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NEW RESTRICTIONS ON CREDITORS' RIGHTS EXCLUSIONS IN TITLE INSURANCE POLICIES

Anyone who obtains title insurance, whether as an owner or a lender, should be aware of a recent abrupt and significant change in title insurance practices across the country. Title companies have recently stated that they will no longer delete creditors' rights exclusions from, or add affirmative creditors' rights coverage as an endorsement to, any of their issued title policies. In fact, the American Land Title Association (ALTA) voted to withdraw the ALTA Endorsements 21 and 21/06 as official forms, effective March 8, 2010, and the California Land Title Association ("CLTA") voted on February 4, 2010, to decertify the CLTA 131 and 131-06, its counterparts to the ALTA 21 and 21/06.

Title insurance policies provide coverage for loss or damage incurred by the insured that result in a complete or partial failure of the insured's title to real property or, in the case of a lender, the invalidity or unenforceability of a mortgage lien on real property. Title policies also contain various exclusions from coverage; one of those exclusions is referred to as the "creditors' rights exclusion." This exclusion removes from coverage loss or damage arising by reason of any claim, which arises out of the transaction creating the interest of the insured lender or owner under the policy, by reason of the operation of federal bankruptcy, state insolvency, or similar creditors' rights laws, that are based on (1) fraudulent transfers or conveyances under state law or the Bankruptcy Code; (2) preferential transfers under the Bankruptcy Code; and (3) equitable subordination under Bankruptcy Courts' general equitable powers.

Concerns regarding creditors' rights arose in the early 1990s as a result of the use of "out-of-the-box" financing techniques and later loan workout techniques that arose when the real estate market softened. Many title companies took the position that the earlier policies, particularly the 1970 policies that were silent on the issue of creditors' rights, did not cover creditors' rights risks arising in the insured transaction. Title companies decided to clarify the issue and added an exclusion to the 1990 title insurance policies for losses resulting from preferential and fraudulent transfers. In 1992, after protests from the lending industry, the title industry modified the exclusion to except from the creditors' rights exclusion challenges that were based on the failure of the title company to timely record the insured document or the failure of the document to impart constructive notice to a purchaser for value or a judgment or lien creditor. Given the consensus in the lending industry that creditors' rights coverage was one of the most important coverages in a lender's policy, many lenders refused to accept the 1990 or 1992 policies, incorrectly assuming that silence on the issue means that it is a covered matter, and required the issuance of the 1970 lender's policy that did not contain a creditors' rights exclusion. The recent collapse of the real estate market, actions of rating bureaus, lack of access to excess reinsurance for these risks, and recent bankruptcy court decisions have caused the title industry to withdraw earlier concessions to lenders, to henceforth refuse to modify any exclusions to coverage for creditors' rights in the 1992 policies, and to advise the lending industry that all 1970 policies must include an exception for creditors' rights claims.

As a result of these industry-wide changes, a creditors' rights exclusion will now appear in all title policies, requiring lenders and owners to evaluate carefully the risks presented by fraudulent transfer and preference laws, and the doctrine of equitable subordination.

First, a transfer of an interest in real estate (including a grant of a lien under a mortgage) may be avoided as fraudulent for up to four years after the transfer, if (a) the transferor or borrower was insolvent at the time of, or as a result of the transaction; and (b) the transfer was for less than reasonably equivalent value received by the transferor. The analysis here will be a strict economic valuation of the extent to which the transfer left the transferor's balance sheet in no worse position than it was before the transfer. The focus is on the amount of value received by the transferor compared to the value of the property that it transferred.

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Second, a debtor's transfer of an ownership or security interest in property may be avoided as a preference if it was made to a pre-existing creditor of the debtor-transferor, on account of a pre-existing debt owed to that creditor, and made within 90 days before the debtor's bankruptcy in most circumstances, or within one year of the debtor's bankruptcy if the creditor was an insider or affiliate of the debtor. Here, the inquiry is purely on the timing of the debtor's transfer, and whether the transfer was on account of pre-existing debt owed to a creditor, or on account of "new value" provided to the debtor by the creditor. Since "new value" does not include an obligation substituted for an existing obligation between the parties, a refinance by a new lender will likely constitute new value, while an existing lender's acceptance of new collateral to restructure prior debt presents preference risks.

Third, a claim or lien may be equitably subordinated if a court, in the exercise of its equitable jurisdiction, deems that a party took unfair advantage of the debtor-transferor and other creditors. Generally, the standard for "inequitable conduct" sufficient to subordinate a creditor's claim or interest (including a lien) is lower the greater the insider relationship between the creditor and debtor. Here, the focus will be on the relationship between the debtor and creditor, and whether the creditor used its position to unfairly benefit itself, to the detriment of the debtor and other creditors. These types of cases are extremely fact-intensive, and it is difficult to predict how a court will exercise its view of what is "equitable" in a given situation.

When should a lender or owner be concerned about potential creditors' rights claims? Though not intended to be exhaustive, the following situations are just a few of those that present risks to a creditors' rights claim:

- Whenever a lender forecloses on its lien or accepts a deed in lieu of foreclosure;
- Whenever there is a potential distressed sale or other transfer of an interest or lien in property for less than reasonably equivalent value being given in exchange to the seller or borrower;
- Whenever mortgage funds are being used for any purpose other than the purchase of the encumbered real estate, such as to acquire the stock of another company (leveraged buy out), to make distributions to an insider, partner or affiliate or to pay the debt of an entity other than the borrower;
- Whenever mortgaging a debtor's property on account of antecedent debt owed to the lender or another creditor; or
- Whenever a mortgage is used to support an upstream (parent support) or cross-stream (affiliate support) guaranty.

While owners and lenders can no longer look to title insurance companies to cover the risk of a creditors' rights issue, these risks can be managed practically. Internally and through the assistance of experienced legal counsel, owners and lenders can conduct the same due diligence that title companies have traditionally conducted to evaluate potential risks from creditors' rights claims. The real estate and creditors' rights lawyers at Holme Roberts & Owen LLP who are listed on this Alert are experienced in analyzing the issues presented by potential creditors' rights claims in a wide variety of scenarios. They work with clients to manage those risks practically and effectively, and enable clients to achieve their business goals. Please contact any of these lawyers to discuss your particular situation or any questions about this Alert.

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