huge boost to the Arizona real estate industry and the Arizona economy in general. It has also enabled thousands of homebuyers to purchase and build their "dream home" in one of the dozens of new subdivisions created by expanding development in the residential market. This explosion in growth has had its costs, however. Whether problems in construction are the inevitable result of the rapid building of so many new homes or are due to builders cutting corners to quickly build and sell as many houses as possible,[1] complaints of problems such as leaky roofs, poor framing, inadequate stucco application, foundation and settling problems caused by insufficient soil compaction, and substandard materials have become all too common in the Arizona residential market. Some of these problems caused by poor construction may not be discovered for years, but can be devastating for a homebuyer who discovers that their "dream home" has turned into a nightmare of property damage and repairs.

REMEDIES FOR A HOMEOWNER

So what are the remedies for a homeowner who discovers that their home has been poorly constructed? The builder may have given an express warranty in the purchase or construction contract, but with little market pressure in a "seller's market" to give buyers any protection, express warranties are usually very limited in time and scope in order to favor the builder. Actions for negligence or products liability for construction defects have been specifically denied in Arizona as causes of action unless the alleged construction defect caused other property or personal injury damage beyond damage to the house itself.[2] If the homeowner believes that the builder intentionally misrepresented the quality of the construction, the homeowner could bring a fraud claim; however, proving that the builder intended to defraud the homebuyer can be very difficult.[3] The filing of a complaint against the builder's license with the Arizona Registrar of Contractors has become increasingly popular during the latest housing boom,[4] but the threat of administrative action against many builders can be insignificant because they may hold multiple licenses and may simply do business in their other license while the complaint against the "bad" license proceeds.[5]

The most effective method for homebuyers to pursue a claim against their builder for construction defects in their home is under the implied warranty of workmanship and habitability.[6] Traditionally at common law the doctrine of caveat emptor controlled, and, absent any express warranty provided by the builder, the buyer had no adequate remedy for construction defects. In 1979, Arizona joined the growing number of states recognizing that, because builders have an enormous advantage over the buyer in expertise and ability to observe and control the construction, by putting the new homes on the market for sale the builders were "impliedly warranting that the construction was done in a workmanlike manner and that the structure is habitable."[7] This is true even if the buyer had an opportunity to inspect the home before purchase.[8]

SCOPE OF IMPLIED WARRANTY

To comply with the implied warranty, the builder must have performed its work in a reasonable manner typical for standards in the industry.[9] Importantly, the homeowner is not required to prove both elements of the implied warranty, that the home was both constructed in a non-workmanlike manner and is uninhabitable. As long as the house is not "reasonably suited for its intended use," the homeowner will have a claim and does not have to demonstrate uninhabitability.[10]

Because this warranty is implied from the contract to perform the construction, actions under the implied warranty are based in contract, and the typical rules and requirements of contract law are applicable. This also means that damages recoverable in a lawsuit can include not only the cost of repair but also attorneys' fees and court costs, and other contract remedies such as rescission are available. Waivers by the homebuyer of the implied warranty are not allowed as against public policy.[11]

The implied warranty was further extended in 1984 to subsequent purchasers of the home,[12] an important development to protect all Arizona residential homebuyers. Any homeowner who discovered a latent defect, not discoverable at the time of the purchase by reasonable inspection, could sue and recover against the homebuilder if they could prove that the defect was the fault of the builder and not the subsequent owners of the property or ordinary wear and tear.[13]

Because of complaints from the homebuilding industry,[14] Arizona added a new law in 1991 to put a time limit on claims against homebuilders for construction defects.[15] The new law established an eight-year limit on actions against builders for construction defects, with an exception of a one-year extension for defects discovered in the eighth year.[16] Essentially claims against builders for construction defects under the implied warranty have an eight-year statute of limitations.[17]

