Reconsidering the Creditors' Rights Exclusion: A Practical Guide for Real Estate Attorneys

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I. INTRODUCTION

The recent downturn in the economy has caused title insurers to become more sensitive to issues surrounding the present and future solvency of parties to insured transactions. This has become acutely manifest in underwriting practices concerning the so-called "creditors' rights" exclusion.

Creditors may seek to set aside a purchase, lease, or loan transaction under federal bankruptcy law or state fraudulent conveyance statutes. Thus, a successful creditors' rights claim may result in a total failure of title and loss of the insured estate. Through creditors' rights coverage, the insured party desires to shift that risk and the duty to defend such claims onto the title insurer.

A title insurance policy includes two types of protection, a duty of the title insurer to defend the insured party against claims and a duty to indemnify the insured party for resulting losses. The duty to defend requires the title insurer to provide the insured party a legal defense (including the payment of court costs and fees) against a claim which is arguably covered by the insuring clauses of the policy even if such claim is ultimately unsuccessful. The duty to indemnify requires the title insurer to reimburse the insured party, subject to the conditions and stipulations in the policy, for its actual loss up to the policy limits for a claim resolved against the insured party.[1]

Creditors' rights claims are difficult and expensive to defend because they require the assistance of expert witnesses, such as appraisers, accountants, analysts, and investment bankers, to testify to issues such as value and solvency. The risks associated with the duty to indemnify are also heightened in the context of creditors' rights claims because of the extraordinary liability associated with a total loss of the insured estate. In addition, matters related to value, solvency, and financial analysis are considered by some title insurance companies to be outside the scope of their expertise, which typically lies solely in the analysis of real property records. Because of the heightened risks and perceived lack of expertise in evaluating creditors' rights issues, title insurers have exercised caution in providing creditors' rights coverage.

This article seeks to provide an overview of creditors' rights claims and the types of title insurance coverage available in regards to such claims in order to assist attorneys in evaluating the risk of such claims and the methods available, where appropriate, to shift those risks onto the title insurer.

II. OVERVIEW OF CREDITORS' RIGHTS LAW

There are a number of applicable provisions under the federal Bankruptcy Code and under state fraudulent conveyance laws by which a creditor or bankruptcy trustee may seek to set aside or subordinate a conveyance of real property or a secured party's collateral interest in real property.

Under section 547 of Chapter 11 of the federal Bankruptcy Code, a voidable preference is a transfer of the debtor's property when insolvent to a creditor for an antecedent debt which enables the creditor to obtain more than it would otherwise receive in a Chapter 7 liquidation case. If the trustee is successful in proving these elements, then the creditor must disgorge the preference and then file a claim for its debt unless the creditor can prove the existence of certain exceptions.[2]

Under section 548 of Chapter 11 of the federal Bankruptcy Code, a bankruptcy trustee may also set aside a transfer if there was an actual intent to hinder, delay, or defraud creditors. Under section 548 even where such actual intent is not proven, the trustee may also set aside the transfer if the debtor received less than "reasonably equivalent value" and one of the following can be shown: (1) the debtor was insolvent at the time of the transfer; (2) the debtor was engaged in business for which the debtor's remaining property was unreasonably small capital; or (3) the debtor intended to incur debts that would be beyond the debtor's ability to pay.[3]

Under section 510(c) of Chapter 11 of the federal Bankruptcy Code, the bankruptcy court may subordinate the claim of a creditor to the claims of other creditors in parity with such creditor based on principles of equity. Section 510(c)(1) generally requires a finding that a claimant has engaged in misconduct injurious to other creditors or leading to an unfair advantage.

Section 544(b) of Chapter 11 also permits a bankruptcy trustee to avoid a pre-bankruptcy transfer under the applicable state's laws regarding fraudulent transfer.[4] The Uniform Fraudulent Transfer Act ("UFTA") is the state law analog of 11 U.S.C. section 548 and 11 U.S.C. section 547. UFTA has been adopted in some form in forty states (including California). UFTA distinguishes between transfers fraudulent as to present and future creditors and transfers fraudulent as to present creditors.[5] A transfer fraudulent as to present and future creditors is not voidable, however, against a person who took in good faith and for a reasonably equivalent value or against any subsequent transferee or obligee.[6]

III. OVERVIEW OF TITLE INSURANCE POLICIES

A. 1970 ALTA Policies

The forms of policies originally adopted by the American Land Title Association ("ALTA") in 1970 contained no specific preprinted exclusion from coverage for creditors' rights claims. Title insurers argued, however, that creditors' right claims were excluded under various preprinted exclusions found in the boilerplate of the policy, such as the following: (i) Exclusion 3(a) (matters created, suffered, assumed or agreed to by the insured); (ii) Exclusion 3(b) (matters not known to the company or dis-

closed by the public records but known to the insured); and (iii) Exclusion 3(d) (matters attaching or created subsequent to the date of the policy). In certain circumstances, prior to 1990, title insurers would also add a specific exception for creditor's rights claims to Schedule B of certain title policies.[7]

B. 1990 and 1992 ALTA Policies

The 1990 ALTA forms of policies contained the first specific preprinted exclusion for creditors' rights claims. Consumers complained, however, that the exclusions were too broadly drafted, seemingly barring coverage even where the applicable creditors' rights claim arose out of the title insurer's failure to timely record documents in connection with the insured transaction.

