Solving the Creditors' Rights Quagmire

An argument for the nationwide prohibition of creditors' rights coverage.

A decade ago, title insurance underwriters might have agreed on what constitutes a reasonable creditor's rights underwriting risk. That is not the case today. The recent sharp rise in fraudulent conveyance actions brought by unsecured creditors has exposed the uncertainty and risks inherent in creditors' rights coverage.

Previously, title insurers comfortably underwrote creditors' rights coverage, a form of title insurance that protects lenders from the invalidation of liens under federal or state fraudulent conveyance actions. During the heady days when credit was plentiful, and the real estate market was rosy, creditors' rights coverage was all but a condition of closing for commercial lenders. >>

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But in 2007 when the real estate market crashed, multi-million dollar loan deals collapsed. Lenders whose secured-loan collateral was now vulnerable to impairment under fraudulent conveyance laws immediately sought refuge under the coverage of creditors' rights protection provided by title insurers.

When major creditors' rights claims began to appear, title insurers took notice. But it wasn't until 2010, in the wake of the Tousa decision — and after the claims arising from the leveraged deals of 2007 had run their course — that the title insurance industry took action.

Recent Developments

The title insurance industry has taken the following action regarding creditors' rights:

1. Prior to 2010, four states had entirely eradicated creditors' rights coverage from their underwriting: Florida, New York, New Mexico and Texas.
2. Effective February 1, 2010, Pennsylvania revoked ALTA Endorsement No. 21, which was the affirmative ALTA endorsement for creditors' rights coverage. New Jersey, Delaware and Oregon quickly followed suit.
3. On February 4, 2010, the California Land Title Association voted to decertify CLTA Endorsements No. 131 and 131-06, its counterparts to the ALTA creditors' rights endorsements.
4. In the second week of February, 2010, First American Title Company and the entire Fidelity Group — including Chicago Title, Fidelity, Ticor, Lawyers Title and Commonwealth — announced that creditors' rights coverage is no longer available
5. Effective March 8, 2010, ALTA voted to withdraw/decertify ALTA Endorsement No. 21. But even if Endorsement No. 21 is no longer available, title insurers that have not revoked creditors' rights coverage can still underwrite creditors' rights by drafting their own affirmative endorsements — unless regulators implement statewide prohibition of creditors rights coverage (as in Florida, New York, New Mexico and Texas).

> It is time for regulators to solve the creditors' rights quagmire once and for all by implementing statewide prohibitions to effect a nationwide ban on creditors' rights coverage.

Clearly, title insurers intend to stop issuing creditors' rights coverage. In repealing creditors' rights coverage, Fidelity and First American exhibited bold leadership in the title insurance marketplace — but there is no guarantee how long the prohibition will last, or if the rest of the industry will follow. Absent clear guidance from state regulators, the title insurance marketplace will remain uneven — and worst of all, uncertain.

Will the revocation of creditors' rights coverage become an industry-wide standard? And if so, for how long? Can the industry self-regulate creditors' rights coverage?

The simple answer is "no." Title insurers are businesses and may succumb to market pressures when major clients make demands. State regulators can and should ensure that the leadership taken by the two largest title companies becomes a permanent, industry-wide standard. It is time for regulators to solve the creditors' rights quagmire once and for all by implementing statewide prohibitions to effect a nationwide ban on creditors' rights coverage.

Overview of Creditors' Rights Coverage

Creditors' rights coverage provides the purchaser of real property or its lender with insurance that the transaction will not be unwound or set aside by a creditor on the basis of the transaction constituting a fraudulent conveyance under federal bankruptcy laws. Under federal bankruptcy law, a conveyance is constructively fraudulent if it meets the following tests. First, the conveyance must: (i) be made while the grantor is insolvent, (ii) make the grantor insolvent, or (iii) leave the grantor with unreasonably small capital to continue its business. Second, the insolvent or undercapitalized grantor must have received less than reasonably equivalent value for its conveyance.

If a lender purchases a loan policy of title insurance including creditors' rights coverage, the lender is entitled to indemnity from its title insurer for loss suffered if the lender's security interest in the real property is invalidated. Frequently, that loss is the value of the property that could have been foreclosed on, if the lien had not been invalidated.