RECENT DEVELOPMENTS

Recent developments in the scope of the doctrine demonstrate the developing nature of this area of the law. In 2004 it was held that knowledge of defects of previous homeowners was imputed to subsequent purchasers.[18] Thus, a discovery of a latent defect by the previous owner would start the statute of limitations running against subsequent owners as well, whether or not the previous owner disclosed the defect to them.[19] And in 2005 it was held that, in contrast to residential purchasers, subsequent purchasers of commercial property were not allowed to bring a claim under the implied warranty; these claims are limited in this context to only the original commercial purchaser.[20]

It is likely that the doctrine of implied warranty will continue to evolve because of its importance to the burgeoning number of new home purchasers in Arizona. Possible changes to simplify the doctrine would be to make violations of the relevant building codes

a per se violation of the implied warranty, or to clarify the confusing exception in the statute by adjusting the time period for latent defect claims from eight to nine years.[21] Unfortunately for homebuyers, it appears that the trend is towards limiting the scope of the doctrine to` make it more difficult, not easier, to bring implied warranty claims for latent defects.[22] The implied warranty of workmanship and habitability is a major tool of homeowners to insure that their homes are built professionally and without defects, but further restrictions favored by homebuilders could limit its usefulness and applicability.

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ENDNOTES

1. Chip Scutari, *Builders Cut Defects Deal Would Have 90 Days for Fixes*, ARIZONA REPUBLIC, April 23, 2002, at 1A (citing homeowner complaints of construction defects as being caused by pressure by builders to build as quickly and cheaply as they can). *See also Edyth Jensen, Initial Check/Code Inspection Failures: 40 Percent of Work in New Construction Fails First Time, And Most Failures Are for Improper Framing*, ARIZONA REPUBLIC, August 9, 2005, at Chandler Republic 1 (noting that "[f]orty percent of the work in new construction in Chandler fails city inspections the first time" and blaming these construction problems on "the pace of construction and consumer demand [and] high turnover in the construction industry").
2. *Nastri v. Wood Bros. Homes, Inc.*, 142 Ariz. 439, 444–45, 690 P.2d 158, 164–65 (Ct. App. 1984) (holding that construction defect causes of action for negligence or product liability were invalid absent "damage to personal property or personal injury").
3. Lynn Y. McKernan, *Strict Liability Against Homebuilders for Material Latent Defects: It's Time*, Arizona, 38 ARIZ. L. REV. 373, 380–82 (1996) (outlining the possible theories for fraud in construction defect cases but noting that "common law fraud is generally difficult to prove").
4. Yvette Armendariz, *Getting Tough on Contracting; No More Mr. Nice Guy. Contractor Inspectors Are Whipping the Building Industry Into Shape*, ARIZONA REPUBLIC, October 31, 2004, at 1D ("The registrar is managing much more contractor activity, fueled by booming housing construction and renovations, than in years past.").
5. *Id.*
6. For clarity purposes, hereinafter the implied warranty of workmanship and habitability will be referred to simply as "the implied warranty."
7. *Columbia Western Corp. v. Vela*, 122 Ariz. 28, 33, 592 P.2d 1294, 1299 (Ct. App. 1979).
8. *Id.* There was no limitation of the implied warranty to residential development, and the implied warranty is applicable to commercial development as well. *Id.*
9. *See, e.g., Kubby v. Crescent Steel*, 105 Ariz. 459, 461, 466 P.2d 753, 755 (1970).
10. *Nastri*, 142 Ariz at 442–45, 690 P.2d at 161–63.
11. *Id.* at 442–43, 690 P.2d at 161–62. The court did not decide whether a "knowing disclaimer" of the implied warranty, presumably between parties of more equal bargaining status and sophistication, would be val*Id. Id.* at 443, 690 P.2d at 162.
12. *Richards v. Powercraft Homes, Inc.*, 139 Ariz. 242, 245, P2d 427, 430 (1984)
13. *Id.*
14. An ultimately successful claim by a homeowner against a builder for a faulty stucco application twelve years after construction prompted the homebuilding industry to lobby the Arizona Legislature to change the law. *Hershey v. Rich Rosen Construction Co.*, 169 Ariz. 110, 116, 817 P.2d 55, 61 (Ct. App. 1991).
15. A.R.S. § 12-552.
16. *Id.*
17. There is a small window during the first two years after construction where the regular six-year statute of limitations for bringing contract claims in Arizona would still apply.
18. *Maycock v. Asilomar Development, Inc.*, 207 Ariz. 495, 499–501, 88 P. 3d 565, 569–71 (Ct. App. 2004).
19. *Id.* In *Maycock*, the plaintiffs discovered the defect in the eighth year and therefore fell under the exception in A.R.S. § 12-552 (B) to the eight year statute of repose in A.R.S. § 12-552 (A). *Id.*
20. *Hayden Business Center Condominiums Association v. Pegasus Development Corp.*, 209 Ariz. 511, 514, 105 P.3d 157, 159 (2005) (holding that Richards would not extend to commercial purchasers because the same public policy concerns were not present).
21. A.R.S. § 12-552(B).
22. This trend is exemplified not only by the cases mentioned supra and the enactment of A.R.S. § 12-552, but also by the enactment in 2002 of A.R.S. § 12-1363, which requires homeowners to give builders sixty days to repair any defects and imposes other requirements before filing a lawsuit. See Edythe Jensen, *Defects Build Bad Blood; Homeowners Raise the Roof Over Flaws, Limit on Lawsuits*, ARIZONA REPUBLIC, August 16, 2002, at 1B.

