

What You Should Know About...

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Swapping Properties: Helping Clients Succeed in a Down Market

Part One of A Two-Part Series

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Security of Funds with 1031s

How does an investment property owner determine if his or her funds will truly be secure during a 1031 Exchange? Currently, there are a few popular methods used by QIs to assure complete security. Each has advantages and drawbacks.

1) Segregated Accounts.

The first level of so-called protection is the establishment of segregated accounts. Instead of co-mingling exchange funds held by the QI, some QIs segregate client funds in separate bank accounts. Touted as the ultimate protection, security of funds in segregated accounts is an illusion. Regardless of FDIC protection, segregated accounts do not receive any protection from QI failure, dishonesty or bankruptcy. If a QI files for bankruptcy, each deposit holder in the midst of 1031 Exchanges with that QI is classified as an unsecured creditor under the U.S. Bankruptcy Code. That is the very bottom rung of priority on the ladder of payouts from the Bankruptcy Trustee. In cases of bankruptcy, unsecured creditors typically receive pennies on the dollar of lost sale proceeds. Indeed, one QI that recently filed for bankruptcy had segregated accounts that did not preserve the investment property sale proceeds (exchange funds) after the bankruptcy filing.

2) FDIC Insurance.

FDIC Insurance - capped at \$100,000 - is also publicized as a source of protection for exchange funds. Though FDIC raised insurance limits in April, 2006, the new cap applies only to certain types of accounts such as traditional accounts, Roth IRAs and self-directed Keoghs - but not 1031 exchange funds. Also, the \$100,000 insurance coverage provided is per depositor. Most QIs will title accounts in their own name to meet federal rules that restrict investment property owners from having access to exchange funds. Thus, in cases of malfeasance or bankruptcy, the \$100,000 insurance provided by FDIC is shared equally by all for whom the QI is holding exchange funds at the time that the QI failed to perform. Moreover, there is no

guarantee that a QI actually deposits funds from its 1031 exchanges in a bank. A few QIs have invested exchange funds in risky stocks, derivatives, hedge funds or any other unregulated, uninsured investment vehicles without their clients' knowledge.

3) Too Big to Fail?

The next level of protection for the investment property owner doing a 1031 Exchange is to choose a large QI unlikely to file for bankruptcy. Unfortunately, recent failures of mega companies such as Worldcom, Enron, Barings Bank and similar financial miscreants have shaken the public's confidence in such giant enterprises. While some may believe that regulated industries afford a higher level of protection, the S&L crisis of the 1980s revealed a wave of savings and loan institution failures costing taxpayers and depositors approximately \$150 billion.

4) Strong Current Ratio.

More important than the sheer size of the company is the company's liquidity — the actual amount of cash on the company's balance sheet. That should be compared to its current liabilities to then determine the company's current ratio. A current ratio indicating the company can weather at least six months of expenses before running out of cash is good evidence that exchange funds are fairly safe (especially since 1031 Exchanges must be completed within 180 days).

5) Bonding and Insurance.

The ultimate protection for 1031 exchange proceeds is to use a QI that is bonded and insured. In assessing the bonding or insurance limits of a QI, there are two important considerations: the amount of the bond or insurance and whether the coverage limits are aggregate or per occurrence. Aggregate bonding or insurance refers to the total amount of coverage for which the insured (the QI) is covered by the policy. For example, if a QI has an aggregate insurance policy for \$1,000,000, it means the maximum that the insurance company will cover is \$1,000,000 in total losses, regardless of how many clients are involved or how much each client has lost.

6) The Gold Standard.

The best coverage a QI can have is a large per occurrence policy. Per occurrence coverage provides bonding up to the amount identified for each client in the midst of a 1031 exchange. Using the prior example, a \$1,000,000 per occurrence policy means the QI has \$1,000,000 of protection from loss for each client in the midst of a 1031 exchange. Not many QIs can afford large per occurrence bonds, as the auditing and investigation process is extremely strict. Even with such safeguards in place, the coverage is still quite expensive. Only the very safest QIs provide a very large per occurrence policy for each 1031 exchange.

A down market gives a potential buyer plenty of time to shop for the perfect investment — a luxury rarely available in a bull market. For many clients, the option to swap is one that they may not have considered. Real estate professionals should help clients understand that holding may not necessarily be their best choice in a down market. Sometimes swapping their property for a better one is the best way to help clients minimize risk and maximize return. ▲

About Claudia Kiernan and Stephen A. Wayner

Claudia Kiernan, Esq. is the Southeastern Development Manager for Bayview 1031 and an attorney with more than 10 years real estate industry experience. She is a member of both the New York and Florida Bar Associations and is active with the North-east Florida Association of Realtors, Commercial Real Estate for Women, Women's Council of Realtors, Amelia Island - Nassau County Association of Realtors, St. Augustine & St. John's County Board of Realtors, Jacksonville Bar Association, Jacksonville Chamber of Commerce and the St. John's County Chamber of Commerce. She can be reached at (904) 806-0113 or claudiakiernan@bayview1031.com.

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