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Qualified Intermediary Bankruptcies

Individual Rights Versus The Collective Good

By Emil Hirsch and Thomas Lynch

When an IRS Code § 1031 "qualified intermediary" files for bankruptcy, this triggers unique challenges to the constitutionality of the bankruptcy process, as well as to the boundaries of a bankruptcy court's equitable powers under Bankruptcy Code § 105 and interpretations of state property law. Section 1031 of the U.S Tax Code allows taxpayers to avoid paying taxes on capital gains resulting from sales of real property through a type of "like-kind exchange." To accomplish the exchange, the taxpayer must give a "qualified intermediary" (QI) constructive possession of the proceeds from the sale of real property, and direct the QI to apply those proceeds the purchase of a "replacement" within 180 days. Once the exchange is completed, the taxpayer is no longer required to pay any capital gain taxes on the proceeds. Often, the QI is given full legal dominion over the proceeds under an exchange agreement for period from the original sale until closing on the replacement property.

Ideally, 1031 exchanges provide a significant tax benefit while allowing the QI to make a profit on the 180-day private investment. However, when the investment does not yield a profit and obligations exceed the amount of incoming funds, the model crumbles. Bankruptcy may then result, and the ensuing case can be emotionally charged and present significant administrative and legal challenges for creditors and debtors. A recent example of such a case is the Land America bankruptcy, in which approximately 450 individual exchangers suddenly lost legal possession of their exchange proceeds when Land America filed for bankruptcy.

Emil Hirsch is a partner and **Thomas Lynch** is an associate with Bradley Arant Boult Cummings LLP in Washington, DC.

Substantive Issues

In the Land America case, over 100 adversary proceedings were filed based on the exchange agreements and creditors' claims that the exchange funds could not be tied up in the Land America bankruptcy. The key legal question, as in any QI bankruptcy, was whether, under state law, the exchange funds were property of the debtor's estate under § 541 of the Bankruptcy Code. The exchangers claimed that the funds were held in trust under Virginia law and could not be the property of the debtor's estate. The exchange agreements were largely identical with respect to the material terms, including a provision that Land America had "sole and exclusive possession, dominion, control and use" of the exchange funds during the 180-day exchange period. However, the material difference between the agreements, and the key to the final treatment of the various creditors under the final confirmation order, was how the exchange agreement required the funds to be treated by Land America during the exchange period. In general, those creditors whose funds were held in segregated accounts or express trusts received more favorable treatment than those whose funds were held in commingled accounts intermixed with Land America's general operating and investment accounts. Because § 541 commands that the question of what is considered property of the bankruptcy estate be determined under state property law principles, this treatment was ostensibly justified by the court's interpretation of the various exchange agreements under state contract and property law. Counsel for exchangers are encouraged to explore theories of express trust, implied trust and constructive trust in seeking to recover exchange funds from the debtor's estate under § 541.

Administrative and Due Process Issues

Another challenging aspect of a large QI bankruptcy is the significant case administration and due process issues presented by the sheer number and dollar value of adversary complaints filed by exchangers. In the Land America case, it would have taken many months and a great deal of judicial resources for a single bankruptcy court to resolve over 100 adversary proceedings filed by separate exchangers, each with its own difficult § 541 legal and factual questions. Without some sort of procedural structure to streamline the resolution of fact issues and legal questions common to each adversary plaintiff, mass exchanger litigation in many cases would severely diminish the bankruptcy estate, and ultimate recovery by the exchangers, in a death by a thousand cuts. One hundred answers would have to be filed by the debtor. One hundred sets of written discovery would be issued and answered. One hundred dispositive motions would be briefed and argued, and so on. To avoid depletion of the estate in this manner, bankruptcy courts overseeing a large QI bankruptcy will likely create a virtual class-action type structure to streamline the litigation.

Case Management in the Land America Case

In the Land America case, the court created five separate classes of adversary plaintiffs, each of whom would be represented by a lead plaintiff, according to whether their funds were deposited into: 1) segregated accounts; 2) escrow accounts; or 3) certain types of commingled accounts. (It should be noted that, although the term "classes and "class-action system" are used here, classes were not created under the class action certification criteria under Federal Rule of Bankruptcy Procedure 7023 and Federal Rule of Civil Procedure 23.) Those not selected as lead plaintiffs were enjoined from prosecuting their adversary proceeding until further order of the court, but could file briefings on common legal issues presented in the lead cases and were granted the right to view discovery.

The court ultimately issued a summary judgment ruling for the debtor in all of the lead plaintiff cases, finding the funds were property of the debtor's estate. The court then ordered mediation to reach a global settlement of all exchanger claims. Exchangers who were not lead plaintiffs were barred from participating in the mediation. Ultimately, the mediation led to a proposed Chapter 11 plan of liquidation which paid out the five classes of creditors based on the court's treatment of that class at the summary judgment stage. The plan was accepted by a majority vote of the creditors.

Procedural Strategy Considerations

The structure used in Land America does increase efficiency, but also poses undeniable risks to those creditors not named as lead plaintiffs. Because the virtual class system will likely be created early in the case, not all fact patterns or scenarios relevant to the ultimate determination of who owns the exchange funds can be anticipated. Indeed, in Land America, many adversary proceedings were filed after the scheduling order protocol was put in place. This could lead to an outcome that does not resolve all the unique exchanger claims and theories. The debtor and the court may also resist attempts to modify or customize the structure to account for issues unique to a relatively small number of exchangers out of concern for efficiency. The Land America case clearly shows that those creditors who are appointed lead plaintiffs retain a great deal more control and bargaining power that those whose cases are stayed or relegated to representative litigation. As demonstrated in Land America, this includes a seat at the negotiating table.

