THE LENDER WITH TWO MORTGAGES ON THE SAME PROPERTY
Risks and Strategies

Brian D. Hulse

The Fall 2009 issue, Vol. 44, Issue No. 3, of the *Real Property, Trust and Estate Law Journal* will include an article entitled *The Lender With Two Mortgages on the Same Property: Risks and Strategies*, by Brian D. Hulse. The article will explore some difficult and little-known issues facing lenders holding two or more mortgages or deeds of trust on the same property. The most fundamental of these issues is the risk that, by foreclosing one of the two mortgages, a court will deem the debt secured by both mortgages to have been satisfied. If the lender does not anticipate these issues in planning its realization strategy, it can severely impair its rights.

The case law in this area is inconsistent and has created unpredictability and unnecessary variations in outcomes from state to state. This is an undesirable situation in the modern world of real estate finance where lenders and the secondary markets deal with a national lending market and unnecessary local variations only add additional costs to the lending process, which are ultimately passed on to borrowers.

Most cases hold that, if the lender forecloses the more senior mortgage, while that foreclosure will wipe out the junior mortgage as a lien on the property, that foreclosure will generally not operate to extinguish the debt secured by the junior mortgage. *See, e.g., Urbach v. Monchamp Corporation*, 110 Or. App. 275, 821 P.2d 1116 (1991); *United Bank of Lakewood National Association v. One Center Joint Venture*, 773 P.2d 637 (Colo. App. 1989). Notwithstanding this general rule, there are situations and states in which such a foreclosure will be held to have extinguished the junior debt. *See, e.g., Iwan Renovations, Inc. v. North Atlanta National Bank*, 296 Ga. App. 125, 673 S.E. 2d 632 (2009); and *Simon v. Superior Court*, 4 Cal. App. 4th 63, 5 Cal. Rptr. 2d 428 (1992).

Oregon recently retreated somewhat from the ruling in *Urbach* in the case of residential foreclosures by a 2009 amendment to its trust deed statute. The amendment amends the state's antideficiency law, to provide that, where a residential trust deed is foreclosed judicially or nonjudicially, no deficiency or other judgment may be entered on any "other note, bond or other obligation" where that other obligation is secured by another residential trust deed or mortgage on the same property if (i) the two obligations were "created at the same time" and (ii) the other obligation is "owed to the beneficiary in the residential trust deed that was subject to the trustee's sale or the foreclosure."

The law is somewhat different where the junior mortgage is foreclosed. In that case, "if the holder of both a junior and senior mortgage forecloses the junior and buys at the foreclosure sale it is generally held that, in the absence of an agreement to the contrary, the mortgagor's personal liability for the debt secured by the first mortgage, or for a deficiency, is extinguished." *See*, 1 NELSON AND WHITMAN, REAL ESTATE FINANCE LAW § 6.16 (5th ed. 2007) and cases cited therein. The cases have reached this result by a variety of theories, some of which are of questionable merit. Further, courts have too often applied technical legal theories, such as the doctrine of merger, in mechanical ways that do not address the underlying equities of the case.

The article will explore all of these issues in detail, will discuss state variations in the law and will propose strategies for the secured creditor to employ, at both the documentation stage and at the foreclosure stage, to minimize the risks. These issues have heightened importance in the current environment of greatly increased numbers of foreclosures after a long period of a buoyant real estate market with a very low foreclosure rate.

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Speed Kills:

Buyers Risk Liability and Physical Harm for Former Meth Labs

By Marlene S. Gomez[1]

The contamination left over from former methamphetamine laboratories ("meth labs") can wreak havoc on unsuspecting home buyers. Widespread and numerous meth lab seizures in areas not usually associated with drug activity have led to an increasingly familiar story: after being plagued by mysterious illnesses ranging from nausea and dizziness to chemical burns, severe migraines and respiratory ailments, the unwary homeowners discover that their family has been living in a house that was a former meth lab.[2] The acids, solvents, volatile organic compounds and other toxic chemicals that were used to "cook" the meth have been lurking in the walls, carpets, counters, air ducts and appliances that surround them. The hazardous wastes produced from the manufacturing process were poured down drains or directly onto the ground and may persist for years in the soil and groundwater. These are not the threats that most people think of when they think of meth labs – such as fires and explosions. Rather, the invisible contamination left over from a former meth lab can be just as harmful. Adding insult to injury, the affected homeowners are financially responsible for the remediation of the contamination at their home which will carry the stigma of being a former "meth house."

The federal government defers meth lab cleanup to the states. Pursuant to the Methamphetamine Research and Remediation Act of 2007, however, the Environmental Protection Agency (EPA) has been working on model, health-based clean-up guidelines for states and localities with the goal of ensuring former meth lab sites are safe and livable. EPA is still revising a draft version of the guidelines. Because each state has been affected by meth use to different extents, a myriad of different approaches has developed. Western states, such as Washington and Oregon, tend to have the most comprehensive programs requiring cleanup of contaminated property, establishing cleanup standards and mandating disclosure to prospective purchasers. But a growing number of meth lab incidents in the South and Midwest,[3]

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2 Take a look at websites like www.methlabhomes.com for examples of the increasing frequency with which meth contamination has brought physical and financial ruin to innocent homebuyers.