The 1992 ALTA Owner's and Lender's policies still generally excluded claims arising out of fraudulent conveyance and preferential transfer.[8] In response to concerns raised by title insurance consumers, however, the 1992 ALTA policies were amended to exclude the title insurer's failure to timely record documents from the creditor's rights exclusion.[9]

The 1992 ALTA policies provided no specific affirmative coverage in regards to creditor's rights claims. But, in certain circumstances title insurers' have deleted the preprinted creditors' rights exclusion by way of endorsement.

C. 2006 ALTA Policies

The 2006 ALTA Policies were the first forms to provide express affirmative coverage for creditors' rights claims. The coverage, however, is limited to claims arising from events occurring prior to the date of the policy.[10] Thus, the 2006 ALTA Policies provide coverage for fraudulent or preferential transfers occurring prior to the transaction vesting title in the insured owner or creating the lien of the insured lender.[11] But, creditors rights claims arising out of the insured transaction itself remain expressly excluded in the preprinted exclusions set forth in the 2006 ALTA Policies. Exclusion 4 of the 2006 ALTA Owner's Policy reads as follows:

> [The following matters are expressly excluded from the coverage of this policy, and the Company will not pay loss or damage, costs, attorneys' fees, or expenses that arise by reason of:]
>
> "4. Any claim, by reason of the operation of federal bankruptcy, state insolvency, or similar creditors' rights laws, that the transaction vesting the Title as shown in Schedule A, is
>
> > (a) a fraudulent conveyance or fraudulent transfer; or
> >
> > (b) a preferential transfer for any reason not stated in Covered Risk 9 of this policy."

Exclusion 6 of the 2006 ALTA Lender's Policy reads:

> [The following matters are expressly excluded from the coverage of this policy, and the Company will not pay loss or damage, costs, attorneys' fees, or expenses that arise by reason of:]
>
> "6. Any claim, by reason of the operation of federal bankruptcy, state insolvency, or similar creditors' rights laws, that the transaction creating the lien of the Insured Mortgage, is
>
> > (a) a fraudulent conveyance or fraudulent transfer, or
> >
> > (b) a preferential transfer for any reason not stated in Covered Risk 13(b) of this policy."

IV. DOES LACK OF A CREDITORS' RIGHTS EXCLUSION OR DELETION OF THE CREDITORS' RIGHTS EXCLUSION PROVIDE AFFIRMATIVE COVERAGE?

As discussed in Section III, no ALTA policy provides affirmative coverage regarding creditors' rights claims arising in connection with the insured transaction. The 2006 ALTA policy provides affirmative coverage only for creditors' rights claims arising out of past transactions.

In certain circumstances, the creditors' rights exclusion has also been deleted from the 1990, 1992 and 2006 ALTA policies by way of a separate endorsement.[12] An endorsement of this form does not itself expressly provide affirmative coverage regarding creditors' rights claims, it merely deletes the specific preprinted exclusion. Therefore, even when such an endorsement has been issued, it is questionable whether the policy imparts any affirmative coverage for creditors' rights claims. The question then becomes, to what extent does a policy form which contains no creditors' rights exclusion provide affirmative coverage against creditors' rights claims.

Insured parties and their legal counsel could argue that creditors' rights coverage exists whenever a policy is issued with no specific exclusion to coverage because a creditor's right to set aside the insured conveyance is a defect in title like any other claim which divests the insured party of its interest in the subject property. In addition, the title insurers' practice of including specific creditors' rights exceptions in Schedule B of certain policies issued prior to the 1990 ALTA forms and the later inclusion of a specific pre-printed creditors' rights exclusion in the 1990, 1992, and 2006 ALTA policies could be argued to evidence the parties' intent that the title insurer would assume creditors' rights risks whenever a pre-1990 ALTA form policy was issued without a specific creditors' rights exception in Schedule B.[13]

Title insurers might argue that even in the absence of a specific exclusion regarding creditors' rights, other generic preprinted exclusions found in the pre-1990 ALTA policy forms nonetheless bar creditors' rights claims. Title insurers could contend that the inclusion of a specific creditors' rights exclusion in the 1990 ALTA policies (and other later forms) was not intended to imply that prior policy forms provided such coverage. The additional exclusion was intended merely to clarify the insurance companies' prior position that creditor's rights claims had always been excluded from coverage under the other generic preprinted exclusions.

