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Real Estate Update: Creditors' Rights Endorsement Developments

By Gina B. Masterson and Nicolas B. Hoskins

On February 2, 2010, the American Land Title Association ("ALTA") Board of Governors unanimously voted to withdraw and de-certify the ALTA Form 21 (or creditors' rights) endorsement. This change is effective on March 8, 2010. The major title companies are not waiting until March 8, 2010 and have issued underwriting notices that they will no longer delete the creditors' rights exclusion, issue the ALTA 21 or similar endorsements, or modify in any other way the basic policy form to provide affirmative coverage for creditors' rights issues. The creditors' rights endorsement or deletion placed the burden of the borrower/seller's financial viability on the title company rather than the lender or buyer. Because such financial viability is not generally considered a title matter, title companies opted to shift the risk of seller/borrower bankruptcy, insolvency or other creditors' rights issues arising out of the insured transaction squarely back to buyers and lenders, who are ostensibly in a better position to perform the necessary due diligence. Therefore, lenders and buyers will no longer be able to rely upon title insurance and will have to undertake their own due diligence and take necessary steps to protect themselves from preference and fraudulent conveyance or transfer risks.

Background of ALTA Endorsement 21

In general, ALTA form owner's and loan policies exclude coverage for certain claims arising out of the insured transaction by reason of the operation of federal bankruptcy, state insolvency or similar creditors' rights laws. Particularly, the policies provide that the title insurance company does not protect the insured for post-policy challenges to the insured title or lien if the insured transaction is deemed a fraudulent transfer or preferential transfer, subject to certain limited exceptions.

Fraudulent transfers can take many forms, but arise most often where a buyer or lender receives property or collateral for less than reasonably equivalent value while the seller or borrower is insolvent, or as part of a transaction that renders the seller or borrower insolvent. The bankruptcy judge in the TOUSA (Engle Homes) case in Florida recently applied this theory to avoid \$500 million of liens on the bankrupt debtors' property where, among other things, some of the entities that pledged collateral, i.e., subsidiaries, did not directly benefit from the loan proceeds. A preference may result when an insolvent seller or borrower transfers assets to satisfy a pre-existing debt.

In 2004, ALTA adopted Endorsement Form 21 which expressly provided the insured coverage for creditors' rights matters. This endorsement insured against loss (including cost of defense) under an owner's or lender's policy because of the occurrence, on or before the date of the policy, of a fraudulent transfer or preference under federal bankruptcy law, state insolvency law or creditors' rights laws. Coverage was excluded where the insured knew that the transfer was fraudulent or was not a buyer in good faith.

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Risks and Mitigation

Without creditors' rights coverage, the burden is now on lenders and buyers to conduct the necessary diligence to avoid fraudulent transfer, preference and related entanglements. On significant transactions (from loan originations and modifications to purchases and deeds-in-lieu of foreclosure), lenders and buyers need to be aware of the borrower/seller's financial situation and consult with counsel about how best to insulate themselves against creditors' rights issues.

Ms. Masterson practices in the areas of real estate transactions, finance, litigation, including real estate lending, foreclosures, workouts, real estate acquisitions and sales and leasing. Prior to joining Fennemore Craig, Ms. Masterson was Associate General Counsel for MMA Realty Capital LLC in Littleton, Colorado, where she represented the company in all aspects of its real estate investment management business, including real estate finance, litigation, foreclosures, workouts, acquisitions, and sales and leasing. She earned her B.A. (1991) from Florida International University and her J.D. (1994) from University of Miami School of Law.

Mr. Hoskins practices in the areas of bankruptcy and creditors' rights, as well as commercial and real estate litigation. His bankruptcy practice involves representing secured and unsecured creditors in a broad array of industries, as well as real estate oriented debtors. His creditors' rights practice includes commercial collection and enforcement actions, pre- and post-judgment remedies (including garnishments, attachments, and fraudulent transfers), receivership litigation and trustee sales. Mr. Hoskins' commercial litigation practice includes contract, partnership, landlord-tenant and real estate litigation. He earned his B.A. (1998) from Rutgers College and his J.D. (2002) from New York University School of Law.



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