3 Missouri State Highway Patrol, *2009 Meth Lab Incidents*, at http://www.mshp.dps.mo.gov/MSHPWeb/DevelopersPages/DDCC/methLabDisclaimer.html. Missouri far

have prompted a number of states to begin enacting laws to address the problem. Nationally, meth lab seizures reached a high in 2003 and 2004 when there were over 17,000 meth lab incidents in the U.S. for two years in a row.[4] The number of incidents fell steadily after that due to the enactment of federal legislation, but the number of incidents rose again in 2008. Despite the high numbers of meth lab seizures over the past few years and the fact that many labs are often found in dwellings like houses or apartments, almost half of the states do not have any meth cleanup or disclosure laws in place.

Washington was one of the first states to have a comprehensive meth cleanup program in place and enacted legislation in 1989.[5] The Washington initiative has since been used as a model by a number of other states that have created their own programs. Some key provisions of Washington's program are as follows:

- The current owner of the contaminated property is held financially liable.

- The responsible health official must determine whether property containing an illegal drug lab is "fit for use" or "unfit for use." Any property deemed "unfit for use" will be reported to the state health division and a copy of the "unfit for use" order will be filed with the county auditor meaning that anyone who conducts a title search on the property will find a notice that the property was used as a meth lab in the land records. The decision may be appealed or the owner may choose to decontaminate the property and seek certification that the property has been properly decontaminated.[6]

- Regulations and guidelines have established decontamination standards. These include numeric remediation levels for hazardous chemicals.[7]

- The seller always retains the option not to decontaminate the property, but the property may only be sold with full written disclosure to the prospective buyers. Even if the property is decontaminated, sellers must still disclose to potential buyers that the property was once used as an illegal drug-manufacturing site.[8]

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surpasses any other state for meth lab incidents in 2009. "Incidents" include labs, dumpsites and chemical and glassware seizures.

4 U.S. Drug Enforcement Agency, *Maps of Methamphetamine Lab Incidents*, at http://www.usdoj.gov/dea/concern/map_lab_seizures.html.

5 *See* WASH. REV. CODE § 64.44 (2009).

6 *Id.* § 64.44.030.

7 WASH. ADMIN. CODE § 246-205-541 (2009).

8 WASH. REV. CODE § 64.46.020 (2009).

The cleanup standards that states have put in place throughout the U.S. range from enforceable regulations to more general guidelines that do not have numeric remediation levels. Some states have cleanup guidelines but do not have any laws requiring disclosure of the property's use as an illegal drug manufacturing site. The absence of meth cleanup or disclosure laws in many states does not mean that those states are necessarily insulated from the meth problem. For example, Nebraska does not have cleanup standards in place or meth disclosure laws, despite the fact that meth lab incidents, after dropping sharply in 2007, doubled from 2007 to 2008.[9] Reasons for the delay by states appear to include questions about the legality of requiring home owners to disclose the history of their home to a potential buyer. There are also concerns in a number of states with the lack of data analyzing the effects of long-term exposure to meth contamination and the resulting inability to devise health-based standards.

In the absence of meth cleanup standards, the presumption should be that the environmental laws of the state control. In addition to providing cleanup standards (although maybe not meth-specific) some states have environmental laws with deed notification requirements that are triggered when hazardous substances have been released into the environment. Depending on the particular substances and quantities involved, meth lab contamination may constitute a release under state laws, which raises a broader question: does the failure to disclose meth contamination in the deed constitute a defect in title and implicate a claim against the title insurer? But it may not be true in all states or under federal environmental laws that a spill inside a building would be subject to the same environmental regulations as a spill in the yard or a release to groundwater. Environmental laws have been developed to address different types of threats and are not typically set up to address indoor pollution. And even if meth contamination would technically qualify as a release under federal or state environmental laws, it is also unlikely that smaller operations typically found in homes would receive any enforcement action under those laws.

Some states have chosen to take an approach that uses real estate disclosure laws to put prospective buyers on notice before sale. Most states already have laws that require disclosure of everything from water in the basement to environmental contamination. In such cases, it would be quite simple to add a provision that alerts sellers that environmental contamination includes meth labs or to create a separate provision for illegal drug manufacturing. Illinois is an example of one state that has taken this route. It has thus far declined to devise clean up standards, but just recently amended its Residential Real Property Disclosure Act to require the disclosure by a seller of real property if the property is "known" to be used for the manufacture of methamphetamine. The Illinois legislation, Public Act 96-232, was signed and became effective on August 11, 2009.

Nevertheless, the "disclosure-law-only" approach suffers from the glaring defect that it relies on the knowledge and honesty of those making the disclosures.

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[9] U.S. Drug Enforcement Agency, *supra* note 4.

Depending on the language of the statute, the responsibility to disclose the property's history may fall on the seller and the realtor, or just the seller, who may have incentive to lie or may not have known the extent of the activities conducted on the property (for example – the activities of former tenants). Of course, this is always the case with disclosure forms, which is why testing or a comprehensive program like Washington's which raises red flags in the land records, may be the way to go. Even more troubling is that disclosure laws may be rendered practically worthless without cleanup standards in place. States may choose to exempt from disclosure properties that have been "cleaned up," but without enforceable standards and certification methods, how does one know what is "clean"?

Questions may then arise if misrepresentations are made in the disclosure statement, the answers to which will depend on the particular real estate laws of individual states. Is it possible that a misrepresentation could render the transaction voidable? Or will the only recourse be trying to recover through the legal process cleanup costs from the seller, who may or may not have any assets?