The resolution of this debate, however, is largely unanswered because there is only one reported case addressing whether the failure to include a specific creditors' rights exception resulted in affirmative coverage of a creditor's rights claim. In considering a pre-1990 form ALTA policy, the court in *Chicago Title Insurance Company v. Citizens and Southern National Bank* found in favor of the title insurer stating that the failure to include a specific creditors' rights exception did not itself imply the parties' intent to provide coverage.[14] In the *Citizens and Southern National Bank* case, the lender had extended an unsecured line of credit to the borrower. When the borrower subsequently showed signs

of financial insecurity, the lender and borrower entered into a new loan transaction secured by the borrower's real property assets and a lender's policy of title insurance was issued in connection therewith.[15] The proceeds of the new loan were used to repay the existing unsecured line of credit. Subsequently, the borrower filed for Chapter 11 bankruptcy, the secured loan was challenged as a preferential transfer and in settlement of certain claims the lender voluntarily agreed to release its security interest in the borrower's real property assets. The lender also sought indemnification under its title insurance policy for damages related to loss of its security interest.[16]

The court in *Citizens and Southern National Bank* found that the lender's claims were excluded under Exclusion 3(d) (matters attaching or created subsequent to the policy) because both the borrower's bankruptcy petition and the lender's voluntary relinquishment of its security interest were matters arising subsequent to the date of the policy. In dicta, the court also stated without citation or further reasoning: "Just because Chicago Title may have inserted even more specific language in other policies does not mean that the language in this contract actually contemplated coverage of the risk of a preference action voiding the bank's secured interest."[17]

Although *Citizens and Southern Bank* is often cited in favor of the proposition that failure to include a specific creditors' rights exception or exclusion does not impart affirmative coverage, it is difficult to conclude from this one case that the issue has been finally resolved in favor of the title insurers. First, the statement was made in dicta and without any explicit reasoning for the proposition stated. Second, it is a lone case from a district court binding only on the parties. Finally, the case cites no legal authority for the above-quoted proposition and no subsequent court has cited *Citizens and Southern Bank* in favor of that proposition.

There is no reported California case specifically addressing whether or not a pre-1990 form ALTA policy issued without an express creditors' rights exception in Schedule B provides affirmative coverage for creditors' rights claims.[18] In interpreting the breadth of coverage afforded by insurance contracts, however, California courts look first and foremost to the insuring clauses found in the applicable policy. For example, in *Elysian Investment Group, LLC v. Stewart Title Guaranty Company*, the insured party purchased a home which included a converted garage that violated certain municipal zoning laws.[19] The title insurer failed to include a specific exception in the title policy for a notice of zoning violation which had been recorded in the real property records.[20] The court found however that no coverage existed because the recorded notice merely warned of a physical defect in the property, but did not affect title to the property and was therefore outside of the insuring clauses of the policy.[21] The court expressly considered an exclusion found in the applicable policy for, "Any law, ordinance or governmental regulation (including but not limited to building or zoning laws, ordinances, or regulations) restricting, regulating, prohibiting or relating to (i) the occupancy, use, or enjoyment of the land; (ii) the character, dimensions, or location of any improvement now or hereafter erected on land;…or the effect of any violations of these laws, ordinances, or governmental regulations, *except to the extent that a notice of the enforcement* thereof or a notice of a defect, lien, or encumbrance resulting from a violation or alleged violation affecting the land has been recorded in the public records at Date of Policy."[22] The court reasoned that an exclusion from coverage does not itself imply that the policy covers matters not so expressly excluded.[23] Since the recorded notice did not constitute a lien or encumbrance, within the meaning of the insuring clauses, the language set forth in the exclusions was irrelevant.

Elysian could stand for the proposition that the inclusion of a laundry list of exclusions does not itself imply that a particular matter not found on that list of exclusions is affirmatively covered. Even in *Elysian* where the exclusion in question actually excluded recorded notices, which created a fair implication that recorded notices were thus covered, the court found against the insured party. In *Elysian* the court looked solely to the insuring clauses to determine the breadth of coverage. Thus, title insurance companies could argue that California case law favors their position since the insuring clauses of an ALTA policy do not explicitly mention creditors' rights claims arising out of the insured transaction as an insured risk.

ALTA policies, however, expressly state that they insure "defects" in title. Thus, "defects" are expressly within the scope of the insuring clauses. But, is a creditor's rights claim a defect in title? Under California law, a "defect" need not be a matter apparent merely from review of the title records.[24] For example, the defects covered by a title policy include lack of competency or capacity of grantors in the chain of title.[25] Title insurance also insures against forgery of an instrument or fraudulent inducement of the execution of an instrument conveying title, neither of which defects can be discovered through review of title records.[26] Therefore, it can be argued that a "defect" includes any matter in existence as of the date of the policy which could later be used to set aside the insured party's interest in the insured estate. The insured party may argue that the grantor's failure to receive reasonably equivalent value as of the closing, which permits a creditor to set aside the insured transaction, is a defect in the conveyance functionally equivalent to the grantor's lack of capacity, which may allow the conveyance to be later set aside.

ALTA itself seems to agree with the position that creditors' rights claims fall within the coverage of title insurance on the theory that voidability of title is a title defect regardless of the reason.[27] ALTA has also taken the position that a creditor's right to avoid an insured interest as a preference or fraudulent conveyance is not excluded from coverage as a post-policy matter. The president of ALTA stated in a 2001 letter, "The fact that the proceeding in which avoidance takes place occurs after the policy's effect date is immaterial. The vast majority of title insurance claims are discovered or brought about by litigation after the date of the policy."[28]

