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The Loss Of The Creditors' Rights Endorsement For Title Insurance Purposes

FNMA no longer requires creditors' rights endorsements for loans it purchases and, if rumors can be trusted, the American Land Title Association will soon eliminate the ALTA 21 Creditors Rights Endorsement available for the 2006 and 1992 ALTA Loan Policies. Since the ability to transfer risk to a third party indemnitor (the title insurance company) may be gone, lenders must carefully review each commercial loan transaction and the parties behind it. At a time where state and federal regulatory authorities are trying to expand credit availability, this act may further constrain or restrict loan transactions.

You may recall from our past Commercial Lending Seminars (or you may have watched us agonize over this issue at a closing) that we have always advocated obtaining affirmative insurance coverage to address situations where the loan transaction may later be unraveled if the borrower files for bankruptcy or is sued by another creditor in state court. Specifically, Section 547 (preference actions) and Section 548 (fraudulent transfers) of the United States Bankruptcy Code and certain state insolvency statutes expose each loan transaction to scrutiny after the fact and even force the loan to be restructured or undone. To avoid a lender making a claim under its title insurance policy should a bankruptcy court restructure the original deal, the 1992 ALTA Loan Policy contained important exclusion. Specifically, coverage was denied for any claim which arose out of a transaction insured by the policy by reason of the operation of federal bankruptcy, state insolvency, or similar creditors' rights laws that was based on:

(i) the transaction creating the estate or interest insured by the policy being deemed a fraudulent conveyance or fraudulent transfer; or

(ii) the transaction creating the estate or interest insured by the policy being deemed a preferential transfer.

But title insurance companies recognized a potential source of business when they saw it and sought to capture additional

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revenue from lenders. The ALTA 21 Creditors Rights Endorsement was offered for an additional premium which attempted to "write over" this exclusion. Most astute lenders and their lawyers insisted on this endorsement, particularly for new borrowers. But title insurance companies recognized a potential source of business when they saw it and sought to capture additional revenue from lenders. The ALTA 21 Creditors Rights Endorsement was offered for an additional premium which attempted to "write over" this exclusion. Most astute lenders and their lawyers insisted on this endorsement, particularly for new borrowers.

The 2006 ALTA Loan Policy sought to mitigate the underlying risk to lenders, at least somewhat. As part of the "Covered Risks" part of the 2006 Loan Policy, Section 13 provides the following "protection":

> *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 (emphasis added)*

As noted, the "covered risk" under Section 13 of the 2006 ALTA Loan Policy applies only to transfers or transactions occurring prior to the loan transaction covered under the policy. While of some benefit, it offers little comfort to most lenders, hence the need for the ALTA 21 Endorsement.

Over these last several months the ALTA 21 endorsement has became hard to obtain as business conditions deteriorated. Title insurers figured out that they were being required to underwrite the loan. In the good times, this was no problem. But as the underlying business conditions worsened, insurers were hit with more and more claims. To counteract this problem, title insurers required extensive financial information and the completion of long questionnaires as a first step to obtaining the endorsement. For those of you that have had special purpose entities as borrowers, you know the heightened level of scrutiny that title insurers put these organizations through. Now, it appears title insurers are getting out of this business altogether.

There is some support for ALTA's decision. In its purest sense the risk that a loan transaction will be avoided under Section 547 or 548 of the United States Bankruptcy Code is not a real estate risk but a financial one. No review or analysis of the public records, survey of the property, or even review of the loan terms can answer this question. The only way to ascertain the extent of this risk is to investigate and understand the creditworthiness of the borrower, the borrower's principals and, possibly, the seller.

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The elimination of the ALTA 21 endorsement requires the lender to use great care in reviewing a potential financing opportunity up to the very day of the closing. The lender must constantly monitor borrower solvency, the facts or background of the loan transaction, contingent debt or liabilities of the borrower's principals, and possible market risks that might undermine the transaction. If something seems amiss or should there be new developments such as collateral litigation involving one or more of the borrower's principals, the entire transaction will need to be reviewed. In the end, the solvency/insolvency determination is as much a legal issue as it is an accounting matter. Attached is a piece we distributed at last year's CLS regarding solvency which, unfortunately, is hard to pin down or define.

