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CREDITORS' RIGHTS TITLE INSURANCE COVERAGE FOR LENDERS

By: Thomas C. Rogers, Esquire

There is a sea change in progress nationally on the availability of creditors' rights title insurance coverage for lenders under their loan policies. This is a result of numerous challenges in various bankruptcy proceedings wherein the debtors (borrowers) or their trustees in bankruptcy have sought, in some cases successfully, to set aside or avoid an insured mortgage as a fraudulent transfer or conveyance. A successful avoidance renders the mortgage ineffective and the loan unsecured in the absence of liens on other collateral held by the lender.

In one case that has gained much notoriety, In Re: Tousa, Inc., the Bankruptcy Court for the Southern District of Florida set aside as fraudulent transfers first and second lien mortgages securing debt in excess of $500 million. The lenders involved had mortgagee's title insurance policies that included coverage against creditors' rights risks. Needless to say, the possible loss exposure by the title insurance company is enormous.

As a result of the ruling in Tousa and other similar cases around the country, the American Land Title Association (ALTA) "decertified" (withdrew from use) the ALTA creditors' rights endorsement forms 21 and 21-06 effective March 8, 2010. This is critical as the ALTA is the national trade association for, and the "voice" of, the title insurance industry. Virtually every title insurance company is a member of the ALTA which promulgates the forms of policies and endorsements used in most of the country. Endorsement forms 21 and 21-06 provided title insurance to the lender against loss by reason of the avoidance in whole or in part of the insured mortgage as a fraudulent or preferential transfer under federal bankruptcy, state insolvency or similar creditors' rights laws.

Without the creditors' rights coverage provided by the ALTA 21 or 21-06 endorsements (or their local state counterparts), there is otherwise very limited title insurance coverage for creditors' rights risks as it pertains to the insured transaction under the standard mortgagee's loan policy form used in most of the country (the ALTA 2006 form loan policy). That form of policy excludes from coverage any loss, damage, costs, attorney's fees or expenses due to any claim under federal or state bankruptcy or insolvency laws that the transaction creating the lien of the insured mortgage is (1) a fraudulent conveyance or fraudulent transfer, or (2) a preferential transfer not covered elsewhere in the loan policy. The 2006 form of loan policy does provide for certain limited creditors' rights coverage for claims arising due to a transfer occurring prior to the transaction creating the insured mortgage or because the insured mortgage is determined to constitute a preferential transfer due to its failure to be recorded timely or because the insured mortgage does not impart proper notice of its existence. The challenges being made in the bankruptcy courts are as to the transaction creating the insured mortgage and not as to prior transactions in the chain of title.

Consistent with the approach of the ALTA, in the last month California, Delaware, New Jersey and Pennsylvania (and perhaps other states) have moved to withdraw, or are moving toward withdrawing, from availability the ALTA Endorsement Forms 21 and 21-06 or their local state counterparts. The withdrawal of this coverage became effective in Pennsylvania on February 1, 2010 and in New Jersey on February 18, 2010. Delaware's withdrawal is still pending.

A number of reasons have been given by the title insurance industry for the withdrawal of this coverage including the rash of recent adverse bankruptcy decisions, the economy in general, the lack of ability to reinsure these risks and, let's face it, the potentially enormous amount of possible claims and the costs to defend those claims.

An often heard statement from the title insurance industry on

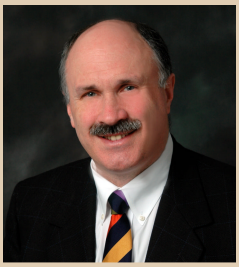
this issue is that the lender is in the best position to assess the creditors' rights risks in a transaction and not the title insurance company involved. That is no doubt true. Nevertheless, in the "go-go" days prior to 2008/2009, the title insurance industry was willing to take the creditors' rights risk for the additional premiums charged (in Pennsylvania the creditors' rights coverage premium was 10 percent of base policy premium). With the down-turn in the economy and the huge risk exposure that already exists, they are no longer willing to take that risk going forward.

What does this mean for real estate lenders?

1. Lenders that have been obtaining creditors' rights coverage for certain transactions may no longer be able to do so depending on the state in which the property is located. That is certainly true in the states noted above that have withdrawn the coverage. More states will no doubt soon follow due to the action taken by the ALTA. Even in those states that have not officially withdrawn the creditors' rights coverage, many title insurers will, as a matter of underwriting policy, not issue the creditors' rights endorsement or will only do so for transactions with virtually zero creditors' rights risks.

2. Lenders will be more careful in the structure of their transactions and in assessing the various creditors' rights risks. This requires an analysis of the borrower's solvency and capital, the use of the loan funds and the structure of the transaction generally with the aid of creditors' rights counsel. This is particularly true for transactions that have always had such risks, including a new or amended mortgage securing a pre-existing debt, mortgages given by non-borrower affiliates, and the like.

CONTRIBUTORS



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