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Title Insurance Industry Reacts to Recession: Creditors' Rights Endorsements Decertified by ALTA and Generally Unavailable

The title insurance industry has for all practical purposes eliminated an important layer of coverage provided by both owner's and lender's title insurance policies. This coverage, embodied in what is called the "creditors' rights endorsement," protected real estate owners and lenders from risks that would customarily arise when either the party from whom the insured owner purchased the property, or the mortgagor who granted the insured lender a mortgage, files for bankruptcy. Real estate purchasers and lenders will have to evaluate these bankruptcy risks themselves rather than relying on the title insurer to do it for them. Below is a discussion of what this means to the real estate industry.

The current (2006) American Land Title Association ("ALTA") form of loan policy of title insurance, which is in general use by title insurers throughout the United States, excludes from coverage the following (collectively, "Creditors' Rights"):

Any claim, by reason of the operation of federal bankruptcy, state insolvency, or similar creditors' rights laws, that the transaction creating the lien of the insured mortgage, is:

- i) a fraudulent conveyance or fraudulent transfer, or
- ii) a preferential transfer for any reason not stated in Covered Risk 13(b) of this Policy.

(Covered Risk 13 (b) covers loss arising out of Creditors' Rights by reason of a failure to timely record the instrument creating the estate or lien, or a defect in that instrument resulting in failure to impart record notice.)

There is a similar exclusion in the ALTA form of owner's policy of title insurance. California has its own forms that are prescribed by the California Land Title Association and which tend to mirror the ALTA forms.

The purpose of this exclusion is to isolate the title insurer from liability under the title policy in the event that the acquisition of the subject property (as to an owner's policy) or the encumbering of the subject property by a mortgage, deed of trust or equivalent (as to a loan policy) by the insured is challenged by a creditor of the transferor or by a trustee in bankruptcy on the basis of the fraudulent conveyance provisions of Section 548 of the United States Bankruptcy Code (the "Code") or substantively equivalent state laws, or on the basis of the preferential transfer provisions of Section 547 of the Code.

In addition to transfers made with an intent to defraud a creditor, fraudulent transfers under the Code include transfers for less than “reasonably equivalent value” *and* in which the party transferring the property is insolvent, illiquid, or undercapitalized. If a creditor successfully asserts that a transaction is a fraudulent transfer under the Code, that transfer can be voided and the property that was fraudulently transferred, or its value, can be recovered from the transferee for the benefit of the bankrupt’s estate. Transferees are afforded protection if the property interest was acquired for value and in good faith, but the transferee would have to establish those facts in bankruptcy court.

Therefore, if a purchaser acquires fee simple to a shopping center for a price that is drastically under market, and is aware that the seller will be insolvent after the transfer, then other creditors of the shopping center seller could force the seller into bankruptcy, attack the sale as a fraudulent transfer, and seek to recover from the purchaser the difference between the price paid and the market value of the center.

A preference under Section 547 of the Code includes a transfer of an interest in property to secure an antecedent debt made while the debtor was insolvent and within 90 days before the date of the filing of the bankruptcy petition. Lenders in the current environment are scrambling to get better secured. Let’s say a lender made a \$5,000,000 loan to an office building owner secured by a deed of trust on the building. Suspecting that the value of the property has declined, the lender obtains an appraisal, which shows that the property is now worth only \$1,500,000. This breaches a loan covenant, and the lender notifies the borrower of that fact. The borrower responds that she owns a beach house worth \$3,000,000 that is unencumbered. She offers to give a mortgage on that house to secure the \$5,000,000 loan, and the lender accepts. Within 90 days she declares bankruptcy. The lender’s mortgage on the beach house can likely be set aside as a preference.

