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Proration of Property Taxes and the Merger Doctrine

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Background

Buyers and sellers of US property must, as a general proposition, contend with the so-called 'merger doctrine'. Under the merger doctrine, upon the delivery of a deed at the closing of a sale of property the provisions of the purchase and sale contract will merge into the deed, with the effect that the deed will be the only binding instrument following the closing. However, buyers and sellers of property are often faced with situations where the negotiated elements of their deal must, of necessity, be addressed after the closing - for example, where the seller has made certain commitments to complete construction or make repairs following the closing, or certain representations and warranties as to certain matters that may affect the continued use of the property or the value of the property. Similarly the parties may have negotiated how rents received after the closing are to be allocated between the buyer and the seller.

In *Czarobski v Lata*(1) an Illinois appellate court addressed the merger doctrine in the context of proration of property taxes in connection with the sale of property. The parties had agreed that *ad valorem* property taxes would be prorated at the closing. However, in Illinois, the amount of the property taxes for the year in which the closing is to occur may not be ascertainable at the time of closing. For example, with a transaction closing in 2007, depending on when the tax bill is issued, it is possible not only that the amount of the 2006 tax bill is unknown, but that the tax bill for 2007 may be unknown also. Property taxes are liens on the property in question beginning on January 1 of a given year, but the amount of taxes payable for that year is not ascertainable until the following year. In effect, taxes are payable a year in arrears. Therefore, buyers and sellers are faced with determining an appropriate method to prorate taxes when the actual amount of the tax bill to be prorated is not ascertainable. Parties frequently agree to prorate taxes based upon the last ascertainable tax bill issued for that property.

However, the last bill that is ascertainable might be the tax bill from the second year preceding the closing (in the example used above, the last ascertainable tax bill might have been the tax bill issued in 2005). This situation may be exacerbated because the situation pertaining to the property in question might have changed. For example, the last ascertainable tax bill might have been issued on the basis of property that was unimproved or only partially improved. The parties might address the situation by providing in their contract of sale and purchase that they will tentatively prorate taxes at the closing based upon the last ascertainable tax bill and agree to adjust finally the amount of the proration when the tax bill for the year(s) in question were issued. However, in doing so, they must consider application of the merger doctrine. Sellers and buyers might consider addressing the merger doctrine in their agreements by expressly providing in their sale and purchase agreement that the provisions of the contract will survive the closing and delivery of the deed and, accordingly, will not merge with the deed.

In *Czarobski*, the purchasers purchased a property in Illinois from the sellers in 2005. The contract between the parties provided that general property taxes would be prorated as of the date of closing. The contract specifically stated that:

"*Prorations of general taxes shall be on the basis of 105% of the last ascertainable bill. If said bill is based on a partial assessment or on an unimproved basis for improved property, a written agreement (with escrow) for final proration when the complete*

assessment information is available from the county assessor shall be signed at closing by the parties hereto."

At closing, the sellers gave the purchasers a property tax credit for 2004 and a *pro rata* share for 2005, which were based on the property tax figure for 2003, plus 5%. However, the parties did not enter into a written agreement (with escrow) at the closing to address the final tax proration. Evidently, the contract did not provide that the provisions of the contract would survive the closing and delivery of the deed and would not be merged with the deed. After closing, the final tax bill for 2004 was issued for an amount in excess of the tax credit given by the sellers. Subsequently the purchasers discovered that the 2003 tax bill was based on a partial assessment.

The purchasers sued to collect the excess taxes, alleging that the discrepancy was a mutual mistake of fact or was known by defendants and not disclosed. The sellers, on the other hand, defended the claim on the basis of the merger doctrine, alleging that they did not know that any property taxes were based on a partial assessment and that the parties did not enter into an agreement at closing to account for partial assessments. If the sellers prevailed in their merger doctrine argument, they would not be required to pay the excess amount to the purchasers.

Decision

The court concluded that the merger doctrine did not bar the purchasers' action. It recognized the general rule in Illinois that a deed in full execution of a contract for sale of land merges the provisions of the contract into the deed and the deed becomes the only binding instrument. The court stated that modern courts do not favour the merger doctrine, but also recognized that exceptions to the general rule exist where (i) the contract contains provisions collateral to and independent of the provisions of the subsequent deed, or (ii) the evidence clearly and convincingly proves that a misrepresentation or mutual mistake existed when the deed was delivered. To determine whether and to what extent a contract has merged into a deed, courts look to the intention of the parties and the surrounding circumstances. The court held that in this case both parties were mistaken and did not know that the tax bill used to calculate the credit was based on a partial assessment. Therefore, the merger doctrine did not preclude the purchasers' action to recover the excess taxes.

Comment

The parties might have avoided the litigation by entering into the written agreement (with escrow) described in the contract. However, according to the facts reported in the case, the parties were unaware that the last ascertainable tax bill was issued on a partially improved basis. Generally, all remaining contractual terms between the parties merge into the final deed. However, *Czarobski* indicates that under certain circumstances a court will overlook the merger doctrine.

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Endnotes

(1) 371 Ill App 3d 346, 862 NE2d 1039 (4th D 2007).

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