Risk Factors of Mexico Real Estate

By Bruce D. Greenberg

As with any real estate investment, particularly in a foreign country, acquiring real estate involves a number of risks that prospective buyers should carefully note. Here are some issues to consider:

POLITICAL STABILITY IN MEXICO.

The Mexican political system, while not as stable as that of the United States, is becoming more so. The election of Vicente Fox in 2000 marked the first time since the 1910 Mexican Revolution that the opposition defeated the party in government, suggesting that elections are becoming more free and more fair. Because the Mexican economy is largely interwoven with that of the U.S., it is highly unlikely that any new government would consider backing out of NAFTA or jeopardizing its relations with the United States. To the contrary, Mexico's trade with the U.S. and Canada has tripled since the implementation of NAFTA in 1994. Likewise, recent reforms to the Mexican constitution and judicial system have significantly strengthened the rights and freedoms of foreign owners of Mexican property. The National Law Center for Inter-American Free Trade, based in Tucson, is proactive and working with the Sonoran government for increased securitization (mortgage) programs to further assist Americans acquiring real estate in Mexico, specifically Sonora.

CURRENCY CONSIDERATIONS

Mexico experienced a currency crisis in late 1994, when the devaluation of the peso led to economic turmoil. Mexico has since recovered, posting an economic growth rate of 4.4% in 2004. Inflation has been under 5% for the past couple of years. The peso, meanwhile, has stabilized and traded in a band of 10.5 to 11.5 to the dollar over the past two years. Even if there were another peso devaluation, it would probably have little impact on the performance of homesites, or residences in Puerto Peñasco. Real estate in Rocky Point is dollar dominated and not peso based, therefore a devaluation of the peso most probably would not adversely affect real estate processes in Rocky Point. Construction costs and various Mexican services are peso dominated, but a devaluation would simply make these less expensive for the American consumers. Regarding Mexico's capital gain tax, as long as the cost basis of the property is adjusted to Mexican inflation, the implications of a peso devaluation should be modest here as well. If, by contrast, the dollar were to undergo a considerable devaluation relative to the peso and other world currencies, then real estate in Mexico could serve as a partial hedge for U.S. investors, in which a consumer could consider pricing their lots and homes in pesos.

CHANGES IN TAX LAW

It is possible, though not likely, that a new Mexican government would raise the country's tax rates, including its capital gains tax rate. Unless the U.S.-Mexico tax treaty were repealed or fundamentally altered, and unless new restrictions are placed on the ability of U.S. taxpayers to claim the foreign tax credit, any increase in Mexico's capital gains taxes would most likely translate into a larger foreign tax credit, which would essentially offset it. American buyers should consult with their tax advisers and/or members of our organization, International Consulting Services, about the implications of tax issues in both the United States and Mexico.