The risks of severe health effects from exposure to residual contamination from meth labs are serious enough to warrant state laws that are designed to protect the public from exposure to meth contamination. States have taken a variety of approaches, ranging from establishing comprehensive cleanup programs to doing nothing. If the country really is facing a "meth epidemic", is doing nothing the right policy?

MERS' Standing to Foreclose Upheld in Rhode Island State Court Challenge

by

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Rhode Island is the most recent state in a long line of jurisdictions to rule that Mortgage Electronic Registration Systems, Inc. ("MERS") has standing to foreclose. The Rhode Island court further ruled that MERS, as mortgagee and nominee for the mortgagee, may exercise the statutory power of sale in its own name.

The case of *Bucci v. Lehman Brothers Bank, et al.,* C.A. No. PC 09-3888, was filed in the Providence County Superior Court. The facts of the underlying action are typical of many foreclosure scenarios occurring across the country. A loan was originated and the borrower executed a promissory note made payable to the lender. Contemporaneously, as security for the repayment of the promissory note, the borrower granted a mortgage on the residential property to MERS. The mortgage was granted by the borrower/mortgagor to MERS as nominee for the Lender, granting all the rights and privileges of a mortgagee to MERS, including the statutory power of sale.

As with many non-judicial jurisdictions, Rhode Island's legislature enacted a statutory process allowing a mortgagee to foreclose on its mortgage following a borrower's default. Rhode Island General Laws § 34-11-22 codifies the statutory power of sale, which many, if not all MERS originated mortgages incorporate by reference ("Statutory Power of Sale").

The borrower eventually defaulted on its repayment obligations under the terms of the promissory note. The loan was accelerated and the borrower failed to cure. Non-judicial foreclosure proceedings were commenced whereby, pursuant to Rhode Island's statutory scheme, a notice of foreclosure was sent to the borrower and foreclosure notices were published in the statutorily prescribed form and manner.

In this case, prior to the scheduled foreclosure date, the borrower filed a complaint seeking injunctive relief to enjoin the foreclosure sale. The complaint alleged, *inter alia*, that: the Rhode Island statutory scheme does not allow MERS to exercise the Statutory Power of Sale in the mortgage because Rhode Island does not recognize a "nominee mortgagee"; MERS, because it is not the Lender, does not have standing to foreclose; and MERS is precluded from foreclosing because it is not the owner of the promissory note. The Court granted the initial request for relief pending a substantive hearing on the issues. In an unusual procedural move, the Court administratively consolidated dozens of other cases raising similar issues throughout Rhode Island. Five days later, a preliminary injunction hearing was held and, pursuant to Rule 65(a)(2) of the Rhode Island Rules of Civil Procedure, the Court consolidated the preliminary injunction hearing with the trial on the merits.

Following the full hearing, on August 25, 2009, the Court issued its decision denying the borrower's requests for relief. In so ruling, the Court "specifically [held] that MERS, in the case at bar, has standing to and may foreclose the mortgage granted to it by the Plaintiffs utilizing the Statutory Power of Sale referenced therein."

After a brief description of MERS' functions, the Court first considered MERS' contractual right to foreclose pursuant to the mortgage document. Citing directly to the mortgage, the Court noted that the borrower granted “the Statutory Power of Sale to MERS, as nominee for Lender, its successors and assigns.” The Court went on to quote the mortgage which stated that: “if necessary to comply with law or custom, MERS (as nominee for Lender and Lender’s successors and assigns) <u>has the right</u> to exercise any or all of those interests, including, but not limited to, the right <u>to foreclose and sell the Property</u>[.]” (Emphasis in decision). In addition, the Court, rejecting certain of the borrower’s other contentions, found that the “fact that paragraph twenty-two of the mortgage states that the Lender ‘may invoke the STATUTORY POWER OF SALE’ does not negate the previous language in the mortgage directly granting MERS, as mortgagee in a nominee capacity, the right to invoke the Statutory Power of Sale.” Accordingly, MERS has the contractual right to exercise the Statutory Power of Sale because it is the named mortgagee and nominee of the Lender, and its successors and assigns, and MERS was acting on behalf of the beneficial owner of the promissory note.

Next, the Court tackled the borrower’s assertion that MERS does not have the statutory authority to foreclose. First, the Court determined that there is no express statutory prohibition impacting MERS' ability to foreclose. Next, citing the Statutory Power of Sale, the Court determined that because the “mortgagee or his, her or its executors, administrators, successors or assigns” can exercise the power of sale, so too can MERS as the mortgagee. Simply put, the Court found that MERS “is the mortgagee because the mortgage executed by the [borrower] so states.” “The fact that MERS acts in a nominee capacity for the lender . . . does not diminish MERS' role as the mortgagee nor is there created a new legal term ‘nominee mortgagee.’” Therefore, not only is there “[n]othing in the Rhode Island statutes prohibit[ing] MERS, as mortgagee in a nominee capacity, from foreclosing under the Statutory Power of Sale,” MERS “may invoke the Statutory Power of Sale as the mortgagee.”

Through its decision, the Court, in the clearest language addressed the various challenges that have been asserted against MERS' authority to foreclose under Rhode Island law. As a result, the multitude of pending cases seeking to enjoin Rhode Island foreclosures by attacking MERS' standing will most likely be resolved in a perfunctory and consistent manner in favor of MERS. An appeal by the borrowers is anticipated.