Lenders typically request creditors' rights protection as protection from post-closing challenges to title, or to the validity, enforceability or priority of an insured lien. If a loan secured by real property is deemed by a court to be a fraudulent conveyance and the lien is invalidated, then the insured lender loses its security interest in the real property collateral. If the lender obtained creditors' rights coverage under its policy of title insurance, the lender may tender a claim to its title insurer for the loss that the insured suffered due to the potential invalidation of the lien.

Endorsement No. 21

Prior to 1990, lenders' title policies were silent regarding coverage for claims arising under creditors' rights laws. At that time, the most common ALTA title policy form was known as the 1970 policy. Beginning in 1990, ALTA adopted language expressly excluding creditors' rights coverage from its form policies. ALTA added the creditors' rights exclusion to the form policy because title insurers did not consider creditors' rights coverage to be title insurance. Lenders, however, were concerned that the 1990 creditors' rights exclusion would allow the insurer to deny coverage for any avoidance claim — even where the basis of the claim was solely the failure of the title insurer to record documents properly. In 1992, ALTA responded by adopting an amended creditors' rights exclusion, clarifying that coverage could not be denied for certain recording defects.

Over time, and in response to market pressure, many title insurers "endorsed over" the 1992 creditors' rights exclusion to satisfy the demands of insistent lenders. ALTA standardized this approach in 2004 by adopting Endorsement No. 21, affirmatively providing creditors' rights coverage for commercial transactions. Endorsement No. 21 specifically insures against loss or damage resulting from a fraudulent transfer. Nevertheless, four states — New York, Texas, Florida and New Mexico — did not adopt Endorsement No. 21 because they determined that creditors' rights coverage poses an unacceptable risk to title insurers. These states only allow policies to be issued with creditors' rights exclusions; they do not permit Endorsement No. 21 (or any other endorsement) to remove those exclusions.

In early 2010, ALTA voted to withdraw Endorsement No. 21, but left open the possibility that title insurers could once again "endorse over" the creditors rights exclusion using their own endorsement. Shortly thereafter, the states of New Jersey, Pennsylvania, Delaware and Oregon moved to withdraw Endorsement No. 21. Regardless of whether Endorsement No. 21 or similar creditors' rights endorsements are available, title insurance companies still have the legal option to issue creditors' rights coverage by drafting their own affirmative creditors' rights endorsement — unless they are in a

ALTA Board Approves Changes to Several Policy Forms

In meeting market demands and changes, the ALTA Board of Governors approved recommendations to revise seven existing forms, adopt four new forms and decertify one form during a meeting on Feb. 3. A 30-day comment period ended March 8.

The following forms are impacted by the Board actions:

Decertified Form:

ALTA Endorsement 21-06 Creditors Rights: The existing ALTA Endorsement Form 21-06 (Creditors' Rights) is designed for issuance with an Owner's Policy or Loan Policy when insuring with respect to voidability of an estate or interest or the lien of the Insured Mortgage 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, subject to the terms and provisions of the endorsement and subject to the Exclusions from Coverage and other terms of the policy. Revision or decertification and withdrawal of the Form was discussed with benefit of outside antitrust counsel. The ALTA Forms Committee was unable to arrive at agreement on the applicable terms and concluded that developing a new or revised standard ALTA form is not achievable or in the industry's best interest, due to a lack of unanimity among industry participants about the ongoing need for and terms of a standardized industry endorsement. Decertification of the form will not affect the ability of each title insurer to separately decide what coverage or endorsement, if any, it will be willing to provide.

continued on page 14

state expressly prohibiting any and all forms of creditors' rights.

Title Insurers Should Not Underwrite Creditors' Rights Coverage

Lenders Hold All the Cards

Title companies cannot match the teams of experts assembled by lenders. Lenders' diligence teams include accountants, solvency experts (who would typically provide a solvency opinion), investment bankers and lawyers. These experts possess extensive knowledge and sophistication regarding financial analysis, and they have access to all of the lenders' files — including files from other experts engaged by the lender. Additionally, the experts engaged by lending institutions receive very large fees and perform comprehensive financial analysis. Notably, more and more of the lenders' outside teams of experts refuse to provide written opinions regarding creditors' rights claims. Additionally, these experts include liability limits in their retention agreements and limit the content of their opinions to such an extent that the lenders seek additional indemnity from title insurers. Thus the true creditors' rights experts — the lenders and their diligence teams — have succeeded in shifting the underwriting risk to title insurance companies that are left to assess the viability of these transactions and opine on creditors' rights issues.