CORRUPTION & BRIBES

A history of corruption, crimes and bribery has historically plagued the Mexican economy. While the situation is improving, especially in the prime tourist areas where authorities have exerted significant pressure, these factors continue to be a problem; Rocky Point is generally not known for this issue. In 2004, under pressure from large corporations, particularly multinationals, the federal government initiated various measures to crack down on corruption and crime. By employing highly regarded and well-connected contractors and professionals, consumers should be able to avoid most of these problems.

TITLE ISSUES

Some foreign buyers of Mexican property have encountered title problems of various sorts, such as previously undisclosed liens on the property, boundary disputes, or ancestral claims by community groups (ejidos). In order to avoid any such problems, a consumer should hire a team like International Consulting Services (ICS) to conduct the most thorough title research possible, searching in the agrarian registry as well as the public registry. As an added safety precaution, a consumer can purchase a dollar denominated title insurance policy for the full purchase price of a property.

CONCLUSION

As in the past, I recommend consumers review my web pages at www.mexicovaluations.com or www.icssite.biz and/or the Buyer's Guide information at the Arizona Mexico Commission at www.azmc.org before acquiring real estate in Mexico.

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Can I Cancel My Contract? Lessons from an Up-Market

By Keith L. Hendricks and Nicolas Hoskins

As a trial attorney specializing in real estate litigation, I have been inundated in what I refer to as my "up-market cases." It seems that every seller that has recently contacted me has wanted to cancel its purchase contracts, and every buyer has wanted to maintain its position no matter how many times it has defaulted or missed deadlines. This is all the result of Arizona's spectacular recent real estate boom where the price fluctuation of even a typical house may now justify litigation.

In the environment of meteoric price increases, many have understandably sought to capture as much of the market's upside as possible. In purchase contracts with lengthy escrow periods or delayed closings, such as in the context of new home construction, many disputes over the increased value of the property have arisen.

Two basic patterns have emerged in these up-market cases. First, there are the cases where sellers want out of their sales contracts by asserting that a buyer has breached, and buyers want to close sales contracts no matter how egregious their breaches have been. Second, there is a similar, albeit more one-sided, phenomenon in the case of sellers who have contracts that on their face permit them to cancel at essentially their discretion upon merely refunding the buyer's earnest money. I will refer to the first phenomenon as the "Up-Market Breach Cases" and the second as the "Up-Market Cancellation Cases."

I. THE UP-MARKET BREACH CASE, OR WHEN IS A BREACH REALLY A BREACH?

At their core, most of the Up-Market Breach cases turn on one issue: Was the alleged breach material? Under the law, only "material" breaches justify the cancellation of a contract. Alleged breaches on the part of buyers have included claims such as a failure to provide qualified loan commitments, failure to lock in interest rates, modification of the house prior to closing, and a myriad of other claims. In each instance, the sellers claim that the buyer's failure to do something, or the buyer's affirmative action constitutes a breach of the contract, which gives the seller the right to cancel. The question for the lawyers is whether these alleged breaches were material.

The law has given a legal definition of what constitute a "material" breach. The basic rule announced by the courts is that a material breach occurs when a party fails to do something required by the contract which is so important to the contract that the breach defeats the very purpose of the contract. Obviously, there can be and often are disputes on (1) whether a contract requires some act, (2) whether that act is so important to the contract that its failure defeats the purpose of the contract, and (3) whether there actually was a breach.

Because the number and kind of alleged breaches are so varied and numerous, in most cases there are few hard-and-fast rules for courts, juries, or arbitrators on these issues. This means that the application of the rules can be can be unpredictable, and juries and arbitrators, for example, may rely on their "gut" to determine whether a breach is material.

Arizona courts have attempted to set forth a series of factors that juries should consider in determining if there has been a material breach of the contract. In legal terms, these factors are stated as: (1) the extent to which the injured party will be deprived of the benefit which he reasonably expected; (2) the extent to which the injured party can be adequately compensated for the part of that benefit of which he will be deprived; (3) the extent to which the party failing to perform or to offer to perform will suffer forfeiture; (4) the likelihood that the party failing to perform or to offer to perform will cure his failure, taking account of all the circumstances including any reasonable assurances; and (5) the extent to which the behavior of the party failing to perform or to offer to perform comports with standards of good faith and fair dealing.