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Separate Property v. Property of the Estate:
Determination of Rights in Funds When a 1031 Intermediary Exchange Files Chapter 11

INTRODUCTION

In three separate decisions, the U.S. Bankruptcy Court for the Eastern Division of Virginia decided whether or not funds held by a Qualified Intermediary in connection with a tax-deferred exchange under IRC Section 1031 were deemed to be property of the bankruptcy estate. Upon joint motions brought forth in the Chapter 11 Bankruptcy filing of Land America Financial Group, Inc.[1], an order was entered that set forth five "lead cases" to be heard on an accelerated schedule. On January 16, 2009, these "lead cases" were identified, specifically due to their fact patterns, which were representative of the adversary proceedings filed to date. All other adversary proceedings seeking a determination as to whether taxpayer funds are deemed separate property versus property of the estate were stayed until the lead cases reached a determination. This article will discuss the outcome of three of the five lead cases, two of which deemed the exchange funds to be property of the bankruptcy estate while the other decision deemed such funds to be the property of the taxpayer.

In *Health Care REIT, Inc. v LandAmerica 1031 Exchange Services, Inc*.[2], the Court ruled in favor of the taxpayers by approving a stipulation and settlement agreement set forth by the parties on February 22, 2009. In *Health Care*, the taxpayer's funds were kept in a segregated account with an escrow agreement. However, in the two other cases, *Millard Refrigerated Services, Inc. v. LandAmerica 1031 Exchange Services, Inc.* and *Frontier v. LandAmerica 1031 Exchange Services, Inc*.,[3] the taxpayers' funds were deemed to be property of the bankruptcy estate. No escrow agreement was in place for either of these cases. Moreover, in *Frontier*, the funds were co-mingled. The outcomes of these three "lead cases" will undoubtedly shape future adversary proceedings brought forth that share similar fact patterns. More importantly, the outcomes will shape the planning and drafting of all future Exchange Agreements.

I. Health Care REIT, Inc. v. LandAmerica 1031 Exchange Services, Inc.

Plaintiff Health Care REIT, Inc. filed its complaint in this adversary proceeding seeking return of its funds totaling around $137 million. The facts show two "Exchange Agreements" designating Centennial Bank as an escrow holder. In addition, all three parties involved –

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[1] *In Re LandAmerica Financial Group, Inc.*, Case No. 08-35994 (KRH). Shortly after the proposed merger between Fidelity National Financial Group, Inc. and LandAmerica Financial Group, Inc. fell through, LandAmerica 1031 Exchange Services, Inc., a LandAmerica owned entity providing tax exchange intermediary and related services, posted on its website that it was closing business operations. Reports began to surface that suggested the 1031 Company was unable to liquidate certain invested customer funds to meet necessary exchange deadlines. On November 26, 2008, LandAmerica Financial Group, Inc. as well as its wholly owned subsidiary, LandAmerica 1031 Exchange Services, Inc., each filed a Chapter 11 petition in the Richmond, Virginia Bankruptcy Court. These cases are being administrated together for procedural purposes.

[2] *Health Care Services, Inc. v. LandAmerica 1031 Exchange Services, Inc*. Adv. Pro. No. 08-03149

[3] *Millard Refrigerated Services, Inc. v. LandAmerica 1031 Exchange Services, Inc.*, Adv. Proc. No. 08-03147, *Frontier Pepper's Ferry LLC v. LandAmerica 1031 Exchange Services, Inc.*, Adv. Proc. No. 08-03148

LandAmerica 1031 Exchange Services, Health Care and Centennial Bank – entered into two "Qualified Escrow Agreements."[4] On February 23, 2009, the U.S. Bankruptcy Judge Kevin Huennekens granted a joint motion to approve stipulation and settlement agreement which provided for the return of Health Care REIT's exchange funds and approved the release of the Exchange Funds from the bankruptcy estate.[5]

Even though a Memorandum Opinion was not entered along with the order in this case, it is evident that the parties availed themselves of the safe harbors provided by the Treasury Regulations by not only using a Qualified Intermediary but also utilizing a Separate Qualified Trust.[6]

II. Millard Refrigerated Services, Inc. v LandAmerica 1031 Exchange Services, Inc.

In *Millard*, Plaintiff Millard and LandAmerica 1031 Exchange Services, Inc. entered into an Exchange Agreement. No separate trust agreement existed. The court entered a Memorandum Opinion and Order that determined the Exchanged Funds to be property of the bankruptcy estate.[7] The Exchange Funds were held in a segregated account in which LandAmerica was the only named account holder and the only named signatory. This created a presumption that the Exchange Funds were indeed funds of the bankruptcy estate. In order to determine whether Millard retained some rights to the funds, the Court looked to state law to see if an express or resulting trust was created by the intent of the parties.

Upon review, the Court noted that nowhere in the Exchange Agreement could the words, "trust", "trustee" or "beneficiary" be located.[8] Despite Millard's arguments that it maintained equitable ownership of the Exchange Funds; the Court determined no such intent could be found. Indeed, the Court found an express intent *not* to create a trust because Millard conveyed their "exclusive possession, dominion, control and use of the Exchange Funds to [LandAmerica]".[9] Moreover, the Exchange Agreements contained a merger clause which prevented either party from relying upon representations and warranties not contained in the agreement itself. Therefore, the Court maintained that Millard's argument that LandAmerica had a fiduciary duty towards Millard was unfounded and unsupported by the agreement's plain statements. Moreover, the Court determined that each party was represented by experienced legal counsel and financial professionals. Considering all these factors, the Court found the Exchange Funds to be part of the bankruptcy estate.

