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Caveat exchanger; A qualified intermediary's bankruptcy becomes a customer's nightmare

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**Chicago
Deferred
Exchange
Corp.**

In March of 2003, the U.S. Bankruptcy Court for the District of Minnesota held that exchange funds under the control of Nation-Wide Exchange Services, Inc., as Qualified Intermediary (QI), were subject to claims of Nation-Wide's creditors in bankruptcy.

As a result of this decision, the court ordered that all disbursements made by Nation-Wide during the 90 days preceding its bankruptcy filing be voided and returned to the bankruptcy trustee. In re: Nation-Wide Exchange Services, Inc., 291 B.R. 131: 2003 Bankr. Lexis 267; 91 A.F.T.R. 2d March 31, 2003.

As reported in court opinion, in November of 1999, Miller & Holmes, Inc. (M&H) commenced a like-kind exchange on property it owned in St. Paul, Minnesota. M&H hired Nation-Wide to act as its QI. Under the terms of their "Phase I Exchange Agreement," M&H assigned its rights in the contract for the sale of the Minne-

sota property to Nation-Wide. At closing, the sale proceeds were paid directly to Nation-Wide.

M&H also signed a contract to purchase replacement property in Wisconsin and entered into a second agreement with Nation-Wide: a "Warehousing or Construction Improvement Exchange Agreement." According to court opinion, the agreement specified that legal title to the Wisconsin property be transferred directly to Nation-Wide and that Nation-Wide hold the property until the construction of improvements was complete. At such time, or at the end of the 180-day exchange period, Nation-Wide would transfer the improved property to M&H as replacement property.

Nation-Wide was not obligated to maximize the return on the sale proceeds, but was required to give precedence to security and liquidity in its choice of investments. According to court opinion, the agreement specifically listed acceptable investment alternatives, including: certificates of deposit, cash management, working capital or money market accounts, banker's acceptance, or U.S. obligations. What Nation-Wide did with the sale proceeds is commingle the funds with its other customers' deposits in a brokerage account where it proceeded to execute short-

term "day trades." When Nation-Wide sustained losses in its investment account, it used more recent customer deposits to meet its obligations to acquire replacement property for customers who were approaching completion of their exchanges. Ultimately, Nation-Wide was unable to meet its obligation to acquire replacement property for transactions that were to be completed by the spring of 2000, and filed for bankruptcy under Chapter 7 which resulted in a liquidation of the business and its assets.

As recorded in court opinion, the bankruptcy trustee then successfully argued that payments made on behalf of M&H, in the 90 days preceding the filing, were preferential payments and should be voided. The payments referred to were payments made, with M&H's approval, for construction on the Wisconsin property. The three payments equaled more than 50% of the total value of the project.

The court ordered the payments be returned to the bankruptcy estate on the grounds that M&H's funds, which were not segregated into a separate account and were commingled with all of Nation-Wide's customers' funds, were not directly traceable to the sales proceeds of the Minnesota property. In addition, Nation-Wide's de facto

practice of commingling and diverting sales proceeds effectively converted the funds to Nation-Wide's property for purposes of bankruptcy law.

The court noted: "[Client] was a trusting exchanger. It is painful to observe this in hindsight, but greater prudence would have dictated inquiry into [Nation-Wide's] practices." **This case is a stark reminder that taxpayers should exercise the greatest discretion in choosing and hiring a Qualified Intermediary.**

Chicago Deferred Exchange Corp. (CDEC) sought a legal opinion in regard to the some of the bankruptcy issues which arose in this case. While every exchange transaction is unique, this opinion concluded that the use of a trust format and the consequent segregation of exchange proceeds would serve to protect our customers from the claims of the creditors of CDEC and LaSalle Bank National Association. Additionally we open separate accounts for each of our clients and LaSalle Bank carries a \$240,000,000 Banker's Blanket Bond. Proof of this insurance can be made available to our customers.

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