In addition, some courts have found that when the insured party purchases so-called "extended coverage" whereby certain pre-printed exclusions are deleted in exchange for the payment of additional premium that the deletion of those exclusions evidences the parties' intent that affirmative coverage will exist.[29] For example, in *Rackouski v. Dobson*, the insured party purchased property with a barn and a fence that encroached onto adjoining property.[30] The adjoining property owner sued to force the insured party to remove the encroachments. The insured party tendered the claim to his title insurer who argued that the

claim did not fit within the scope of the title policy because the insuring clauses did not cover encroachments.[31] The policy in question, however, was a so-called "extended" coverage policy in which certain pre-printed exclusions, including an exclusion for encroachments and overlaps had been deleted. The court reasoned that, "Although the deletion of an exclusion should not automatically be construed as providing coverage when the appellee [the insurer] expressly waived such a specific exception, we believe that the logical conclusion is that the policy, as executed, does cover such encroachments..."[32]

Under the reasoning set forth in *Rackouski*, a 1990, 1992 or 2006 ALTA policy where the creditors' rights exclusion has been deleted by separate endorsement arguably provides coverage. The deletion by way of endorsement of something specifically excluded arguably implies the existence of coverage. Although not specifically addressed in *Rackouski*, this would seem to be an especially convincing argument in cases where the insured party paid additional premium for the endorsement deleting the creditors' rights exclusion (as in the case of the additional premium paid for so-called "extended coverage"). If no coverage was found, then the additional premium would have been paid for nothing. It does not seem logical that the parties would intend that the insured party pay additional premium to receive nothing in return. This argument has not yet been addressed by any court. Title insurers, however, often include an endorsement deleting the creditor's rights exclusion at no charge to the insured party, so the issue may not be litigated.

Because of uncertainties in the law, lawyers should advise their clients that use of a pre-1990 form of ALTA policy (or deletion of the creditors' rights exclusion by separate endorsement) may not be sufficient to provide affirmative coverage for creditors' rights claims. As discussed in Section V, where it is available, the insured party should consider obtaining an endorsement affirmatively providing creditors' rights coverage. In those jurisdictions where an endorsement providing affirmative coverage for creditors' rights claims does not exist however, the use of pre-1990 form of ALTA policy will at least provide the insured party with a colorable argument that coverage exists.

V. AFFIRMATIVE COVERAGE BY ENDORSEMENT (ALTA 21)

It is possible in certain jurisdictions to obtain an endorsement providing affirmative coverage regarding creditors' rights claims. The most common form of endorsement is the ALTA 21, which reads as follows:

> The Company insures against loss or damage sustained by the Insured by reason of the avoidance, in whole or in part, or a court order providing some other remedy, based on the voidability of any estate or interest shown in Schedule A or 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.
>
> The coverage provided by this endorsement shall include the payment of costs, attorneys' fees, and expenses necessary to defend the Insured against those counts, and no others, of any litigation seeking a court order that will result in loss or damage against which this endorsement provides insurance to the extent provided in the Conditions.
>
> This endorsement does not insure against loss or damage if the Insured (a) knew when it acquired any estate or interest shown in Schedule A, or the Insured Mortgage that the transfer, conveyance, or Insured Mortgage was intended to hinder, delay, or defraud any creditor, or (b) is found by a court not to be a transferee or purchaser in good faith.
>
> This endorsement is issued as part of the policy. Except as it expressly states, it does not (i) modify any of the terms and provisions of the policy, (ii) modify any prior endorsements, (iii) extend the Date of Policy, or (iv) increase the Amount of Insurance. To the extent a provision of the policy or a previous endorsement is inconsistent with an express provision of this endorsement, this endorsement controls. Otherwise, this endorsement is subject to all of the terms and provisions of the policy and of any prior endorsements.

The issuance of an ALTA 21 or similar type endorsement is currently the only means by which an insured party can obtain coverage against creditors' rights claims with certainty. However, the ALTA 21 endorsement is not available in certain jurisdictions where prohibited by statute (e.g. New York, Texas, Florida, and New Mexico).

Issuance of an ALTA 21 endorsement may require the payment of an additional premium to the insuring title company. In addition, the title insurer may need to conduct significant due diligence with respect to the insured transaction, including, analysis of the transferor's financial statements, payment history, debts, and capitalization, and the use of funds and parties to whom those funds are distributed.[33] Therefore, legal counsel should also consider, in consultation with the client, any confidentially issues that may arise in sharing these documents with the title insurer, the extent to which the transaction documents obligate applicable parties to timely provide such documentation and the additional time prior to closing that may be required in order to permit the insurer to underwrite the endorsement.

Finally, the ALTA 21 endorsement does not provide coverage where the insured party knew that the insured transfer, conveyance or mortgage was intended to hinder, delay, or defraud creditors or if the insured party is found not to be a transferee or purchaser in good faith. Unlike Exclusion 3(b) of the policy, these exclusions in the ALTA 21 endorsement for matters known to the insured apply even when the applicable matter is known by or disclosed to the title insurer in writing or otherwise set forth in the public records. Therefore, consideration should be given to whether the insured party has actual or constructive knowledge of any matters which would negate coverage.

VI. UNDERWRITING ISSUES

As noted in Section II, under both federal bankruptcy law and UFTA, the determination of whether a creditors' rights claim exists revolves around whether the transferee has received "reasonably equivalent value"; provided, that, the purpose of the transaction is not to intentionally defraud creditors. If no intent to defraud exists and the transferor or borrower receives "reasonably equivalent value", then the title insurer should generally

be able to delete the creditors' rights exclusion and/or provide affirmative coverage in regards to creditors' rights claims.

