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Real Estate Workout Advisory

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To Contact the Distressed Real Estate Group:

Mark S. Edelstein (Chair)
212.468.8273

Brett H. Miller (Co-Chair)
212.468.8051

James E. Hough (Co-Chair)
212.468.8158

Media inquiries contact:

PR@mofo.com

What Does The Withdrawal Of Creditors' Rights Protection Under Title Insurance Policies Mean?

Lenders will no longer be able to acquire the customary "creditors' rights protections" under ALTA Endorsements 21 and 21-06 for their title insurance. We have received numerous inquiries about this title insurance change and thought it would make sense to provide a brief summary of where things stand as of today.

The American Land Title Association ("ALTA"), the trade association for the title insurance industry, voted to "de-certify," effective as of March 8, 2010, the creditors' rights endorsements for its form title insurance policies. The endorsements were designed to provide affirmative coverage for losses sustained through a finding of fraudulent transfer, preference or equitable subordination claims under federal bankruptcy, state insolvency, or similar creditors' rights laws. While each title insurer remains free to continue issuing creditors' rights coverage,[1] most of the major title companies (including First American Title Insurance Company and Fidelity National Title) have announced that they will no long offer creditors' rights coverage.[2]

These developments remove an important form of protection for lenders in many states[3] against certain bankruptcy-related risks associated with real property-secured loans. They also provide a reminder of the need for careful consideration of potential fraudulent transfer, preference and equitable subordination risks in making, modifying and acting under real property loans, possibly including a complete loss of a lender's lien on the underlying real property.

The Potential Risk Is Significant

Because under certain circumstances a creditor or trustee may be able to set aside elements of a loan or loan modification transaction (such as the granting of collateral or security interests), the losses can be significant to a lender. There are a number of provisions of federal bankruptcy (and state fraudulent transfer) law which may be used to attack a real property lender's lien, including:

- Section 510(c) of the Bankruptcy Code, which permits the bankruptcy court to "equitably" subordinate the claim of one creditor, including such creditor's lien, to the claims of other creditors.
- Section 548 of the Bankruptcy Code, which allows the bankruptcy court to set aside certain transfers (e.g., if made within two years – or longer in some states – before the petition date), such as a lien, if the court finds an actual intent to hinder, delay or defraud other creditors, or in the absence of such intent, if the court determines that the debtor did not receive "reasonably equivalent value" and the debtor (a) was insolvent at the time of the transfer, (b) was engaged in a business

1 A number of state title insurance regulators, including those in Pennsylvania, New Jersey and Oregon have taken steps to disapprove the issuance of creditors' rights endorsements in future policies, with many ALTA members reeling under the weight of significantly increased volumes of claims.
2 The California Land Title Association, which is an analog to the ALTA on the state level in California that promulgates forms of policies and endorsements for its members, de-certified its Endorsement Forms 131 and 131-06 on February 4, 2010.
3 Affirmative creditors' rights coverage has not recently been available in some major markets, including Florida, New York and Texas, where insurance regulators prohibited title companies from offering such coverage.

for which the debtor's remaining assets provided unreasonably small capital or (c) intended to incur debts which were beyond its ability to pay.

- Section 544, empowering trustees in bankruptcy to use state fraudulent transfer laws, such as the Uniform Fraudulent Transfer Act, which has been adopted by the vast majority of states and provides for the voidability of certain transfers that are deemed fraudulent as to present and/or future creditors on a basis similar to Section 548.

- Section 547 of the Bankruptcy Code, which establishes an avoidable preference when an insolvent debtor transfers an interest in its property (including granting a lien) to or for the benefit of a creditor on account of an "antecedent debt," which transfer was made while the debtor was insolvent and occurs 90 days or less (or one year in the case of transfers to insiders) before the filing of a bankruptcy petition by or against the debtor and which allows the creditor to receive more than it would be entitled to receive in a Chapter 7 liquidation of the debtor.