III. Frontier Pepper's Ferry, LLC v. LandAmerica 1031 Exchange Services, Inc.

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[4] *See generally, footnote 2*

[5] *Id.*

[6] *See* Treasury Reg. 1.1031 (k)-1(g).

[7] *See Millard Refrigerated Services, Inc. v. LandAmerica 1031 Exchange Services, Inc.*, Adv. Proc. No. 08-03147

[8] *Id.* at 16.

[9] *Id.* at 17.

As in *Millard*, the Court entered a Memorandum Opinion and Order in the *Frontier* adversary proceeding.[10] Frontier executed an Exchange Agreement with LandAmerica 1031 Exchange Services. Similar to Millard, no separate trust agreement existed. The funds from the sale of the taxpayer's relinquished property were deposited directly into LandAmerica's *commingled* account. The Court found that, absent any trust agreement, a presumption existed deeming the Exchange Funds to be property of the bankruptcy estate. Again, without any express language contained in the exchange agreement creating a trust, the Court looked to Virginia's state law to see if the *intent* to create a trust existed.

After examining the facts of the case, the Court determined that Frontier conveyed exclusive control and use of the exchange funds over to LandAmerica 1031 Exchange Services. *Frontier*, similar to *Millard*, held that Frontier maintained equitable ownership of the Exchange Funds at all times. However, as pointed out by the Court, at no point was Frontier allowed to withdraw the exchange funds after the funds were directly deposited from the third party purchasers of the relinquished properties into the commingled account. Moreover, Frontier specifically disclaimed "any right, title or interest in and to the Exchange Funds" per the Exchange Agreement.[11] Therefore, the Court found that it was the intention of the parties to the Exchange Agreement *not* to create a trust. Noting that the Exchange Agreements were fully documented commercial transactions and that the parties were represented by financial and legal professionals, the Court entered an order on May 7, 2009 that determined the Exchange Funds to be part of the bankruptcy estate.

CONCLUSION

It is clear that failing to utilize the Qualified Trust safe harbor provision, in addition to the Qualified Intermediary provided for in the Treasury Regulations, has proven to be fatal to the taxpayer's position that it retains equitable ownership in the Exchange Funds. The Treasury Regulations permit the use of multiple safe harbors to secure a transferee's obligation to deliver replacement property which include the use of a separate Qualified Trust. Although the terms and conditions of the safe harbors must be satisfied separately, they are not mutually exclusive.

In determining whether or not an implied trust exists, a bankruptcy court will look towards the controlling state law for guidance. Unfortunately for the taxpayer, in two of these lead cases, their own Exchange Agreements prevented such intent from being detected. These lead cases will no doubt enable a speedy outcome for the remaining 100 or so adversary proceedings in the LandAmerica Chapter 11 bankruptcy proceeding. More importantly, they should serve as guidelines for the planning and drafting of Exchange Agreements going forward.

[10] The remaining two of the five "lead cases", *Howard Finkelstein v LandAmerica 1031 Exchange Services, Inc.* Adv. Pro. No. 08-03171 and *Matthew B. Luxenberg, Trustee of the Matthew B. Luxenberg Revocable Family Trust v LandAmerica 1031 Exchange Services, Inc.* Adv. Pro. No. 09-03023 were combined in this memorandum opinion and order because all five fact patterns dealt with commingled account agreements. For purposes of this article, these two cases will not be discussed in detail.

[11] *See Frontier Pepper's Ferry LLC v. LandAmerica 1031 Exchange Services, Inc.*, Adv. Proc. No. 08-03148 at 8.

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Congress Passes Tax Relief through 2010 for Solvent Debtors Holding Real Estate

Mark Stone[1]

We are all aware of the economic crisis affecting real estate and other businesses. Many in the real estate bar are also somewhat or passingly familiar with tax issues that can arise from restructuring, retiring or otherwise modifying the underlying debt of an enterprise favorable to the debtor. In short, we have to deal with aspects of cancellation of indebtedness income ("COD") at the time of such event, i.e. does it apply, if it applies are there any exemptions or other rules to lessen the tax impact.[2] The American Recovery and Reinvestment Act of 2009 (the "2009 Act"), signed into law by President Obama on February 17, 2009, includes a provision that adds tax relief for the solvent real estate debtor (and in certain circumstances the insolvent debtor) for COD realized in 2009 and 2010. Thus, there is a short window of opportunity presently available to use this new tool.

Background

COD in General

So what exactly is COD and how is it taxed for federal income tax purposes? Section 61(a)(12) of the Internal Revenue Code of 1986, as amended (the "Code") provides that gross income includes income from discharge of indebtedness. It is treated as ordinary income and not capital gains. COD is generally equal to the excess of the adjusted issue price of the debt being satisfied (in general, for debt without original issue discount ("OID"), the current outstanding principal balance amount or, if there is OID, the original issue price plus accrued unpaid interest less payments of principal) over the amounts paid to satisfy such debt.[3]

> **Example 1** – Assume that a limited liability company ("LLC") held equally by five U.S. resident members owns a single rental building acquired in 2003 for $90 million with its sole mortgage of $80 million outstanding. Two of the members are insolvent to the extent of $5 million each and the other three are very solvent. Assume further the property has dropped in value to $55 million today and that the lender agrees with the owner to reduce the principal amount of the loan to $60 million.