These factors all constitute *legalese* for asking the question of just how bad was seller hurt by the buyer's failure to do something, and how bad will the buyer be hurt if the sale does not go through. More practical questions are such things as: (1) has the Seller always enforced this condition; (2) has the seller closed other sales with the same issues (3) will the buyer be losing a home to live in, or is it just an investment where money from the opportunity will be lost; or (4) what are other sellers requiring or expecting. Answers to these questions go a long way to persuading a jury or arbitrator that a breach was or was not material.

It is generally not possible to predict how a court or jury will decide the materiality issue. Conventional wisdom is that a monetary default, meaning the buyer was required to pay some money and did not, is material. Timing, on the other hand, is usually only material if the contract contains a clearly worded time-is-of-the-essence clause. Non-monetary defaults, especially in the context of lease/purchase agreements, often end up with courts, juries and arbitrators all over the map. Whether a non-monetary default is found to be material can be and often is simply a crap shoot.

A purchase contract that identifies certain types of breaches as "material" breaches may give a seller more ammunition. On the other hand, if such a list of "material defaults" exists, anything not on the list will likely be argued as non-material, and a clause that says that everything is material loses its effectiveness. In the end, it still comes back to a judge, jury, or arbitrator deciding whether or not a breach was material.

When contemplating a lawsuit, either as a buyer or seller, in addition to contacting a lawyer, it can sometimes be of use to get some perspective on the breach by simply asking your friends or family how significant they think the breach is – they are not necessarily different than the jury who may ultimately decide that very same question.

Another question is one of leverage. When a lawsuit over a purchase contract is filed, a *lis pendens* is also typically filed. As a practical matter, this means that the seller can no

longer sell the property because the new buyer will not be able to get title insurance. If there is interest and carrying costs running on the property during the pendency of a lawsuit, which if fully litigated will likely last 1-3 years (depending on appeals), this can create significant pressure on the seller to settle. On the other hand, a buyer may not have the resources to fight a litigation battle for that length of time. As such, the length of time can cut both ways.

Also, mandatory arbitration clauses in contracts may affect the parties' leverage during the litigation. If the seller can quickly resolve the matter and keep the property out of court, it may reduce the buyer's leverage. On the other hand, arbitrators are also known to "split-the-baby." In recent up-market cases, experience has shown that arbitrators often find creative ways to give some of the increased equity to both parties. Accordingly, if either party is seeking an all or nothing proposition, arbitration is less appealing.

II. THE UP-MARKET CANCELLATION AND THE DUTY OF GOOD FAITH AND FAIR DEALING

It is not uncommon for builder/sellers to include in their sales contract the discretion to cancel the contract, with the buyer's remedy limited to a refund of the earnest money payment. In a hot market, the builder/sellers' incentives are clear: (1) cancel the contract; (2) return the buyer's nominal earnest money; and (3) sell the newly constructed home to a new buyer at the current, much higher, market rate. The potential of a low-cost upside makes this an attractive option, but it is not without its risks, and it should not be pursued without first consulting a lawyer. The crux of the risk may be a doctrine called "the duty of good faith and fair dealing" which is implied into every contract, and cannot be excluded. The duty of good faith requires that neither party do anything that prevents the other party from receiving the benefits of their agreement and their reasonable expectations.

This duty should be kept firmly in mind when canceling a contract for the sole purpose of capturing equity in a home. Courts and arbitrators have proven sensitive to the difference in bargaining power between residential home buyers and builder/sellers, and have concluded in some cases that exercising the clear contract right of cancellation violates the duty of good faith. In addition to being liable for attorneys' fees, a party that breaches the duty of good faith and fair dealing may also be liable for consequential damages (such as the cost of the buyer's temporary lodgings). By taking these steps on a systematic basis, a builder may even open itself up to class-action liability. Ultimately, where the seller can point to no breaches by the buyer as the basis for canceling the sales contract, the builder/seller is taking a calculated risk when it relies upon its discretionary cancellation clause.

