

Investors Still Ensnared in 1031 Exchange Facilitator Collapses

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Last spring, hundreds of individual property investors preparing to go to settlement on their half of 1031 tax exchange purchases or sales tried to contact their qualified intermediary in the deals only to find that the QI had suddenly closed shop and sought protection in the U.S. bankruptcy courts.

Two high-profile bankruptcy cases left investors with more than a quarter of a billion dollars in investments and deals in jeopardy and facing the prospect of stiff tax penalties. While only a handful of qualified intermediaries failed, the cases had a much wider impact, rupturing investor confidence and attracting added scrutiny on the 1031 exchange process, which had become enormously popular over the past several years.

As those cases wind their way through bankruptcy proceedings, many of the creditors directly involved in the cases are not showing much confidence in recouping the bulk of their losses.

The troubles first came to light in May when The 1031 Tax Group LLC, a Richmond, VA-based, privately held, consolidated group of 16 qualified intermediaries for deferred like-kind property exchanges, filed for chapter 11 reorganization in U.S. Bankruptcy Court for the Southern District of New York. The 1031 Tax Group was the largest of the cases and spanned investors across the country.

In total, creditors were owed nearly \$160 million in money, most of which was missing when the companies filed for protection.

Then in late August, 1031 Tax Group finalized their plan of reorganization a plan that is scheduled to come up for a bankruptcy court hearing in two weeks.

The plan proposes that unsecured creditors (of which there are about 340) would receive \$142 million. The money is to come from a loan to be made to Edward H. Okun, owner and sole "member" of The 1031 Tax Group and affiliates.

JPS Capital has agreed to arrange loans to Okun and his various companies up to \$300 million to fund the plan. The loan(s) would be secured by Okun's various real estate and personal assets. Okun, through various entities, controls 13 investment properties with an estimated value of more than \$162.5 million. He also controls four personal residences with an estimated value of about \$19.5 million. He also owns nearly 20 automobiles, including four Indy racecars, two Lamborghinis, a Bentley and a Rolls Royce three airplanes, a helicopter and eight boats.

While it all sounds good on paper, creditors have showed little confidence in the plan. In fact, some of those unsecured creditors that know the most about the bankruptcy proceedings have bailed on the plan.

In nearly every large bankruptcy case, the U.S. Trustee in the case appoints a small committee of unsecured creditors to represent all of the others in the case. In the case

of The 1031 Tax Group creditors committee, three of the original nine members resigned from the committee after disclosure of the reorganization plan.

Of those, two have sold their rights to any potential settlement at a discount to what they are owed.

Soix Realty Corp. of Astoria, NY, sold off its claim of \$3.9 million to Stonehill Institutional Partners of New York City.

Sierra Group PBT of New York sold off its nearly \$1 million claim to Hain Capital Holdings of Rutherford, NJ.

The remaining committee members have recommended the plan be approved.

Firms like Stonehill and Hain are investment firms that specialize in acquiring bankruptcy claims at a discount. They then profit when, and if, settlements in the cases are disbursed. Stonehill has acquired nearly \$11 million in claims in this case. Hain has acquired about \$1.6 million. A third firm, ASM Capital has acquired another \$780,000 in claims.

The reason for the sell off, according to buyers and sellers who requested anonymity, is that there are still a lot of uncertainties involving Okuns proposed settlement. For example, Okuns plan of reorganization has a proposed alternative or back up plan in place, should the JPM loan not go through.

Under the first scenario, unsecured creditors would recoup from 75% to 84% of their investment.

Under the back up plan, they would get only 52% to 66%. The back up plan would have Okun "implement the steps necessary to meet their obligations," which could include liquidation of some of his assets.

The only other alternative would be to liquidate all of the 1031 exchanges - an alternative that would leave creditors with just 9 to 10 cents on the dollar.

Given the uncertainties, some creditors seem to be questioning whether the plan will ever receive bankruptcy court approval, in part because of the uncertainty of what investors could actually receive. At the very least, some were expecting that the plan of reorganization could be amended.

In a second large 1013 exchange accommodator collapse, Southwest Exchange, based in Henderson, NV, was forced into liquidation this past spring owing investors about \$100 million. Various lawsuits involving the exchange allege that its ex-chairman, Donald McGhan, used investor escrow deposits to finance the expansion of his MediCor Ltd., a Las Vegas-based maker of breast implants, also now in bankruptcy.

The bankruptcy judge in the MediCor case ruled recently that MediCor could sell its European breast-implant business. Southwest Exchange clients claim that sale unfairly benefits the hedge funds that own most of MediCor's debt even though money from Southwest Exchange clients was used to finance MediCor.

Federal investigations began last spring on The 1031 Tax Group and Southwest Exchange entities involved in the bankruptcy cases. McGhan and Okun have repeatedly denied doing anything wrong with exchange funds.

While the courts struggle with restoring some of the creditors' money, the 1031 exchange industry has been struggling to restore some confidence in the 1031 exchange process.

When troubles hit last spring, critics were quick to seize the moment and point out the need for greater oversight to protect investors from what they see as a major flaw in the like-kind exchange system.

1031 qualified intermediaries while collecting, holding and investing hundreds of million dollars a year in escrow accounts, receive little government oversight.

Currently, only one state, Nevada, regulates 1031 exchange intermediaries. In August of this year, the Federation of Exchange Accommodators (FEA) submitted a petition to the Federal Trade Commission (FTC) to adopt a regulation that would apply the force of federal law to accepted industry standards and help protect investors who engage the services of exchange facilitators.

The FEA is the only national trade organization formed to represent the exchange facilitator industry. Members are holding their annual convention this week in Chicago.

"Until now, our industry has been able to self manage the high standards imposed upon ourselves, but recent experience shows that due to the actions of a few individuals, further measures need to be established in order to protect consumers," said Hugh Pollard, president of the FEA.

"We strongly support any additional consumer protections that can be put in place to establish trust and confidence between customers of 1031 Exchanges and their intermediaries," Pollard said. "This petition would place into federal law the principles of the FEAs own code of ethics, which holds exchange facilitators to a set of strict ethics expectations."

The petition calls for the FTC to adopt uniform nationwide rules that would require persons who want to act as exchange facilitators to register with the FTC impose standards to safeguard consumer funds entrusted to like-kind exchange facilitators and establish standards to demonstrate that a person has the appropriate level of competency to act as a facilitator. It would also require that a facilitator maintain certain specified levels of insurance, bonds, letters of credit, and/or deposits.

In a report two weeks ago, the U.S. Treasury Inspector General for Tax Administration also called for tougher oversight, particularly as it relates to the capital gains being

reported. The inspector general's report concluded that there appears to be little IRS oversight and the oversight that is there needs to be "more consistent and complete."

The IRS concurred with the report.

Meanwhile, other states have also begun to look into issues raised by the troubles, with legislators and regulators in at least California, Georgia, Idaho, Utah, and Washington all having begun to hold hearings or enact changes to various aspects of their tax laws.