The term "reasonably equivalent value" is not defined in the bankruptcy code but is a factual inquiry determined by the applicable court on a case-by-case basis. Factors which have been considered include the good faith of the parties, the difference between the amount received and fair market value and whether the transaction was arm's length.[34] In the specific instance of a real estate mortgage foreclosure, the U.S. Supreme Court has ruled that the price received at a regularly conducted, non-collusive foreclosure sale conducted in accordance with State law equals "reasonably equivalent value".[35] Otherwise, the courts will consider the factors described above, which can create a fair amount of uncertainty.

In the case of a sale transaction, the title insurer must determine how the sale price was established (e.g. appraisal, comparable sales data, negotiation through brokers, etc.).[36] In the case of the loan transaction, the title insurer must establish that the party pledging its real property assets will receive the loan proceeds or otherwise be benefited by the loan. The title insurance underwriter may consider, among other things: What is the purpose of the loan? Are all loan proceeds being used to satisfy existing debt or to construct improvements? Are the loan proceeds distributed to owner or an entity related to the owner or to buy out an owner? Does the loan include any cross collateralization of other properties owned by others? Will the indebtedness exceed current land value?

Generally, if a real estate transaction involves an arms-length sale between unrelated third parties, each represented by independent professionals or involves a straight forward purchase money mortgage or refinancing, then the transaction should not pose significant creditors' rights concerns to the title insurer.[37] If the borrower or transferor will not receive "reasonably equivalent value," then under UFTA or federal bankruptcy law, the title insurer would need to analyze the solvency and capitalization of the borrower or transferor and its ability to pay its debts. Because this analysis falls outside the general expertise of title insurers, it can be expected that the title insurer will be reluctant or fail to agree to delete the creditors' rights exclusion or issue affirmative creditors' rights coverage where the parties cannot demonstrate that "reasonably equivalent value" will be received.

Several less-straightforward, but nonetheless common, transaction structures pose special problems in regards to the requirement that the transferee receive "reasonably equivalent value" or raise issues that the transaction will be treated as a preference under 11 U.S.C. section 547 or section 5(b) of UFTA. The following list provides some common examples, but is not exhaustive:

A. "Upstream" and "Cross-Stream" Loans and Guarantees

An "upstream" loan refers to a transaction (or series of transactions) in which the loan proceeds or a portion thereof are distributed to a "parent" entity of the borrower. A "sidestream" or "cross-stream" loan refers to a transaction (or series of transactions) in which the loan proceeds or a portion thereof are distributed to an affiliate, "sister" entity of the borrower. In either such transaction, the borrower may pledge its real property assets as security for the loan, in which case the lender may require a title insurance policy insuring its security interest. In an "upstream" guaranty transaction the "parent" entity acts as the borrower, the subsidiary acts as a guarantor and the assets of the subsidiary (which may include real property) are pledged as security for the guaranty. Likewise, a "sidestream" or "cross-stream" guarantee refers to a transaction wherein one affiliated, "sister" entity acts as the guarantor of a loan where the proceeds will be distributed to another affiliated "sister" entity and pledges its assets (which may include real property) as security for the guaranty. If the guaranty will be secured by real property, the lender may require a title insurance policy insuring its security interest. Even in the absence of a separate "guaranty" agreement, an "upstream" or "sidestream" guaranty relationship will nonetheless exist if the applicable subsidiary or affiliated entity pledges its assets by means of a mortgage or deed of trust to secure the repayment of a loan made to a "parent" or "sister" entity.[38]

In any of the above-referenced transaction structures, the applicable loan or guaranty is at heightened risk to be set aside under federal or state fraudulent conveyance laws because the borrower or guarantor in question arguably has not received "reasonably equivalent value". In the case of an "upstream" or "sidestream" loan, the loan proceeds are distributed to an affiliated entity, so the borrower arguably has received no value. Likewise, in the case of an "upstream" or "sidestream" guaranty, the guarantor has encumbered its assets without receiving the loan proceeds. Depending upon the transaction, it could be argued that the applicable subsidiary or affiliate received indirect benefits if, for example, the applicable loan transaction permitted the parent to obtain a favorable loan and provide funds to the subsidiary or if the transaction increased the overall "good-will" of a family of companies.[39]

B. Leveraged Buyouts

A leverage buyout is a transaction (or series of transactions) in which all or a substantial portion of the purchase price to acquire a "target entity" is borrowed from a third-party lender and the loan is secured by the assets of the "target entity."[40] If those assets include real property, then the lender may require a title insurance policy insuring its security interest.