As real estate counsel for the LLC in Example 1, you may be feeling great about the debt restructuring you have negotiated for your client. That is, until you speak with your tax

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[2] This report does not consider tax consequences to the debtor arising from foreclosure, deed in lieu, or similar transactions which are very different from those arising from COD (where the debtor remains owner).

[3] For simplicity, unless otherwise noted, this report assumes that non-publicly traded debt arising from a third party loan and not seller financing is: (a) retired for cash or, (b) reduced in principal amount without other economic changes to the terms of the debt instrument. Such other economic changes (interest rates, payment dates, security, etc.) favorable to the debtor arising from the restructuring or modification of the debt increase the complexity as to the amount of the COD. Whether the debt that is considered retired or reissued is publicly offered within the meaning of section 1273 of the Code also affects the amount of COD.

partner. In Example 1, the LLC would recognize $20 million of COD ($80 million former principal amount less $60 million revised principal amount), allocated among its owners in 2009 unless exemptions or other rules come into play. It is worth noting that this diminution in value likely corresponds to reduced income from the property and an otherwise distressed financial situation in the company, although it may also arise from cap rate changes at maturity of a balloon instrument. Nonetheless, the company, or since it is an LLC, its owners, will have to pay tax on $20 million of income ($4 million for each member) without generating any corresponding funds from the transaction to pay such taxes.[4]

Is there any relief to the owners of the LLC from the recognition of $20 million in income in 2009 in Example 1?

Section 108 of the Code in General

Section 108 of the Code is designed to ameliorate some of the harsh effects of COD recognition, particularly when the taxpayer is in a troubled economic condition. Section 108(a)(1)(A) of the Code provides that COD does not arise if the taxpayer is under the jurisdiction of the court in a U.S. Title 11 bankruptcy case. Section 108(a)(1)(B) of the Code provides that COD does not arise to the extent the taxpayer is insolvent (the excess of taxpayers' liabilities over the fair market value of their assets just prior to the debt release).[5] Another rule provides that in determining whether the taxpayer is under the jurisdiction of a court or insolvent, ownership of the property by a partnership is disregarded and the determination is made at the partner level.[6]

In Example 1, the LLC is clearly insolvent (debt of $80 million exceeds the fair market value of the assets $55 million, by $25 million). But the insolvency of the LLC is not relevant to the COD analysis. Three of its members, on the other hand, are not under the jurisdiction of a court in a Title 11 case and are solvent, so the two main exemptions are not applicable to such members. Prior to the 2009 Act, and still remaining in the Code, other exemptions include: qualified farm indebtedness (not relevant in Example 1), qualified real property business indebtedness (relevant and discussed below), qualified principal residence indebtedness (not relevant in Example 1), interest indebtedness of a cash basis taxpayer (not relevant in Example 1), seller financing indebtedness (not relevant in Example 1), and contribution of indebtedness to corporate capital (not relevant in Example 1).[7]

> **Example 2** – We change the facts of Example 1 to provide that the loan is made to an LLC whose business is not the ownership, operation or development of real property; such as to a wholesaler of goods whose $80 million loan is secured by its receivables.

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[4] An LLC is treated as a partnership for federal income tax purposes unless it has made an election to be treated as a corporation. We assume, consistent with the great majority of LLCs, that the LLC has not made the corporate election and is treated as a partnership. Thus, it is a nontaxable "flow-through" entity and its members are taxed on their distributive share of its income.

[5] Establishing insolvency and its extent typically requires a competent appraisal. There is no guarantee that the IRS will agree with the appraisal or taxpayer's independent evaluation.

[6] Section 108(d)(6) of the Code.

[7] The bankrupt, insolvent and farm exemptions are not pure exemptions in the sense that they come with a tax cost. The tax cost is loss of certain future tax benefits of the taxpayer, in the amount of such COD, such as net operating loss carryovers ("NOLs") and reduction in basis in property, in a prescribed order. Section 108(b) of the Code.

In Example 2, the three solvent owners, prior to the 2009 Act, would be required to include $4 million each of the $20 million COD into income in 2009. However, the 2009 Act, establishing section 108(i) of the Code, could provide some welcome relief to the owners of such wholesale enterprise.[8] The two insolvent owners, on the other hand, would receive tax protection under the insolvency exemption (they are insolvent to the extent of $5 million each in our example) and would not need any further tax relief.

Section 108(i) Deferral Relief

The LLC in Example 2 may elect under section 108(i) of the Code to defer the owners' share of the 2009 COD income to 2014 and to include such income ratably over the five year period 2014 to 2018 ($800,000 per year). Thus, the owners get a ten year interest free deferral of their tax obligations.[9] While this looks attractive to the solvent members, the insolvent members may object to any such election since all of their COD income is excluded under the insolvency exemption on a permanent basis.[10] Let us take a look in more detail at how section 108(i) of the Code works.

Section 108(i) of the Code permits a taxpayer to elect to defer the recognition of COD income from the reacquisition of an applicable debt instrument in the years 2009 and 2010 only. Thus, it has a very limited life. The election is made (on a debt by debt basis) by the issuer of the debt, in this case by the LLC. The COD income is deferred until the year 2014 and included in income ratably over the five year period 2014 to 2018.[11] A reacquisition includes any acquisition of the debt instrument for cash, the exchange of the instrument for a new instrument favorable to the debtor (including a deemed exchange resulting from a reduction in the principal amount of the debt and other modifications), and certain restructuring changes. An applicable debt instrument is any debt instrument issued by a C corporation, and any other person (which would include an individual or an LLC) but such other person must hold the debt in connection with the conduct of a trade or business. If the taxpayer dies, the business is terminated, or the taxpayer terminates its interest in a partnership or other pass-through entity, the balance of any deferred amount not yet included in income is accelerated to the year of such termination.