On the other hand, if an exchanger occupies a class with a strong lead plaintiff that can fund effective litigation of its rights, it can benefit from obtaining favorable treatment at no cost by monitoring the case and riding the coattails of a successful lead plaintiff. In Land America, many exchangers combined their resources, and ultimately their power to affect the case through lead plaintiff representation, by pooling together and employing the same counsel as other similarly situated plaintiffs. This led to appointment of the joint counsel as a lead plaintiff and a joint sharing of the litigation costs. Whatever the nature of a client's financial situation, counsel should consider their strategy to create and navigate a class structure in a way that will maximize their client's interests.

The Grunstead Adversary Proceeding

The court's role in balancing due process with efficiency becomes very important in a large QI bankruptcy. The debtor will resist any attempts to customize the class action structure established at the beginning of the case. If one exception to the class structure created at the outset of the case is made, debtors may argue, it will create a slippery slope in which every adversary plaintiff will find a reason to justify its own day in court. On the other hand, there must be limits to a court's ability to extinguish the claims of an individual adversary plaintiff in summary fashion. The lack of guidance provided in the Bankruptcy Code and the Bankruptcy Rules regarding the administration of a class-action type adversary proceeding structure only adds to importance of the court's balancing of these concerns.

An example of how efficiency concerns for the overall bankruptcy can clash with the due process rights of individual creditors is the Grunstead Adversary Proceeding in the Land America case. The Grunstead exchange agreement provided a unique factual pattern which was not contemplated when the original scheduling protocol was entered. Under § 1031 of the Tax Code and the Land America exchange agreement, when an exchanger fails to identify replacement property within 45 days of the closing of the sale on the original property, the exchange cannot be completed, the exchange agreement is terminated and the funds must be returned to the exchanger. For Grunstead, this termination date occurred 16 days prior to the filing of the petition by Land America. Because the exchange agreement was terminated prior to bankruptcy, Grunstead argued, the § 541 analysis was different than in the lead plaintiff cases, where the court analyzed the 541 issue within non-terminated, executory exchange agreements. Grunstead argued that the provisions of the exchange agreement providing for sole possession of the funds by Land America no longer applied in a terminated exchange scenario. Therefore, the exchange funds were imposed with a constructive trust in favor of the exchanger on the date of termination and could not be property of the debtor's estate. Grunstead did not file its adversary proceeding until the day the court's scheduling protocol was entered and, because of this timing, was precluded from arguing that terminated exchangers should be created as a sixth category of lead plaintiff.

Grunstead made several expensive attempts to modify the court's class-action structure and obtain a meaningful hearing. First, Grunstead filed two motions to modify the stay of its proceeding, one before the lead plaintiff summary judgment rulings and one after. Both were turned back by the court, on the reasoning that the lead plaintiff system adequately represented Grunstead and because allowing Grunstead to go forward would create a situation in which each exchanger would want its own day in court. Grunstead appealed to the district court, on due process and abuse of discretion grounds, arguing that unless it was allowed its day in court, the case would proceed to confirmation and its adversary claim would be extinguished. The district court denied Grunstead's appeal and held that the Bankruptcy Court's ruling was not an abuse of discretion because: 1) it was justified by the judicial economy concerns faced by the Court; and 2) the ruling that Grunstead was precluded from moving forward with its adversary proceeding was not final in its effect because Grunstead would be able to challenge the court's ruling a third time at the confirmation hearing.

Faced with these rebukes and the Bankruptcy Court's refusal to hear the merits of its adversary proceeding, Grunstead was left to object to the confirmation of the final plan. These constitutional objections were settled at the confirmation hearing itself, when the debtor and Grunstead agreed that the confirmation order provide that Grunstead be afforded a trial on the merits of its adversary proceeding. Grunstead was the only exchanger in the entire case to receive its own trial on the merits with funds set aside to cover any judgment in favor of Grunstead. Shortly before the trial date, the parties settled the issue of payment to Grunstead, and its claim was ordered to be paid out at an intermediate level, higher than the class it was assigned but lower than the class of exchangers whose funds were placed in a segregated account.

Conclusion

The Grunstead adversary proceeding highlights the difficult procedural and constitutional issues litigants may face in a large QI bankruptcy. The debtor and the court, in attempting to resolve a QI bankruptcy quickly and inexpensively so as to maximize exchanger recovery, must fashion a virtual class-action structure that provides for summary resolution of similarly situated claimants while still allowing the structure to account for, or be modified to account for, those cases which present unique legal or factual issues. In making these judgments, the court and debtor must also be wary to not to create exceptions to the lead plaintiff structure which have the effect of defeating its efficiency goals by allowing too much individual litigation. In other words, the lead plaintiff structure should be designed to allow those exchangers who would be denied due process a meaningful hearing but at the same time be crafted in such a way as to avoid opening the litigation floodgates to other exchangers whose fact patterns are not materially different from lead plaintiffs. Therefore, once a lead plaintiff system is established, the strategic considerations facing the debtor will be whether to oppose all attempts by non-lead plaintiffs to alter the lead plaintiff system, thereby exposing any final plan to constitutional challenge, or to modify the structure to settle out and allow individual litigation by exchangers with unique legal issues and fact patterns not covered by the original lead plaintiff structure.

On the other hand, exchanger counsel who are frozen out of the original lead plaintiff structure will be faced with balancing the possible benefits of challenging the lead plaintiff structure to obtain bargaining power and appropriate treatment for individual legal and factual issues against the cost of the challenge and the likelihood of obtaining different or better treatment than other exchangers in its class. The balancing of these issues in large QI bankruptcies should provide new and interesting developments in bankruptcy law and challenges to the lawyers involved for years to come.