Fraudulent transfer, preference and equitable subordination concerns can arise not only in connection with the origination of a real property loan, but also in the context of a loan modification, where the nature of the lender's lien is being modified (e.g., new or different collateral is being given or a loan paydown is being made). For an example of the potentially draconian effect of the application of the avoidance powers of the bankruptcy court, see our recent Real Estate Workout Advisory, *How to Avoid a Fraudulent Transfer Finding: What the In re Tousa, Inc. Fraudulent Transfer Decision Teaches About Savings Clauses, Solvency Opinions and Due Diligence.*

<u>Title Insurance as a Mitigant</u>

As a general matter, a title insurance policy provides two types of protection: first, the insurer agrees to defend the insured against claims that are covered by the policy; and, second, the insurer agrees to indemnify the insured against losses arising from such claims. In the context of creditors' rights claims, both the cost defending such claims and the possible losses associated with such claims – i.e., a total loss of the lender's lien – are potentially significant. Accordingly, title coverage or such claims can provide an important benefit to lenders. Such insurance also is important when the original lender wishes to sell its loan after a default to claims traders.

Historically, the ALTA forms of title insurance policies have not provided coverage for creditors' rights claims arising out the insured transaction itself (e.g., the creation or modification of the insured mortgage). The 1970 ALTA form policies do not contain any express coverage, nor do they contain any express exclusion, for such claims.[4] The 1990 and 1992 ALTA forms policies contain express exclusions for creditors' rights claims (other than, in the case of the 1992 form, for such claims arising from the title company's failure to timely record documents), although title companies sometimes negotiated special affirmative coverage outside of the policies to cover such risks. The 2006 ALTA form policy is the first ALTA form policy to provide affirmative coverage for creditors' rights claims. However, the coverage under this policy is limited to claims arising from events occurring *prior to the date of the policy* (i.e., for fraudulent or preferential transfers occurring prior to the transaction creating the lien of the insured lender). The 2006 form policy thus continues the tradition of excluding, in the preprinted exclusions, coverage for creditors' rights claims arising from the insured transaction itself.

In response to demands for affirmative coverage associated with creditors' rights claims, the ALTA promulgated its form Endorsement 21 in 2004. This endorsement insures, among other things: "against loss or damage sustained by the insured by reason of the avoidance in whole or in part, or a court order providing some other remedy, based on the voidability of any estate, interest, or mortgage shown in Schedule A because of the occurrence on or before Date of Policy of a fraudulent transfer or a preference under federal bankruptcy, state insolvency or similar creditors' rights laws."[5]

It has become standard practice in most commercial loan transactions for lenders to request the title insurer delete by endorsement the preprinted exclusion for creditors' rights and/or issue a creditors' rights endorsement, such as the ALTA Endorsement 21 or 21-06 or other negotiated forms.

Title insurers who agreed to such requests assumed the risk of insuring not only insured losses from successful

4 It is an unsettled question whether policies issued on these forms actually provide affirmative coverage for such claims. Arguably, creditors' rights claims would be covered by the insuring clauses which provide coverage for "defects" in the insured title; however, title companies have taken the position that such coverage was excluded based upon other preprinted exclusions in the policy "jacket," including exclusions for matters known to the insured and not known to the insurer or disclosed in the public records and for matters attaching or created subsequent to the date of the policy. See Chicago Title Insurance Company v. Citizens and Southern National Bank, 821 F. Supp. 1492 (N.D. Ga. 1993), aff'd sub nom Chicago Title Ins. Co. v. Nationsbank, 20 F.23 1175 (11th Cir. 1994) (observing that the absence of a specific exclusion or exception for creditors' rights claims does not create affirmative coverage under the policy).

5 The ALTA endorsement also provides that the insurer will pay the "costs, attorneys' fees and expenses necessary to defend the insured against those counts, and no others, of any litigation seeking a court order which will result in loss or damage against which [the] endorsement provides insurance to the extent provided in the [preprinted Conditions and Stipulations governing the policy]." The endorsement "does not insure against loss or damage if the insured: (a) knew when it acquired any estate, interest, or mortgage shown in Schedule A that the transfer, conveyance, or mortgage was intended to hinder, delay, or defraud any creditor; or (b) is found by a court not to be a transferee or purchaser in good faith."

creditors' rights claims, but also the obligation to defend such claims. As a result, the title insurers were required to underwrite the risk that creditors' rights claims would be asserted. This required the title insurers to review the financial attributes of the underlying transaction, including values ascribed to the mortgaged property, the solvency of the mortgagor and any seller, and the existence of other creditors of the mortgagor (including any other mortgagees), as well as assess the risk that parties involved in the transaction or with the mortgagor might bring creditors' rights claims. Title insurers often required affidavits from the mortgagor and/or other related parties and, in some cases, indemnity agreements from creditworthy affiliates.