Lenders Don't Provide Time for Proper Underwriting

In addition to lacking the expertise and financial resources of the lenders and their diligence teams, title insurers are also severely disadvantaged by the lack of time in which they must conduct their review. Repeatedly, lenders request creditors' rights coverage shortly before a closing deadline, many months after the lender's team of professionals vetted the solvency issues. Further, the prediction of the solvency of the grantor after a transaction requires the title insurance company to analyze the future of the borrower's business as well as the future of the external economy. By that stage, the lender's solvency experts have already spent months conducting such analysis, so the title insurer's financial analysis is duplicative.

Title Companies Lack Access to Critical Data

To underwrite creditors' rights coverage properly, the title insurer must conduct rigorous due diligence with respect to both the borrower and the transaction. The title insurer must determine whether the grantor received reasonably equivalent value for the transfer, was solvent at the time of the transfer, will remain solvent despite the transfer and will have sufficient capital to carry on its business.

When the grantor is a public company, title companies are further handicapped by SEC disclosure requirements that prevent title insurers from receiving material nonpublic information, while the lenders and their analysts do receive it. Lenders receive recent nonpublic financial results, which are absolutely essential to a meaningful analysis of the solvency of the grantor. Title insurance companies have less time to digest the data they receive, as well as less bargaining power to receive the most vital information available.

Additionally, making a determination of solvency requires knowledge of the fair market value of the transferor's assets, but that information is difficult or impossible for title insurers to obtain. GAAP financial statements report book value for each asset and not fair market value. A title insurance company thus needs an independent appraisal of the market value of the transferor's assets, and must also assess the potential effect a bankruptcy could have on those assets. Further, the recent Tousa case demonstrates that even apparently qualified appraisers and experts can disagree and that a bankruptcy judge may make his or her own independent determination of solvency. If solvency experts cannot agree on a proper analysis, then it is extremely difficult, if not impossible, for title insurance companies to make accurate assessments of a transferor's solvency.

Insufficient Fees to Cover the Risk

A title company must incur diligence costs at the underwriting stage, and is in turn exposed to massive legal defense costs whether or not the insured suffers a loss. The cost of defending a creditors' rights claim is often millions of dollars, even if the lender insured ultimately prevails on the merits. Understanding the underwriting and defense costs of offering creditors' rights coverage, title insurance companies should increase premiums substantially from current market rates. But title insurance premiums are often state-regulated, and in some states, title insurance companies are prohibited from charging a material premium for providing creditors' rights coverage. In general, there is only a nominal charge for title insurers to underwrite creditors' rights. As a result, title insurance companies are not compensated for either the expensive underwriting or

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Revised Forms:

ALTA Endorsement 4-06 Condominium: The existing ALTA Endorsement Form 4-06 (Condominium) is designed for issuance with an Owner's or Loan Policy insuring title to a condominium unit. Paragraph 4 has been modified to clarify that the endorsement insures priority of the lien of the Insured Mortgage over any lien for charges and assessments provided for in the existing condominium statutes and condominium documents.

ALTA Endorsement 5-06 Planned Unit Development: The existing ALTA Endorsement Form 5-06 (Planned Unit Development) is designed for issuance with an Owner's or Loan Policy insuring title to a lot or tract in a planned unit development. Paragraph 2 has been modified to clarify that the endorsement insures priority of the lien of the Insured Mortgage over any lien for charges and assessments in favor of any association of homeowners that are provided for any existing document at Date of Policy.

ALTA Endorsement 10-06 Assignment: The existing ALTA Endorsement Form 10-06 (Assignment) is designed for issuance when the lien of the Insured Mortgage is assigned. The Form has been modified to clarify the endorsement by addition of the defined term "Assignee" and by addition of a creditors' rights exception that is consistent with the creditors' rights exclusion in the ALTA Loan Policy.