Purchasers and lenders have been able to obtain coverage over Creditors’ Rights (except in New York, Texas and New Mexico), either by obtaining title insurance in the form of the 1970 (revised 1984) ALTA policies (which do not exclude Creditors’

Rights from coverage), deleting the Creditors’ Rights exclusion by endorsement, or obtaining a “creditor’s rights endorsement” (which ALTA adopted as ALTA Endorsements 21 and 21-06, and which CLTA adopted as CLTA 131 and 131-06) that results in insurance protection from the assertion of these Creditors’ Rights. In order to obtain such coverage, title insurers have had to separately underwrite the risk that Creditors’ Rights would be asserted and have customarily required the submission by the parties to the transaction of a “creditors’ rights affidavit” and financial information regarding both the subject property and the transferor under the deed or mortgage to be insured. In many states, an additional premium has been charged for this coverage. Given the considerable benefits conferred by Creditors’ Rights coverage, its issuance has become fairly standard for commercial real estate transactions, and the creditors’ rights endorsement has long been a staple on the menu of endorsements required by lenders. If the shopping center owner in the first example above had an owner’s policy with Creditors’ Rights coverage, it could have made a claim on its owner’s policy for the loss suffered. If the lender taking the beach house as additional collateral had a loan policy with Creditors’ Rights coverage, she could likewise make a claim for loss arising out of the avoidance of the lien of the mortgage, subject to the other terms of the policy.

The recent turmoil in the commercial real estate markets has led to the challenge, particularly in the context of a bankruptcy, of sales and mortgages as either fraudulent conveyances or preferential transfers. Where the subject transaction has involved the issuance of a title insurance policy with Creditors’ Rights coverage, the insured has tendered the defense of these claims to the title insurer. This in turn has led to considerable exposure to the title insurance industry, both for the costs of litigation and ultimately for the full amount of insurance under the applicable title insurance policies.

The magnitude of this exposure has led to the recent announcement by ALTA that it has voted to withdraw or decertify the ALTA Endorsements 21 and 21-06 as official ALTA forms effective March 8, 2010. ALTA has confirmed that title insurers may decide on their own whether to issue coverage over Creditors’ Rights and what form of

endorsement to use, but as of March 8 there will be no current ALTA approved form.

Recently, the states of New Jersey, Pennsylvania, Delaware and Oregon (which are states that require the approval of endorsement forms issued by title insurers writing policies in their respective jurisdictions) have taken the same step.

Pennsylvania's action took effect February 1, 2010; the effective date in the other states awaits final administrative action. Effective February 4, CLTA decertified CLTA 131 and 131-06. The result is that creditors' rights endorsements are no longer available in these states.

As might be expected, the Fidelity National Title group of underwriters, which includes Chicago Title, Fidelity National Title, Ticor Title, Lawyers Title, Commonwealth Land Title, Security Union Title and Alamo Title, announced on February 4, 2010 that effective as of that date, Creditors' Rights coverage will no longer be offered. In addition, First American Title Insurance Company announced on February 8, 2010 that it too will no longer provide Creditors' Rights coverage. First American cites "the economic impact of our current market cycle, actions of rating bureaus, recent Bankruptcy Court decisions and a lack of availability of excess reinsurance for these risks." While some title insurers may be willing to continue to issue coverage over Creditors' Rights, the more

reasonable expectation is that all title insurers will follow suit.

Where does this leave purchasers and lenders who have become accustomed to Creditors' Rights coverage? The burden of underwriting the risk of a fraudulent transfer or preference has been shifted from the title insurers to their insureds. Lenders purchasing owner's policies for property purchased out of a foreclosure or by deed in lieu must be careful to calculate any bid or relief of indebtedness to approximate the fair market value of the property. Lenders will need to pay even closer attention to the value of their collateral and the financial strength of their borrowers. Borrowers must negotiate any requirement for creditors' rights coverage out of their loan commitments. Purchasers will likewise need to be alert to sales for less than value and sellers in financial distress. Doing so is particularly difficult in the current environment of declining values and general financial instability.

There is likely little comfort in knowing that purchasers and lenders nationwide will now be treated the same as their counterparts in New York, Texas and New Mexico. In any event, just as these counterparts, they will have to rely on their own analyses of the fraudulent conveyance and preference risks inherent in their transactions, price them accordingly and act at their own, and not the title insurers', risk.

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