We have posited in Example 2 that the LLC taxpayer debtor is engaged in a wholesale business, which would constitute the conduct of a trade or business within the meaning of section 108(i) of the Code. In the real estate setting, operating the rental business of a large commercial or residential office building, as in Example 1, would likely qualify as the conduct of a trade or business, although there is some question whether an owner's building operations under a triple net lease rise to the level of the conduct of a trade or business or merely

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[8] We are digressing from the focus of this report, tax relief for debtors holding real estate, to provide background on the COD tax relief for debtors in most other businesses. Such background will aid in understanding the relief provided to real estate concerns.

[9] Although the election appears to make sense for the three solvent owners, there are a number of factors to consider, one of which is whether one anticipates that tax rates will be significantly higher in the out years. As discussed further, the election generally makes no sense for the two insolvent owners.

[10] The insolvent members must take into account loss of any NOLs or depreciable tax basis in their properties arising under the statute from the insolvency exemption, but in most cases the trade-off for loss of these tax benefits is outweighed by permanent avoidance of the COD.

[11] For fiscal year taxpayers, the COD is includable in the fifth taxable year following the taxable year in which the reacquisition occurs for reacquisitions occurring in 2009 and the fourth taxable year following the taxable year in which the reacquisition occurs for 2010 reacquisitions.

constitute a passive investment activity. It seems unlikely that a debt reacquisition arising from the ownership of undeveloped land would qualify.[12]

The section 108(i) election trumps the other section 108 exemptions so that any bankruptcy or insolvency protection a taxpayer may otherwise be entitled to is lost. In a nutshell, this means that such persons must include COD in income in the sixth through tenth year following reacquisition when they may never have had to include such amounts into taxable income in the first instance because of the insolvency or bankruptcy exemption in the year of reacquisition or in any of the years six through ten. Once the election is made, it is irrevocable.

On August 17, 2009 the IRS issued Rev. Proc. 2009-37 (the "2009 procedure") to flesh out the taxpayer election procedure. Under the statute, the election is made, in our examples, by the LLC in its 2009 annual tax return filed on partnership Form 1065. The election must contain the identity of the specific applicable debt instruments,[13] and the amount of the related COD. The 2009 procedure thankfully avoids some of the rancor that might arise from an election at the LLC level otherwise applicable to all members by permitting the LLC to effectively elect on a member by member basis. So in Example 2, the election would be made for the three solvent members only. Detailed information must be included on the K-1 of each member and detailed information must be filed with each subsequent year of the LLC until all the deferred income has been recognized. The election concerns at the LLC level, while abated somewhat by the 2009 procedure, raise interesting questions about the LLC manager's obligations to the company and its members that may not be addressed in the company operating agreement and is beyond the scope of this report.

Section 108(c) Real Estate Special Exemption

In Example 2 a wholesale operation debt discharge is described giving rise to COD income to its solvent owners. In Example 1, however, the debt arises from a real estate transaction. Unlike most other business activities which have no specific section 108 exemptions available,[14] there is an exemption for distressed real estate at the enterprise level, termed the qualified real property business indebtedness ("QRPBI") exemption, similar in nature to the insolvency exemption at the owner level. If applicable, it provides tax relief to the solvent owners.[15]

QRPBI (applicable to solvent individuals and solvent individual owners or beneficiaries of trusts, S corporations and other entities, but not C corporations, holding distressed real estate) arises when the following factors are present: (1) the debt was incurred or assumed in connection with real property used in a trade or business and is secured by the realty; (2) the

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[12] There are also rules under section 108(i) of the Code dealing with any OID that might arise from the reacquisition and with certain esoteric provisions applicable to C corporations known as the AHYDO rules that are not applicable to our fact patterns.

[13] As indicated, the taxpayer can elect to defer COD on some debt instruments but not others that may have been discharged or otherwise adjusted.

[14] The other business which enjoys a COD exemption is farming. It may be applicable to certain of your real estate clients so engaged, but applies to far fewer taxpayers than the general real estate exemption and is not discussed. Section 108(a)(1)(C) and (g) of the Code.

[15] The insolvent owners must rely on the insolvency exemption to avoid recognition of COD. Section 108(a)(2)(B) of the Code.

debt was incurred or assumed to acquire, construct, reconstruct or substantially improve such real estate or to refinance such debt (debt raised to cash out partners would not qualify) and subject to the following limitations: (3) on a property by property basis it applies only to the extent of the excess of the outstanding principal amount of the debt over the fair market value[16] of the property (that is, only to the extent the property is "under water") and further limited to (4) the aggregate tax basis of any depreciable real property, including the secured realty subject to the debt discharge to the extent it constitutes depreciable property, held by the member or other owner immediately prior to the debt discharge.[17]

In Example 1 the debt exceeds the value of the LLC real estate by $25 million ($80 million debt less $55 million fair market value). The LLC's tax basis in the depreciable property is well in excess of the $20 million being discharged (assuming most of the $90 million original cost is attributable to the building and not the land), so each member should have sufficient tax basis in the secured depreciable property alone to meet tests 3 and 4 above. Therefore, an election by a solvent member of the LLC[18] can be made under section 108(c) of the Code to have the QRPBI exemption apply. The election would result in complete exemption of such member's $4 million share of COD in 2009 at a loss of only $4 million in future tax depreciation deductions in this or other properties held by the member. Loss of tax depreciable deductions in Example 1, if a commercial building, with 33 years to run on its depreciable life means that the $4 million in income will eventually be reported to the IRS, but over 33 years. In the tax field, we call this a pretty good deal.

