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REAL ESTATE UPDATE

Creditors' Rights Coverage Disappearing? How to Mitigate Risk

The Creditors' Rights Endorsement to a title insurance policy insures against loss or damage sustained by the insured party based on a claim that the insured transaction is voidable as a fraudulent conveyance or preferential transfer under bankruptcy, insolvency or other creditors' rights laws prior to the date of the title insurance policy. Title companies have been offering coverage for the creditors' rights risk by endorsement since around 1990. Until the past year or so, this coverage was typically issued with little or no discussion.

Recently, creditors' rights coverage has been difficult and expensive to obtain. Now the board of governors of the American Land Title Association (ALTA) has voted (on February 3, 2010) to decertify the ALTA Endorsement Form 21-06 (Creditors' Rights) effective as of March 8, 2010. While the decertification of the endorsement by ALTA does not preclude title insurers from issuing the endorsement, ALTA's decision has prompted some title insurers and the land title associations of some states to announce that they will no longer offer the coverage, and it is likely that more will follow. Because buyers of real property and mortgage lenders may no longer be able to obtain insurance against the risks related to creditors' rights issues, buyers and mortgage lenders should evaluate their practices and policies for performing due diligence on the seller's or borrower's financial condition and the effect of the transaction on the seller or borrower.

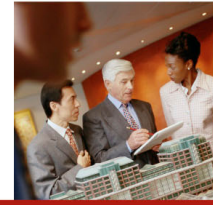
A recent example of how this can affect mortgage lenders is *In re TOUSA, Inc.* (United States Bankruptcy Court, Southern District of Florida). In *TOUSA*, the court found, among other things, that a \$200,000,000 first lien credit facility and a \$300,000,000 second lien credit facility were fraudulent transfers. The court ordered the refund by the prior mortgage lenders of amounts previously paid to them by TOUSA and its subsidiaries (approximately \$403,000,000) and the avoidance of the obligations and liens under the two new credit facilities. The case is now on appeal.

CREDITORS' RIGHTS ISSUES IN ACQUISITIONS

In connection with an acquisition, there is a risk the acquisition will be challenged as a fraudulent conveyance under the federal Bankruptcy Code and comparable state insolvency laws if:

- The purchase of the property was for less than a reasonably equivalent value; **and**
- The seller either was insolvent as of the date of the transfer or became insolvent because of the transfer; had unreasonably inadequate capital after the transfer; or intended to incur or believed it would incur debts that it could not pay.

For a conventional arm's-length acquisition between unrelated parties, the risk is likely more theoretical than practical. Typically, in those situations, there will be some independent



examination of value such as an appraisal or a cap rate analysis. Also, bankruptcy courts are unlikely to question truly arm's-length transactions.

In an acquisition that involves a distressed seller or related parties (such as where the principals of the seller become members of the buyer), however, there may be more of a concern given the possible disparity in bargaining power and the condition of the real estate market in general. The risk is that the bankruptcy court could order the transaction “unwound” or, in certain circumstances, even the payment of a higher purchase price by the buyer.

To mitigate the risk in an acquisition, buyers should obtain an analysis of the reasonably equivalent value of the property, make reasonable inquiry into the financial condition of the seller and require the seller to provide in the purchase agreement representations and warranties as to seller's financial condition.

CREDITORS' RIGHTS ISSUES IN MORTGAGE LOAN TRANSACTIONS

There are two general categories of mortgage loans. The first is a mortgage loan on a single asset to a single entity where the loan funds are being used to purchase, construct or refinance the property. The risk covered by the Creditors' Rights Endorsement is minimal in these situations. The second is a more complicated credit facility where there are cross-stream and upstream mortgages, multiple obligors, a complex borrower structure and/or a complex refinance structure.

In the “good old days,” lenders did not focus on, or have the bargaining power to require, changes in the collateral structure or borrower ownership structure to mitigate the risk of creditors' rights issues. In today's uncertain economic times, lenders should, and should have the bargaining power to, demand loan facility structures that mitigate this risk.

FOR MORE INFORMATION

Our Real Estate practice group has the experience and the resources to guide buyers and mortgage lenders in evaluating, structuring and closing acquisitions and mortgage loans to mitigate the risk from potential fraudulent conveyance and preference claims. For more information, contact:

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