ALERT
JULY 15, 2009

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"SAFE HARBOR" NOT VERY SAFE: THE BANKRUPTCY OF LANDAMERICA 1031 EXCHANGE SERVICES

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A recent decision by the United States Bankruptcy Court for the Eastern District of Virginia, if upheld on appeal, portends great risk for some property sellers who are in the midst of tax-deferred forward exchanges under Section 1031 of the Internal Revenue Code. In *Millard Refrigerated Services v. LandAmerica 1031 Exchange Services*, the court reasoned that some sale proceeds held by a qualified intermediary pending use in acquiring exchange property were not trust or escrow funds held for the benefit of the seller, but rather the property of the intermediary. This startling result, arising in part from atypical language contained in the specific exchange agreement analyzed by the court, reduces the status of the seller to just another unsecured creditor of the intermediary with regard to the proceeds of sale of the relinquished property.

THE LANDAMERICA BANKRUPTCY

On November 26, 2008, LandAmerica Financial Group (LandAmerica) and its subsidiary, LandAmerica 1031 Exchange Services (LES), filed for voluntary relief under Chapter 11 of the Bankruptcy Code. At the time, LandAmerica was the third largest title company in the country, and LES was providing intermediary services in 450 uncompleted exchange transactions.

Prior to the bankruptcy of LES, practitioners believed that the risk of bankruptcy of a qualified intermediary was exceedingly remote, given that its business was essentially limited to being a stakeholder for others. However, as is customary, the exchange agreements between LES and its customers allowed LES to invest the funds it was holding. Unfortunately, LES chose to invest some sale proceeds in auction rate securities, which became illiquid during the economic crisis. When the time came to use the invested funds to complete the designated exchanges, LES had insufficient funds on hand, leading to its bankruptcy.

After the bankruptcy filing, customers of LES brought over 85 adversary proceedings to recover their exchange funds. The court separated these cases into five categories, depending on certain factual distinctions, and then proceeded to hear one representative case in each category.

THE MILLARD CASE - OUTCOME AND IMPLICATIONS

On April 15, 2009, the Bankruptcy Court issued its decision in *Millard*, the representative of those cases in which exchange agreements required LES to hold sale proceeds in segregated accounts pending the consummation of the exchanges. In support of its claim, Millard had contended that it was the beneficiary, and LES was merely the trustee, of an express or implied trust with respect to the funds held in the segregated account established by LES, and funded with Millard's sale proceeds, specifically and solely for Millard's exchange transaction.

Unfortunately for Millard, the court, applying Virginia state law pursuant to the exchange agreement, rejected the company's contention. In so doing, the court noted that the agreement did not contain express language, such as "trust," "trustee," or "beneficiary," that would denote the creation of a trust. Further, the court ruled that the facts of the case indicated that the parties did not intend to create a trust. Although Treasury Regulations required an exchangor to abrogate control over sales proceeds while in the hands of an intermediary (lest the Internal Revenue Service claim that the seller had constructive receipt of the funds), the LES agreement went above and beyond – it stated that Millard disclaimed all "right, title and interest" to the exchange funds and provided LES with exclusive

rights of "dominion, control and use." Further, although Treasury Regulations allowed the use of a qualified trust when conducting a 1031 exchange, Millard had instead chosen to use a qualified intermediary, a different "safe harbor." Also, there were no restrictions on how LES might invest the funds pending their use in the exchange.

Consequently, the *Millard* court held that the sale proceeds in question were not trust funds, but rather part of the bankruptcy estate of LES. While Millard may file a claim in the bankruptcy for the amount of the proceeds, it will be treated as a general unsecured creditor in the case, and will receive only a *pro rata* distribution on its claim. While the distribution rates for unsecured creditors are dependent on the specific circumstances of any given bankruptcy case, it is unlikely that Millard will receive the full amount of its sale proceeds. Also, because the pertinent Treasury Regulations require the purchase of replacement property within 180 days of the sale of relinquished property, the delay caused by the bankruptcy could very well disqualify the transaction for exchange treatment. This could create a considerable, and unanticipated, tax burden.

REDUCING RISK IN 1031 EXCHANGES

There are several ways that sellers can reduce their risk while engaged in a 1031 exchange. Due diligence is more important now than ever – it is essential that exchangors deal only with reputable and financially sound intermediaries. Sellers conducting several exchanges simultaneously should consider diversifying their risk by utilizing more than one intermediary.

Each exchange agreement should be reviewed and negotiated carefully. The agreement should require that the sale proceeds be kept in a segregated account, and specify how the intermediary must hold and invest those funds during the transaction. The seller should specifically retain some equitable interest in the exchange funds, in a manner consistent with all applicable Treasury Regulations so that the exchange is not disqualified.

Sellers might also consider alternative techniques when conducting a 1031 exchange. Although using a qualified intermediary is by far the most common method, Treasury Regulations detail three other "safe harbors" that may be used to avoid a claim of actual or constructive receipt of sales proceeds: a qualified escrow or qualified trust, a security or guarantee arrangement, or an interest or growth factor. While using these methods, either singly or together with the use of a qualified intermediary, might increase the cost and complexity of the transaction, doing so may better protect the sale proceeds.

Anyone currently involved in a pending 1031 exchange should consult with an attorney to determine whether the transaction poses a Millard risk and, if so, the steps (if any) that might be taken now to reduce the risk. Please contact one of Cozen O'Connor's Real Estate attorneys for more information regarding this recent decision or 1031 exchanges in general.

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