ALTA Endorsement 10.1-06 Assignment And Date Down: The existing ALTA Endorsement Form 10.1-06 (Assignment and Date Down) is designed for issuance when the lien of the Insured Mortgage is assigned. The Form has been modified to clarify the endorsement by addition of the defined term "Assignee" and by addition of a creditors' rights exception that is consistent with the creditors' rights exclusion in the ALTA Loan Policy.

ALTA Endorsement 28-06 Easement - Damage or Enforced Removal: The existing ALTA Endorsement Form 28-06 (Easement - Damage or Enforced Removal) is designed for issuance when an existing building encroaches into or over an easement excepted in Schedule B of the Owner's or Loan Policy. The Form has been modified in the introductory paragraph of the endorsement to clarify that it provides insurance with respect to exercise of the easement in accordance with its terms that results in damage to an existing building located on the Land or that results in enforced removal or alteration of that building.

ALTA Expanded Coverage Residential Loan Policy: The existing ALTA Expanded Coverage Residential Loan Policy is designed for issuance when insuring the lien of the Insured Mortgage encumbering title to an improved one-to-four family residence. The Policy has been modified to include a creditors' rights exclusion in order to be consistent with the existing Covered Risk that provides insurance only with respect to certain issues arising out of prior transactions and to be consistent with the ALTA Loan Policy.

ALTA Homeowner's Policy: The existing ALTA Homeowner's Policy of Title Insurance is designed for issuance when insuring title to an improved one-to-four family residence and when the Insured is a Natural person. The Policy has been modified (1) to include a creditors' rights exclusion in order to be consistent with the existing Covered Risk that provides insurance only with respect to certain issues arising out of prior transactions and to be consistent with the ALTA Owner's Policy, and (2) to expand the Continuation of Coverage in Section 2 of the Conditions, by also insuring an Estate Planning Entity (as newly defined) to whom the Insured transfers Title and by insuring anyone who receives Title by a transfer effective on the death of the Insured, as authorized by law.

continued on page 16

for their assumption of significant additional risk of loss and defense costs.

Creditors' Rights Coverage is Credit Insurance

Title insurance differs from other types of insurance, such as credit, property, or casualty insurance, because it is based upon a prior search of land title records and a review of recorded documents regarding a specific property. The coverage typically provided by title insurance companies pertains to title defects, liens and other encumbrances. In contrast, creditors' rights coverage is not underwritten by an examination of title, and the determination of insurability cannot be based on the results of a title search. Creditors' rights coverage is not title insurance; it is credit insurance because creditors' rights claims are a financial risk rather than a title risk. The New York Insurance Department recognized this fact when it issued an opinion in support of a statewide creditors' rights exclusion, because the risks associated with creditors' rights coverage are outside the purpose and scope of title insurance.

Violation of Monoline Restrictions

Because creditors' rights coverage is credit insurance and not title insurance, title insurers should be prohibited from underwriting creditors' rights because many states expressly impose restrictions — known as monoline restrictions — on title insurance companies to prohibit them from issuing any other kind of insurance. For example, California Insurance Code § 12360 provides: "An insurer which anywhere in the United States transacts any class of insurance other than title insurance is not eligible for the issuance of a certificate of authority to transact title insurance in this State, nor for the renewal thereof." These monoline requirements have been imposed to protect the title insurance industry; legislators wanted to ensure that the title insurance industry could not be contaminated by the much higher risks of other insurance lines. Non-title underwriting — specifically, creditors' rights coverage — should be universally prohibited, so that underwriting practices are congruent with state monoline restrictions.

Unpredictability

The risks of offering creditors' rights coverage cannot be assessed accurately. The recent Tousa ruling demonstrates that fraudulent conveyance claims are extremely unpredictable. In October 2009, the bankruptcy judge in Tousa held that when subsidiaries granted liens in connection with borrowings that were for the benefit of their parent company, there was no reasonably equivalent value. Further, the judge rejected the debtor's own financial statements (including prior audits), appraisals of nationally recognized companies and a solvency opinion from an established firm, and concluded that the debtor was insolvent before and after the financing transaction.

The Last Word

Look for more discussion on creditors' rights coverage as John Hollenbeck, ALTA's treasurer, offers another perspective in The Last Word on page 30.