A leveraged buyout transaction significantly affects the "target entity's" capital structure resulting in the "target entity's" equity being exchanged for debt with the "target entity" receiving little or no value. Thus, it may be questionable whether the "target entity" received "reasonably equivalent value" for purposes of federal bankruptcy and state fraudulent conveyance law.[41]

C. Pledge of Security for Existing Loan

If a borrower pledges collateral to a lender (or pledges additional collateral or substitutes more valuable collateral) to secure an existing loan and no additional funds flow to the borrower, then the transaction may be set aside as a preference. The use of proceeds from a secured loan to repay an existing unsecured loan with the same lender raises the same preference concerns. In either type of transaction if the security in question is real property and the lender requires title insurance, then the title insurer may be reluctant to delete the creditors' rights exclusion or provide affirmative coverage in regards to creditors' rights claims.[42]

VII. A FRAMEWORK FOR ADDRESSING CREDITORS RIGHTS ISSUES IN REAL ESTATE TRANSACTIONS

The following steps provide a conceptual framework for real estate transactions to address creditors' rights claims and possible title insurance solutions:

A. Analyze Creditors Rights Issues

Legal counsel should first consider the facts and circumstances surrounding the parties to a given transaction and the transaction's structure to determine what, if any, specific creditors' rights risks exist. For example, if little is known about the seller's creditworthiness or the seller is an individual, then there may be a heightened risk that the seller is or will become insolvent. If title insurance will be used to shift the risk of creditors' right claims onto the title insurer, then legal counsel should anticipate potential underwriting issues. For example, the following questions should be considered along with any other relevant information: (i) Will the transferee receive "reasonably equivalent value" in connection with the transfer?; (ii) What evidence will be available to demonstrate the receipt of "reasonably equivalent value"? (e.g. appraisals, comparable sales data, opinions of brokers, etc.); (iii) Is the transaction truly "arms length"?; (iv) Will proceeds of the sale or loan transaction be paid directly to the transferee, the borrower, or the party pledging its assets?; (v) Does the transaction involve any "upstream" or "sidestream" guaranties?; (vi) Is the transaction a leveraged buy-out?; (vii) Is the partying pledging its assets in connection with an existing loan (as opposed to the origination of a new loan)?; (viii) Will the transferee remain solvent after the transfer?; (ix) Will the transferee remain adequately capitalized given its business after the transfer?; (x) What is the creditworthiness of the transferee generally?

If the transaction raises heightened concern regarding creditors' rights issues for legal counsel, then it can be anticipated that it will also raise concern for the title insurer. If the transaction is not straightforward or no recent appraisal has been performed, legal counsel should begin discussions with the title insurer early on to determine what coverage will be available and what documents the title insurer will need to review as part of its underwriting analysis.

B. Identify Title Insurance Policy Forms Available in the Applicable Jurisdiction

Regulation of the title insurance industry varies from state to state. Depending upon the laws of the state where the real property in question is located, certain forms of title insurance policies may not be available. Also, even where permitted by law, certain title insurance companies may not offer older policy forms as a matter of practice. The title insurer should be contacted early in the transaction to identify what forms of policies the title insurer will issue in a particular jurisdiction. If a title insurance company refuses to issue a preferred policy form as a matter of practice, then consider shopping among title insurers to obtain the best coverage. If a form of policy without a preprinted creditors' rights exclusion will be used (such as the 1970 ALTA policies), then confirm with the applicable title insurance company that a creditors' rights exclusion will not be included in Schedule B. The forms of policies differ in many respects other than their treatment of creditors' rights issues (e.g. insured risks, arbitration provisions, co-insurance provisions, etc.). For example, the 1970 ALTA policies omit a creditors' rights exclusion, but the 1970 ALTA policies do not include affirmative coverage in regards to certain other "Covered Risks" provided in the 2006 ALTA policies (e.g. recorded notices of violations of law). The differences in coverage unrelated to creditors' rights issues between the various policy forms are beyond the scope of this article. The choice of policy form, however, should be a multi-factor analysis taking into account creditors' rights issues and other coverages afforded or not afforded by a particular policy form in light of the risks associated with a particular transaction.

C. Identify the Endorsements which are Available in the Particular Jurisdiction

Depending upon the laws of the state where the real property in question is located, certain forms of title insurance endorsements may not be available. Contact the title insurance company early in the transaction to determine whether endorsements are available in the particular jurisdiction to (i) delete the creditors' rights exclusion; or (ii) provide affirmative coverage in regards to creditors' rights claims (such as the ALTA 21 endorsement). Also discuss with the title insurer the costs of obtaining these endorsements.

D. Confirm the Title Company's Underwriting Practices with Regard to Preferred Policy Forms and Endorsements

In order to fulfill its underwriting requirements in regards to a issuing a form of title insurance policy without a creditors' rights exclusion (or an endorsement providing affirmative coverage), the title insurance company may require that financial statements, appraisals, comparable sales data, opinions of brokers, or other documents and information be provided. Contact the title insurer to confirm what documentation will be required in connection with a particular transaction. Also, discuss timing of the transaction with the title insurer to ensure that the required documentation can be delivered in a timely manner to allow the title insurer to complete its underwriting analysis. Anticipate the need for an adequate time cushion in case any issues arise in connection with the underwriting analysis. Consider any confidentiality concerns that may arise in providing documentation to the title insurer. Remember ALTA policies exclude matters not known to the company or disclosed by the public records but known to the insured, so legal counsel should consider whether any relevant information is known which should be disclosed to the title insurer, even if such information is not expressly requested by the title insurer.