Effect on Lenders

The withdrawal of creditors' rights coverage by title insurers has removed a significant risk mitigation device for lenders in those States where such coverage was formerly available. Prudent lenders have always been attuned to potential creditors' rights claims. Going forward, however, without the backstop of this extra insurance coverage, lenders will need to be more mindful than ever of the potential creditors' rights risks interest in their deals, and encouraged to perform needed financial and legal diligence, both in the context of new financings and also in the context of workouts and restructurings. Lenders will, among other things, be reminded to focus on reviewing financial statements and other evidence of the mortgagor's solvency, and the existence of other debt (and, hence, other creditors), as well as on obtaining evidence, such as an appraisals and the like, on the value of collateral. In the context of a workout, particularly where new collateral is obtained, lenders will want to be satisfied that the mortgagor is receiving reasonably equivalent value in exchange for such new collateral. Lenders should also work with their counsel to structure appropriate representations and other provisions in their loan documents to help address the various creditors' rights issues. They also will want to give greater consideration to obtaining appropriate credit support from creditworthy parents (including appropriately designed "springing recourse" guaranties associated with a bankruptcy of the mortgagor and, in some cases, partial or full payment guaranties). See our Client Real Estate Workout Advisory, *Bad Boy Guaranty Update – Lenders on a Winning Streak.*

While the good faith of the lender may not save it from preference liability under Bankruptcy Code Section 547, evidence of the debtor's solvency can provide defensive support. The lender's good faith also can be important in the defense of fraudulent-transfer claims under Sections 544 or 548, or under state law. Such defensive documentation can be important in achieving protections for lenders.

We will continue to keep you abreast of developments with respect to title insurance coverage for creditors' rights claims. In the meantime, please contact our Distressed Real Estate Group with any questions you may have regarding such insurance or about creditors' rights concerns in general.

SENIOR DISTRESSED REAL ESTATE GROUP MEMBERS

Real Estate

Peter Aitelli (San Francisco)
415.268.7085

Derek Boswell (San Francisco)
415.268.6442

Christopher S. Delson (New York)
212.468.8060

Craig B. Etlin (San Francisco)
415.268.7456

Thomas R. Fileti (Los Angeles)
213.892.5276

Philip J. Levine (Palo Alto)
650.813.5613

Frederick Z. Lodge (Denver)
303.592.2290

John J. McCarthy (New York)
212.468.8241

Scott A. McPhee (Los Angeles)
213.892.5473

Jeffrey J. Temple (New York)
212.468.8031

Andrew J. Weiner (New York)
212.468.8122

Marc D. Young (Los Angeles)
213.892.5659

Bankruptcy

Alexandra S. Barrage (Washington, DC)
202.887.1552

G. Larry Engel (San Francisco)
415.268.6927

Todd M. Goren (New York)
212.336.4325

Melissa A. Hager (New York)
212.336.4324

Gary S. Lee (New York)
212.468.8042

Adam A. Lewis (San Francisco)
415.268.7232

Lorenzo Marinuzzi (New York)
212.506.7365

Larren M. Nashelsky (New York)
212.506.7365

Vincent J. Novak (San Francisco)
415.268.7340

Karen Ostad (New York)
212.468.8041

Norman S. Rosenbaum (New York)
212.506.7341

Kathleen E. Schaaf (New York)
212.336.4065

Litigation

David B. Babbe (Los Angeles)
213.892.5549

John P. Corrado (Washington, DC)
202.887.1525

Gregory P. Dresser (San Francisco)
415.268.6396

Stefan W. Engelhardt (New York)
212.468.8165

Wendy M. Garbers (San Francisco)
415.268.6664

Douglas L. Hendricks (San Francisco)
415.268.7037

Steven M. Kaufmann (Denver)
303.592.2236

Charles L. Kerr (New York)
212.468.8043

Gregory B. Koltun (Los Angeles)
213.892.5551

Jamie A. Levitt (New York)
212.468.8203

Rachel M. Wertheimer (New York)
212.506.7306

Mark C. Zebrowski (San Diego)
858.720.5162