By contrast, if the solvent members permit the LLC to make a section 108(i) election on their behalf, they must include $800,000 in income in each of the years six to ten. This is not nearly as good as the QRPBI election under these facts.

Why Make the Section 108(i) Election?

Since real estate has its own favorable debt relief provision in the tax Code which is superior in many respects to the new 2009 Act provision, why would any real estate related concern make the new election and why did I bother you with all this discussion?

As noted, not all real estate debt relief transactions will qualify.

> **Example 3** – We change the facts of Example 1 to provide that the loan on the building was used to cash out prior members and not for acquisition, construction, reconstruction or substantially improving such property.

The QRPBI exemption does not apply in Example 3 because of the impermissible use of the borrowed funds.

> **Example 4** – We change the facts of Example 1 to provide that the project is for the sale of condominium units[19] rather than commercial rental property, and that the members do not own any depreciable real property.

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[16] Less, in effect, any other mortgage on the property meeting these QRPBI requirements.

[17] Thus, if the business consists of selling condominiums (nondepreciable assets) and the partner has no depreciable real property assets, the QRPBI election provides no tax relief from COD. Section 108(c)(2)(B) of the Code.

[18] The election is made on a partner by partner basis on IRS Form 982.

[19] See footnote 17.

Example 4 will fail to qualify for the QRPBI exemption because it fails test 4 of the rules above (the aggregate tax basis in depreciable real property).

> **Example 5** – We change the facts of Example 1 to provide that the owner of the realty is not an LLC, but rather is a C corporation.

Example 5 fails to qualify for the QRPBI exemption because real estate held by a C corporation, whether publicly or privately held,[20] is not eligible for the QRPBI exemption. The section 108(i) provision, moreover, expressly permits C corporations to make the election. The C corporation can make the election regardless whether it conducts a trade or business within the meaning of the tax law.

> **Example 6** – We change the facts in Example 5 and Example 1 to provide that the underlying real estate held by the corporation consists of undeveloped land.

In Example 6 the C corporation should be able to make the election for section 108(i) debt relief in connection with undeveloped land, whereas the LLC could not.

There may be other instances where the technical rules of the QRPBI provisions can not be met, or its use is not very favorable,[21] and a section 108(i) 10 year deferral option is available and advisable.

The QRPBI election assumes a distressed real estate situation. It is clear that the new section 108(i) deferral election can be made for the solvent owner and the solvent real estate enterprise. But what lender is providing debt relief to a solvent debtor with solvent property unless the debt is a balloon instrument that can not be renewed at maturity due to interest or cap rate changes?

The legislative history to the 2009 Act provision indicates that it was primarily designed to assist companies that can otherwise deleverage by reacquiring their debt at a discount. It was also designed to give financial firms holding such debt more liquidity. The assistance, as discussed in this report, is in the form of the five year deferral and the subsequent five year pay-out of taxes. In effect, the discount may arise not necessarily because the debtor is delinquent in payments or otherwise in default, or is insolvent, or the property has lost value, but rather the market is concerned about the issuer's ability to pay and is willing to take a haircut to get its cash back. Alternatively, the lender in today's economic climate may simply prefer to be bought out and is prepared to take a significant discount to get cash back, even though it may not be concerned about the issuer's ability to pay. Where might a repurchase arise in a non-public company setting?

> **Example 7** – $200 million of debt of an LLC is privately placed with institutional lenders in 2005 for the purpose of acquiring and enlarging by new construction a large residential rental development project. In 2009, as a result of the economic downturn and after a number of the new residential buildings are constructed and rented and the

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[20] Yes, there are still a few privately held C corporations out there holding real estate. The C corporation can take advantage of the insolvency exemption, however, if applicable to its financial condition. Under Example 1, as revised in Example 5, the corporation would be insolvent.

[21] If the debt discharge occurs toward the end of the life of the building, the loss of tax depreciation arising from the insolvency exemption may have to be recovered over a shorter period than the ten year period under section 108(i) of the Code, for example.

existing buildings remain rented, the development is downsized and $50 million of the funds are no longer needed for the revised new construction project. The borrower is otherwise fully capable of meeting its loan obligations. The project has not lost value, or at least has not lost value beyond the equity put into the deal. The institutional lenders are willing to accept $40 million for the $50 million piece of the loan.

In Example 7 the QRPBI exemption is not available since the property is not under water. The section 108(i) election should provide a welcome 10 year relief to the solvent members of the LLC on their share of the $10 million of COD generated by this transaction.

There are doubtless variations on these examples where new section 108(i) of the Code comes into play. As with any new statute, there will be issues raised concerning its application not expressly covered by the statutory language, such as the proper withholding obligation of an LLC on the COD deferred amounts attributable to a foreign member. We can expect further guidance from the IRS and Treasury Department soon, given the short life of this statute. For now, I simply want to make the reader aware of the limited time availability of, and the potential tax benefits derived from, new section 108(i) of the Code.

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