E. Discuss with the Client the Creditors' Rights Risks and Formulate a Plan to Mitigate those Risks Based Upon the Clients Objectives

Legal counsel should identify for the client any known or potential risks regarding creditors' rights claims given the parties involved and the structure of a proposed transaction. Identify and discuss with the client any additional due diligence that should be conducted regarding the parties' solvency or

bankruptcy risk. Identify for the client the potential in a given jurisdiction to shift creditors' rights risks onto the title insurer through a title insurance policy and/or endorsements. If cost is a concern for the client, then discuss the premiums to obtain this coverage. There may also be additional hidden costs (e.g. the cost of an appraisal) in order to obtain coverage.

F. Consider Transaction Documents and Anticipate Issues

It may be necessary to address certain issues in the transaction documents themselves to ensure the title company will be able to issue requested policy forms and endorsements. Are the appropriate parties obligated to provide or obtain the necessary documents to permit underwriting the required coverage (e.g. financial statements, affidavits, appraisals, etc.)? Do the transaction documents require timely delivery of these items? Will the title insurer have adequate time to complete its underwriting analysis in connection with issuing required policy forms and endorsements? Do the applicable transaction documents impose any confidentiality restrictions which would prevent sharing documents with the title insurance company? What rights will the parties have if the title insurance company cannot or will not issue requested policy forms and/or endorsements (e.g. termination rights, return of deposit, etc.)? Legal counsel will need to begin discussions with the title insurance company early to identify potential issues and to ensure the transaction documents adequately address those issues. Also, consider how the cost of title insurance and endorsements (and ancillary costs such as appraisals) will be allocated between the parties under the transaction documents.

VIII. CONCLUSION

In a downward turning economy the likelihood of insolvency increases. Accordingly, the risk that a given real estate transaction may be set aside or that a party may otherwise be adversely affected by creditors' rights claims becomes more significant. Therefore, it is critical that legal practitioners understand creditors' rights law in order to effectively negotiate title insurance coverage in to mitigate the adverse affects of creditors' rights claims.

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ENDNOTES

1 John C. Murray, Title Insurance in commercial real estate transactions (1999) at iv.
2 Colliers on bankruptcy (15th ed. 2008) §1.03[8][b].
3 *Id.* at §1.03[8][c].
4 *Id.* at.§1.03[8][a].
5 § 4(a) of UFTA defines a transfer fraudulent as to present and future creditors as:
A transfer made or obligation incurred by a debtor is fraudulent as to a creditor, whether the creditor's claim arose before or after the transfer was made or the obligation was incurred, if the debtor made the transfer or incurred the obligation:

> (1) with actual intent to hinder, delay, or defraud any creditor of the debtor; or
>
> (2) without receiving a reasonably equivalent value in exchange for the transfer or obligation, and the debtor:
>
> > (i) was engaged or was about to engage in a business or a transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction; or
> >
> > (ii) intended to incur, or believed or reasonably should have believed that he [or she] would incur, debts beyond his [or her] ability to pay as they became due.

§ 8(a) of UFTA defines a transfer fraudulent as to present creditors as:

> (a) A transfer made or obligation incurred by a debtor is fraudulent as to a creditor whose claim arose before the transfer was made or the obligation was incurred if the debtor made the transfer or incurred the obligation without receiving a reasonably equivalent value in exchange for the transfer or obligation and the debtor was insolvent at that time or the debtor became insolvent as a result of the transfer or obligation.
>
> (b) A transfer made by a debtor is fraudulent as to a creditor whose claim arose before the transfer was made if the transfer was made to an insider for an antecedent debt, the debtor was insolvent at that time, and the insider had reasonable cause to believe that the debtor was insolvent.

6 *Id.*
7 John C. Murray, Title Insurance in commercial real estate transactions (1999) at xiii.
8 Exclusion 4 of the 1992 ALTA Owner's Policy reads:

> [The following matters are expressly excluded from the coverage of this policy and the Company will not pay loss or damage, costs, attorneys' fees or expenses which arise by reason of:]
>
> 4. Any claim, which arises out of the transaction vesting in the Insured the estate or interest insured by this policy, by reason of the operation of federal bankruptcy, state insolvency, or similar creditors' rights laws, that is based on:
>
> (a) the transaction creating the estate or interest insured by this policy being deemed a fraudulent conveyance or fraudulent transfer; or

(b) the transaction creating the estate or interest insured by this policy being deemed a preferential transfer except where the preferential transfer results from the failure:

(i) to timely record the instrument of transfer; or

(ii) of such recordation to impart notice to a purchaser for value or a judgment or lien creditor.

Exclusion 7 of the 1992 ALTA Lender's Policy reads:

[The following matters are expressly excluded from the coverage of this policy and the Company will not pay loss or damage, costs, attorneys' fees or expenses which arise by reason of:]

7. Any claim, which arises out of the transaction creating the interest of the mortgagee insured by this policy, by reason of the operation of federal bankruptcy, state insolvency, or similar creditors' rights laws, that is based on:

(a) the transaction creating the interest of the insured mortgagee being deemed a fraudulent conveyance or fraudulent transfer; or

(b) the subordination of the interest of the insured mortgagee as a result of the application of the doctrine of equitable subordination; or

(c) the transaction creating the interest of the insured mortgagee being deemed a preferential transfer except where the preferential transfer results from the failure:

(i) to timely record the instrument of transfer; or

(ii) of such recordation to impart notice to a purchaser for value or a judgment or lien creditor.