Thus, the judge discounted months of financial analysis by teams of experts, and invalidated liens totaling $500 million. There have been many professionals speaking about the Tousa decision, but the lesson learned by the title insurers is that they cannot predict what a Bankruptcy Judge with 20/20 hindsight will hold when presented with a fraudulent conveyance claim. Such an unpredictable risk of a potentially large exposure is inappropriate for title insurers.

> The New York Insurance Department recognized the risks associated with creditors' rights coverage are outside the purpose and scope of title insurance.

Conclusion

As larger title insurers absorb smaller ones, a risk that once was spread across a group of title companies is now shared by only three or four title insurers. In multi-million dollar transactions, there is simply too much risk to concentrate among relatively few insurers. The most efficient solution to the creditors' rights coverage issues is for title insurance

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Adopted Forms:

ALTA Endorsement 29-06 Interest Rate Swap Endorsement - Direct Obligation: The new ALTA Endorsement Form 29-06 (Interest Rate Swap Endorsement - Direct Obligation) is designed for issuance when insuring the lien of the Insured Mortgage that secures a Swap Obligation. A Swap Obligation is defined as a monetary obligation under the interest rate exchange agreement and is often evidenced by a master agreement and confirmation(s). The endorsement is designed so that it may be issued on or after Date of Policy as the Swap Obligations and applicable agreements are executed. The endorsement does not insure with respect to rights or obligations set, created, or confirmed after the Date of Endorsement. The new Form will benefit industry participants and customers by providing a standardized endorsement that insures against loss by reason of the invalidity, unenforceability, or lack of priority of the lien of the Insured Mortgage as security for the Swap Obligation at Date of Endorsement.

ALTA Endorsement 29.1-06 Interest Rate Swap Endorsement - Additional Interest: The new ALTA Endorsement Form 29.1-06 (Interest Rate Swap Endorsement - Additional Interest) is designed for issuance when insuring the lien of the Insured Mortgage that secures a Swap Obligation that is considered Additional Interest.

ALTA Single Transaction Indemnity Letter: Use of a single transaction indemnity letter can facilitate and speed the closing of the new transaction and provide a predictable form that can be requested by a subsequent title insurer. This indemnity could be used in commercial or residential transactions that are not already covered by a Model Inter-Underwriter Indemnification Agreement or by a similar mutual indemnity agreement, and could also be used in transactions to replace the Model or other mutual indemnity. The new form is designed for issuance if a second title insurer is called upon to insure against a specific defect, lien, encumbrance, or other matter based upon an indemnity from a prior title insurer whose policy insured against the matter. There is a need for the new ALTA Single Transaction Indemnity Letter to provide a standardized and predictable Indemnity Letter. The new form will benefit industry participants and customers by standardized form of indemnity that can be promptly produced.

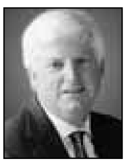
ALTA Single Transaction Indemnity With Performance Letter: This new form differs from the ALTA Single Transaction Indemnity Letter because it provides that the indemnitor additionally agrees to undertake reasonable efforts to eliminate the Indemnified Matter within a reasonable time.

regulators nationwide to ban the issuance of creditors' rights coverage.

In 2010, real estate values remain depressed and many companies are in bankruptcy. With the benefit of hindsight to reflect upon the rise and fall of the real estate market, now is the time to revisit the issue of creditors' rights coverage. In today's market, prudence dictates that underwriters must be conservative and meticulous; title insurers cannot afford to be cavalier in underwriting creditors' rights coverage — the risks are just too high.

Therefore, in the states that still permit title insurance companies to provide creditors' rights protection, it is urgent for state regulatory authorities and the Department of Insurance to act swiftly to prohibit this type of coverage.

The industry cannot rely on title insurers, who face significant competitive market pressures, to self-regulate the abolition of creditors' rights. When the global real estate economy recovers from the current recession, market pressures will compel title insurance companies to resume issuance of creditors' rights coverage. Because title insurance is a vital component of a healthy real estate market, regulators must intervene. A nationwide prohibition of creditors' rights coverage would rescue the title industry from the creditors' rights quagmire.



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