



By **David H. Martyn**
Vice president and
associate senior underwriter
Stewart Title Guaranty Co.

Spotting Bargains in Tax Foreclosures

Help investor clients take advantage of discount properties by advising them on issues that can complicate the process

Savvy investors are always on the lookout for bargains, and tax-lien properties that have been foreclosed for nonpayment of delinquent property taxes offer serious discounts. The unique issues related to the title of these foreclosed properties, however, mean that due diligence, planning and good communication with the title insurer and lender are of the utmost importance.

Depending on the state in which the property is located, tax-foreclosed properties can provide real opportunities or turn into lengthy, complicated deals. Commercial mortgage brokers who are knowledgeable about these properties' issues can offer significant value to their investor clients. Before working with investors on these properties, brokers should become familiar with the unique tax-lien challenges that come with the territory.

Like a mortgage foreclosure, a tax-lien foreclosure is basically a repossession of the property for nonpayment of a debt. The similarities between the two end there, however.

Because the tax debt is owed to the government, the foreclosure of the statutory lien created by the failure to pay the tax is a governmental act of taking property. As a result, the government is required to follow the due process requirements set forth in the U.S. Constitution, which center on providing proper notice to the property owner that the property is being taken for nonpayment of taxes. If the government fails to follow this procedure, the foreclosure of the tax lien can be set aside. Any subsequent sale after a failed tax foreclosure is subject to the original taxpayer's ownership interest, which means that purchasers of a tax-lien foreclosed property must take proper steps to

protect their interests.

The statutory process for the foreclosure of tax liens varies greatly from one state to another. Tax-lien regulations in some states are so inadequate that the title becomes unmarketable for years. For example, it is a fairly common process in some states for the municipal treasurer to hold an auction of delinquent tax liens to third-party tax-lien buyers. The tax-lien buyer then has the right to try to collect the tax from the delinquent property owner. After a certain amount of time — usually years — the tax-lien buyer can attempt to foreclose the tax lien privately and evict the property owner.

In cases of abuse, the property title can become difficult to insure. Furthermore, in many cases, the private tax-lien purchaser has no intention of ever foreclosing on the property. Rather, they simply hope they can make money from the taxpayer under the threat of foreclosure.

Quiet title

In many jurisdictions, the delinquent taxpayer has the ability to redeem the

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Illustration: Dennis Wunsch

David H. Martyn is a vice president and associate senior underwriter of Stewart Title Guaranty Co., and is manager of Stewart's National Title Services office in Detroit. He is a member of the state bars of Michigan and Georgia, and is on the Michigan Land Title Association board of directors. Martyn received his bachelor's degree from Cleveland State University and his juris doctor degree from Emory University. Reach him at dmartyn@stewart.com.

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foreclosed taxes for a period of time. By simply paying the delinquent tax amount (plus any applicable interest, fines and administrative fees), the title to the property is once again vested in the taxpayer. This further adds to the question of the status of ownership because, while the property has been foreclosed, the title to the property is in limbo — and uninsurable until the delinquent taxpayer's redemption rights have expired.

The only way to insure property under tax-lien foreclosure processes, as described above, is to file a lawsuit to “quiet” title. This process can take years to settle the question of ownership, and therefore quiet any challenges or claims to the title. Even after a successful quiet-title suit, financing this type of property is extremely difficult because of the reluctance on the part of the insurance industry to cover a title with so many competing interests.

The advantage to the municipal treasurer in this tax-lien auction procedure is that the treasurer collects some of the delinquent tax money right away through the sale of the tax lien. This benefit is illusory at best because it renders the title to the property unmarketable for years to come, and unmarketable property rarely adds value to the tax rolls.

Government control

You can compare that system to one in which the municipal treasurer actually forecloses on the property and takes title to the property itself, rather than auctioning the lien. In states that operate under these statutes, the treasurer follows a more rigorous tax-foreclosure process, wherein the treasurer provides — or attempts to provide — notice to the property owner.

After complying with notice requirements, the treasurer forecloses through a judicial hearing and the government takes title to the property. At that point, the taxpayer's interest in the property is extinguished, including any redemption rights. Any subsequent auction is not for the tax lien, but for the title to the property itself.

The property usually can be acquired at a deep discount off the market price. If the notice requirements are met, and documentation to that effect is provided, title is generally insurable and lenders often will provide financing.

Under this progressive and more rigorous process, more is required of the treasurer in process and documentation. The result is usually a marketable title to property, however. When it is made available to developers and investors, it can be returned to productive use and adds value to the community.

Pursuing an opportunity

It is worth considering tax-foreclosed property when working with investors or developers. The first step is to meet with a title insurance underwriter to discuss whether it is possible to acquire a title-insurance policy in the state where the tax-foreclosed property is located and, if so, what the title company's requirements are.

If an underwriter is unable or unwilling to insure tax-foreclosed property, shop around. There are several title-insurance companies, and they likely have different underwriting requirements when it comes to tax-foreclosed properties. At this point, you are not asking for a commitment to insure. Rather, you are asking whether a title-insurance policy for this type of property is even available.

Depending on the state, you may find that no underwriter is willing to insure title to the property. If this is the case, then it is obviously not a viable opportunity to pursue. In addition, it is unlikely a prospective property owner can secure financing from a lender under these circumstances.

If an underwriter confirms that insurance may be available, the next step is to meet with a representative from the municipality's treasury office to become familiar with the timeline and process for purchasing tax-foreclosed property. Generally, there will be an auction date for the property that has been acquired.

When a specific property has been

identified, involve your title-insurance company immediately. The insurer likely must acquire a copy of the treasurer's file to confirm that the treasurer has met the notice requirements under state law and the U.S. Constitution. This will take time and may require a Freedom of Information Act request for a copy of the file. That file cannot be reviewed until produced by the treasurer, so prepare for a longer lead time.

Another avenue to pursue is acquiring tax-foreclosed property from a governmental “land bank.” Available in a growing number of states, land banks are designed to acquire vacant, abandoned, blighted or tax-foreclosed property; repair title defects and other issues; and return the property to the stream of commerce. In addition, land-bank properties are eligible for brownfield designation (abandoned or unused industrial or commercial properties) and associated federal grants and funding. Additional information on land banks is available from the Center for Community Progress website at communityprogress.net.

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In 2009, Wayne County, Mich., held an auction of 9,000 tax-foreclosed properties in Detroit. Less than one-fifth were sold. The titles of the remaining 7,200 properties — both commercial and residential — remained with the government. They were not producing tax revenues, jobs nor adding value to the community. Those 7,200 properties represent opportunities to investors, developers and businesses.

Tax-foreclosed properties like those in Wayne County are an increasing burden on communities across the nation in the current economic downturn. In states with progressive statutory processes of foreclosing tax-delinquent properties, or those that have land banks, transactions involving these properties can usually be insured and therefore can provide security for mortgage financing. With proper risk management through title insurance and due diligence, these properties can offer great value and opportunity for investor clients. ●