

UNINSURED, BUT NOT UNINFORMED; EXCLUSION OF CREDITORS' RIGHTS TITLE INSURANCE COVERAGE

Recently, the American Land Title Association (ALTA) voted to withdraw the ALTA Endorsements 21 and 21/06, effective March 8, 2010 (and the California Land Title Association (CLTA) voted on February 4, 2010 to decertify state counterparts CLTA 131 and 131-06). This coincides with the position of many title companies that they will no longer delete creditors' rights exclusions from new title policies nor add creditors' rights endorsements to existing policies. We wanted to bring this significant development to your attention, as it has already delayed and/or prevented the closing of a number of real estate transactions, and may affect the risk management and mitigation strategies of parties entering into future transactions requiring the issuance or continuation of title insurance.

As background, in the early 1990s, concerns about risks and potential losses relating to loan restructurings and bankruptcies in the then very depressed real estate market led title companies to add an exclusion to the 1990 form policy for losses resulting from a bankruptcy court determination that (i) the transfer of property to a purchaser (insured under an owner's title policy) constitutes a fraudulent conveyance or (ii) the grant of a mortgage to a lender (insured under a lender's title policy) constitutes a fraudulent conveyance or preferential transfer. Under applicable bankruptcy and insolvency laws, a "fraudulent conveyance" consists of a transfer made either with the intent of defrauding creditors or for less than "reasonably equivalent value" while the transferor was insolvent. A "preference" under Section 547 of the Bankruptcy Code consists of a payment or transfer to a creditor in respect of an antecedent debt made within 90 days before the date of the filing of the bankruptcy petition that favors such creditor as compared to other creditors. Such a determination, therefore, could result in the voiding of such conveyance or grant, or recovery of the value thereof for the benefit of the bankrupt's estate.

The environment of the 1990s is obviously strikingly similar to our current fiscal crisis. In this severe real estate down cycle, it is commonplace for a creditor in a workout context to ask a weakened borrower for additional collateral to secure its existing (antecedent) indebtedness to such creditor. Also, it is now commonplace for opportunistic investors to actively seek distressed real estate investment opportunities in which a potentially insolvent borrower sells property or a loan seller agrees to transfer assets for a relatively low price that may or may not be "reasonably equivalent value". Such transactions, therefore, present a risk that they will be determined to constitute avoidable transfers if, following such grant of additional collateral or asset transfer, such borrower or seller becomes (voluntarily or involuntarily) a debtor in a bankruptcy proceeding.

In 1992, acceding to heavy pressure from dissatisfied lenders, title companies offered policy endorsements to modify the exclusion, and thereby provide coverage against certain creditors' rights claims. Today, however, in the midst of one of the worst real estate markets on record, debtor insolvencies are widespread and there is a heightened risk of challenges to workouts and sale transactions in bankruptcy proceedings. In the face of significant losses stemming from having issued endorsement coverage in a few high profile transactions, the title companies have recognized that they are not in the business of underwriting credit risk. Consequently, the title industry has decided it will no longer modify the exclusion, and that all title policies will now include the unmodified creditors' rights exclusion.

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In light of this decision, lenders and buyers of distressed debt will need to perform more thorough due diligence in order to better assess the risks of structuring transactions that could be subject to attack under applicable fraudulent conveyance and preferential transfer laws when entering into real estate purchase and financing transactions. Additionally, borrowers will be forced to address changing expectations of their lenders, as both parties seek to come up with new structures and solutions to address the title companies' shift in policies.

For more information regarding this development, including possible strategies in response, please feel free to contact :

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