

## Creditors' Rights Coverage Decertified by ALTA and Withdrawn by Title Insurance Companies

In February the American Land Title Association (ALTA) voted to withdraw and decertify the ALTA Endorsement Form 21/21-06, which provides the insured on a title insurance policy with coverage against challenges and claims arising out of federal bankruptcy, state insolvency, and other similar creditors' rights laws. A 30-day comment period is now in effect and final publication of the decertification will take place on March 8, 2010. In response, most of the major title insurance companies, including Fidelity National Title Group (which includes Alamo Title, Chicago Title, Commonwealth Land Title, Fidelity Title, Lawyers Title, and Ticor Title), First American Title Insurance Company and its affiliated companies, and Stewart Title Insurance Company, have advised their customers that they will no longer offer creditors' rights coverage under their policies.

The New York State Insurance Department, along with insurance regulators in Florida, New Mexico, and Texas, already prohibited title insurance companies from providing affirmative insurance for creditors' rights coverage. In recent weeks, insurance regulators in Delaware, New Jersey, Pennsylvania, and Oregon also have taken steps to prohibit title insurance companies from issuing creditors' rights coverage for properties in such states.

### Creditors' Rights Coverage.

Prior to the issuance of the ALTA 1990 form, title insurance policies issued on standard ALTA forms contained no exclusion from coverage for so-called creditor's rights claims and as a result insured against challenges to a transaction vesting title in the insured (in the case of an owner's policy) or a transaction creating a lien in favor of the lender or collateral agent (in the case of a loan policy)<sup>1</sup> arising from a fraudulent conveyance (whether actual or constructive)<sup>2</sup> or preferential transfer.

Beginning with the ALTA 1990 form, policies issued on the standard form specifically excluded such coverage, including, in the case of loan policies, claims or losses based on the subordination of the insured's interest resulting from equitable subordination (whereby a bankruptcy court may (i) subordinate, on equitable grounds, all or part of a lender's claim or interest, (ii) transfer the lien securing a subordinated claim to the bankruptcy estate, or (iii) disallow the claim entirely even if no preferential transfer or fraudulent conveyance occurred).

In response to industry concerns that such exclusions from coverage were too broad, ALTA adopted a "carve out" to the creditors' rights exclusion to provide coverage to the insured if the transfer was deemed

<sup>1</sup> Under §548 of the Bankruptcy Code, (i) a transfer made with the actual intent to hinder, delay, or defraud a creditor (including transfers to insiders), or (ii) a transfer in which the debtor received less than a reasonably equivalent value and (a) the debtor was insolvent or became insolvent on the date such transfer was made, (b) the debtor was engaged or about to engage in a business or transaction for which the remaining assets are unreasonably small, or (c) the debtor intended to incur, or should have reasonably believed it would incur, debts beyond its ability to pay them as they became due. Many states provide similar coverage outside of bankruptcy.

<sup>2</sup> Under §547 of the Bankruptcy Code, a transfer whereby a creditor receives a greater than fair value of a debtor's assets may be subject to attack by another creditor as a preferential transfer if the transfer was made within 90 days of the debtor's filing of a bankruptcy petition, or, if the transfer was made to an insider, within 1 year of the bankruptcy filing.

preferential as a result of the title company's failure to (i) timely record the instrument of transfer, or (ii) the recordation failed to impart notice to a purchaser for value or a judgment or lien creditor.

In 2004, ALTA adopted Endorsement Form 21/21-06 which, in essence, restored the coverage otherwise excluded by providing coverage against losses or damages under an owner's or loan policy sustained due to the transaction vesting title being voidable because of the occurrence, on or prior to the date of the policy, of a fraudulent transfer or preference under federal bankruptcy law or state insolvency or creditors' rights laws. By adopting this endorsement, ALTA recognized that, notwithstanding the availability of a formal ALTA endorsement restoring such coverage, lenders and owners were obtaining such coverage either by demanding that policies be written on the ALTA 1970 form, which contained no such exclusion, or by obtaining manuscripted endorsements which excluded such coverage.

Although title insurers evaluated on a case by case basis whether they would issue policies on the ALTA 1970 form or issue Endorsement Form 21/21-06, it was not unusual for title insurers to provide a form of creditors' rights coverage with minimal due diligence and at minimal cost.

### The Value of Creditors' Rights Coverage.

The risks of preferential transfers or fraudulent conveyances arise in the context of real estate transactions through mortgages or sales to insiders, upstream guarantees, deeds in lieu of foreclosure, and sales of real estate at below market prices. Leveraged buyout transactions are particularly prone to challenge because the purchaser is using the target company's assets as collateral for a loan obtained to purchase the stock of the target company. The loan proceeds are paid to the outgoing shareholders and, as a result, the target company receives little value from the transaction, but is left with the burden of carrying the new debt and having its assets leveraged. As a result, the transfer made by the target company to the lender runs the risk of being voided as a fraudulent transfer. The crucial issue is whether the target company becomes insolvent or files for bankruptcy within the applicable statute of limitations (4 years in most states).

Obtaining creditors' rights coverage shifts the risk of loss to the title company for any covered real property asset not only for the losses incurred if the subject transaction is voided by a bankruptcy or other court, but also for the costs of defending against a fraudulent conveyance or preference challenge.

As a result, creditors' rights coverage has been often highly sought after in commercial real estate and leveraged buyout transactions and is typically considered by lenders to be one of the most important issues when negotiating insurance title coverage.

### The Rationale for Withdrawing Creditors' Rights Coverage and its Impact on the Market.

In order to properly assess the risks being covered by the ALTA Endorsement Form 21/21-06, a significant amount of due diligence is required by the title company, including a detailed review of the transferor's business and financial statements, the transferor's payment history and ability to pay its debts as they are incurred, the transferor's capitalization before and after the consummation of the transaction, the amount of secured and unsecured debt of the transferor both before and after the consummation of the transaction, and the anticipated use of the funds by each party to whom they will be distributed. From the perspective of the title companies and ALTA, assessing these risks is beyond the area of expertise for most title insurance companies (whose primary area of expertise is in reviewing land title records) and creditors' rights coverage falls outside the scope and purpose of title insurance.

By discontinuing creditors' rights coverage, the title companies will be essentially shifting the burden to lenders and owners to assume the transaction risk of a possible fraudulent conveyance or preference claim with respect to real property assets. This may result in lenders conducting a higher level of due diligence on the parties involved in the transaction and the structure of the transaction. A lack of title insurance coverage has the potential to result in

increased transaction costs, both in the form of legal fees and financial analysis, as well as in potential increases in credit spreads or lower leverage ratios in order for lenders to absorb the additional risk. Moving forward, lenders (without the title insurance coverage) will likely require (i) greater representations and warranties with respect to bankruptcy and insolvency issues (and show greater resistance towards knowledge qualifiers), (ii) more detailed financial reports both prior to the transaction and on an ongoing basis, and (iii) supplemental comfort in the form of financial and legal opinions.

If you would like to learn more about the issues in this alert, please contact your usual Ropes & Gray attorney.