Dovetailing with the duty of good faith and fair dealing is the courts' general skepticism of form contracts that contain limitations of damages. It is entirely possible that the imbalance of power between the two parties could lead a court to allow the buyer its common law remedies, including specific performance, which would allow the buyer to force the seller to convey the property. Alternately, a court may not allow the buyer to force the sale, but may permit the buyer to recover damages in the amount of the lost equity, thereby erasing the entire upside for the canceling seller.

III. CONCLUSION: CANCELING CONTRACTS DEPENDS ON MATERIALITY AND GOOD FAITH.

The recent up-market has created some fantastic opportunities. What I have seen is that litigation often follows when fluctuations become so dramatic. Sellers who rely solely on technical provisions to cancel purchase contract do so at the risk of litigation. The amount of equity at issue in such a cancellation for even a modest home may now all of a sudden be worth pursuing in litigation or arbitration. Sellers who can show a consistent treatment of all buyers and the importance of the provisions that they claim to have been breached fair much better than sellers who cancel contracts solely to capture the increased equity. In all markets, parties to a contract are under a duty to act in good faith with each other, however, in an up-market, there may be enough at issue so that parties actually litigate that obligation.

Keith Hendricks is a director/shareholder (partner) with the law firm of Fennemore Craig. Keith is a 1989 graduate of the J. Reuben Clarke Law School at Brigham Young University, where he graduated cum laude, and Order of the Coif. Keith is certified by the Arizona State Bar as a Real Estate Specialist, specializing in real estate litigation. About 60% of Keith's practice is devoted to real estate litigation. The remaining portion of his practice is business litigation. Keith is a member of Fennemore Craig's Real Estate Practice Group, and its Corporate and Securities Practice Group. Keith is also a member of the Business Law section of the Arizona State Bar. Nicolas Hoskins is an associate at Fennemore Craig. Nick is 1998 graduate from Rutgers College and he received his law degree in 2002 from New York University School of Law. Nick works in commercial litigation and is a member of Fennemore Craig's Bankrupcy and Creditor Rights Practice Group. Fennemore Craig is one of the largest full service law firms in Arizona and the Southwest.

PLEASE NOTE: CANCELLATION POLICY FOR LUNCHEONS

The Section has decided to implement a cancellation policy for its monthly luncheons in Phoenix and Tucson due to the costs to the Section when individuals sign up for the luncheons but fail to attend. Reservations must be made or cancelled no later than two days prior to the luncheon. If you make a reservation and are unable to attend, the Section is still billed for your meal and therefore expects payment for the cost of the luncheon if the reservation is not timely cancelled. If you must cancel at the last moment, please try to make arrangements for someone to take your reservation to avoid being billed for the cost of the luncheon. Your cooperation with this policy will help the Section avoid an unnecessary drain on its finances.

UPCOMING EVENTS

PHOENIX

Tuesday, January 24, 2006
"Creating CFDs"
Marc D. Blonstein, Regional General Counsel, CENTEX HOMES
State Bar of Arizona
4201 N. 24th St., Suite 200

Tuesday, February 28, 2006
"Leasing on Native American Land"
Charles M. King, FENNEMORE CRAIG PC
--Location to be Announced--

Tuesday, March 28, 2006
"Condo Conversions"
Donald D. Dyekman, MARISCAL WEEKS McINTYRE & FRIEDLANDER PA
--Location to be Announced--

Tuesday, April 25, 2006
--Details to be Announced--

Tuesday, May 23, 2006
--Details to be Announced--

TUCSON

The Real Property Section - Southern Counties
All meetings are taking place at the
Arizona Inn, 2200 E. Elm St.,
Tucson, AZ 85719
from 12:00 - 1:00 p.m.

January 11, 2006
February 8, 2006
March 8, 2006
April 12, 2006
May 10, 2006