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 –

---

[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.

---

[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.

Katie Graves Williams, Esq.
CODILIS & ASSOCIATES, P.C.
15W030 North Frontage Road
Burr Ridge, Illinois 60527
katie.williams@il.cslegal.com
(630)-230-2616

Education: B.A. DePaul University, 1997; The John Marshall Law School JD with Distinction for Outstanding Achievement in Real Estate, 2005; The John Marshall Law School LL.M in Real Estate Law, 2007.

Admitted to practice in the State of Illinois and an American Bar Association Fellow 2008-2010 for the Real Estate Property Division. Member of the Illinois State Bar Association, Chicago Bar Association - Real Property Divisions, Chicago Real Estate Council, and the Real Estate Finance Forum. Prior to joining her current Firm, Katie was employed by Barclays Capital Commercial Mortgage Backed Securities division.