9 Paul L. Hammann & John C. Murray, *Creditors' Rights Risk: A Title Insurer's Perspective*, 38 John Marshall L. Rev. 223, 227-228 (2004).

10 Covered Risk 9 of the 2006 ALTA Owner's Policy reads:

[SUBJECT TO THE EXCLUSIONS FROM COVERAGE, THE EXCEPTIONS FROM COVERAGE CONTAINED IN SCHEDULE B, AND THE CONDITIONS, BLANK TITLE INSURANCE COMPANY, a Blank corporation (the "Company") insures, as of Date of Policy and, to the extent stated in Covered Risks 9 and 10, after Date of Policy, against loss or damage, not exceeding the Amount of Insurance, sustained or incurred by the Insured by reason of:]

9. Title being vested other than as stated in Schedule A or being defective

(a) as a result of the avoidance in whole or in part, or from a court order providing an alternative remedy, of a transfer of all or any part of the title to or any interest in the Land occurring prior to the transaction vesting Title as shown in Schedule A because that prior transfer constituted a fraudulent or preferential transfer under federal bankruptcy, state insolvency, or similar creditors' rights laws; or

(b) because the instrument of transfer vesting Title as shown in Schedule A constitutes a preferential transfer under federal bankruptcy, state insolvency, or similar creditors' rights laws by reason of the failure of its recording in the Public Records

(i) to be timely, or

(ii) to impart notice of its existence to a purchaser for value or to a judgment or lien creditor.

Covered Risk 13 of the 2006 ALTA Lender's Policy reads:

[SUBJECT TO THE EXCLUSIONS FROM COVERAGE, THE EXCEPTIONS FROM COVERAGE CONTAINED IN SCHEDULE B, AND THE CONDITIONS, BLANK TITLE INSURANCE COMPANY, a Blank corporation (the "Company") insures as of Date of Policy and, to the extent stated in Covered Risks 11, 13, and 14, after Date of Policy, against loss or damage, not exceeding the Amount of Insurance, sustained or incurred by the Insured by reason of:]

13. The invalidity, unenforceability, lack of priority, or avoidance of the lien of the Insured Mortgage upon the Title

(a) resulting from the avoidance in whole or in part, or from a court order providing an alternative remedy, of any transfer of all or any part of the title to or any interest in the Land occurring prior to the transaction creating the lien of the Insured Mortgage because that prior transfer constituted a fraudulent or preferential transfer under federal bankruptcy, state insolvency, or similar creditors' rights laws; or

(b) because the Insured Mortgage constitutes a preferential transfer under federal bankruptcy, state insolvency, or similar creditors' rights laws by reason of the failure of its recording in the Public Records

(i) to be timely, or

(ii) to impart notice of its existence to a purchaser for value or to a judgment or lien creditor.

11 John C. Murray, Creditors' Rights Coverage in Title Policies: Does Deletion of the Exclusion Imply Coverage? (2007) at 7-8.

12 *Id.* at 6.

13 *Id.* at 2.
14 *Chicago Title Insurance Company v. Citizens and Southern National Bank*, 821 F.Supp. 1492 (N.D. Ga. 1993).
15 *Id.* at 1493.
16 *Id.* at 1494.
17 *Id.* at 1495.
18 *See* CALIFORNIA TITLE INSURANCE PRACTICE (2nd ed. 2007) § 6.48 (noting the lack of California cases that address whether a title insurance policy without a creditors' rights exclusion provides coverage for creditors' rights claims).
19 *Elysian Investment Group, LLC v. Stewart Title Guaranty Co.*, 105 Cal. App. 4th 315 (2002).
20 *Id.* at 318.
21 *Id.* at 321.
22 *Id.* at 324 (emphasis added).
23 *Id.* at 324-325.
24 CALIFORNIA TITLE INSURANCE PRACTICE at § 6.23.
25 *Id.*
26 JOYCE PALOMAR, TITLE INSURANCE LAW (2008) at § 6.31.
27 *Id.*
28 Letter dated May 30, 2001 from Cara L. Detring, President American Land Title Association, to Creditors' Rights in Title Insurance Working Group.
29 *See, e.g.*, *Rackouski v. Dobson*, 261 Ill. App. 3d 315 (1994).
30 *Id.* at 316.
31 *Id.*
32 *Id.* at 317.
33 JOHN C. MURRAY, CREDITORS' RIGHTS COVERAGE IN TITLE POLICIES: DOES DELETION OF THE EXCLUSION IMPLY COVERAGE? (2007) at 6.
34 Paul L. Hammann & John C. Murray, *Creditors' Rights Risk: A Title Insurer's Perspective*, 38 JOHN MARSHALL L. REV. at 246.
35 *BFP v. Resolution Trust Corp.*, 511 U.S. 531 (1994).
36 Paul L. Hammann & John C. Murray, *Creditors' Rights Risk: A Title Insurer's Perspective*, 38 JOHN MARSHALL L. REV. at 251.
37 *Id.* at 250.
38 *Id.* at 253.
39 *Id.*
40 *Id.* at 261.
41 *Id.* at 261-262.
42 *Id.* at 277-278.

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