Should you have questions regarding title issues, the threat of preference actions, insolvency risks, or other matters do not hesitate to contact one of us.

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IS YOUR BORROWER SOLVENT?
Solvency – Its 3 Faces

Introduction.
Figuring out if your borrower is solvent is hard. When you review financial statements and look at the borrower's overall position, you may wonder what is really there. Legally, there are at least three tests for solvency that are applied in different situations. Set out below is a broad overview of these three tests and some of the concerns and issues associated with each of them. As you will see, the best time to rebut the insolvency analysis is at the inception of the loan or at the time of renewal.

I. SOLVENCY – THE BALANCE SHEET TEST.

A. In General.

1. Bankruptcy – Context

a. Section 547 – Preferential transfer made while debtor insolvent

b. Section 548 – Fraudulent transfer if debtor is insolvent

2. Bankruptcy Code definition of insolvency is as follows: 11 U.S.C. 101(32):

The term "insolvent" means:

a. with reference to an entity other than a partnership and a municipality, financial condition such that the sum of such entity's debts is greater than all of such entity's property, at a fair valuation, exclusive of:

i. property transferred, concealed, or removed with intent to hinder, delay, or defraud such entity's creditors; and

ii. property that may be exempted from property of the estate under section 522 of this title;

b. with reference to a partnership, financial condition such that the sum of such partnership's debts is greater than the aggregate of, at a fair valuation:

i. all of such partnership's property, exclusive of property of the kind specified in subparagraph (a)(i) of this paragraph; and

ii. the sum of the excess of the value of each general partner's nonpartnership property, exclusive of property of the kind specified in subparagraph (a) of this paragraph, over such partner's nonpartnership debts; and

c. with reference to a municipality, financial condition such that the municipality is:

i. generally not paying its debts as they become due unless such debts are the subject of a bona fide dispute; or

ii. unable to pay its debts as they become due. (emphasis added)

3. Several issues or problems are associated with the definition:

   a. "Fair Valuation" is not defined.
   b. Balance sheet is only the starting point in that the valuation of assets as per GAAP may be different from tax or cash basis accounting.
   c. Courts will go behind the entity's balance sheet to look at debts as well as the value of assets (historical vs. cost vs. actual valuation).
   d. The entity's "property" may include items fully depreciated and no longer being carried as an asset on the balance sheet.
   e. Debts are recorded only to the extent they are known and quantifiable. Typically, contingent and/or nonrecorded liabilities only surface in an insolvency analysis after the fact.

4. In the 8th Circuit, financial statements showing positive net worth at the beginning of the preference period (which Section 547 defines this as 90 days prior to the filing of any bankruptcy petition) is sufficient to rebut the presumption of insolvency. Silverman Consulting, Inc. v. Hitachi Power Tools, USA Ltd. (In re Payless Cashways, Inc.), 290 B.R. 689 (Bankr. W.D. Mo. 2003) (emphasis added)

5. Certain assets, such as goodwill, should be avoided or netted out for solvency purposes, if possible. But see below concerning "going concern" valuation issues that will surface with regard to the unreasonably small capital test.

6. Contingent assets and liabilities require extraordinary scrutiny and, technically, may not fall under the Bankruptcy Code's insolvency test.

7. Solvency leads to valuation disputes and fights. Value is "...not a natural or fixed quality, but will vary according to the purposes and policies which dictate the determinative judgments and the processes by which it is ascertained." 2 Collier On Bankruptcy §101.32[4].

8. Usual approach is to value the assets as a going concern then subtract the value of the company's liability from the asset value. Bottom line, you need a valuation expert.

B. Presumption of Insolvency.

1. The party against whom the presumption operates (in our case the lender) must come forward with some evidence to rebut the presumption (See the Silverman case above with regard to the effects of this). The presumption merely shifts the burden of going forward to the debtor.

2. The best time to get your file in shape is at renewal or at the loan closing for solvency/insolvency purposes.

3. If presumption of insolvency is rebutted, then the trustee or debtor must prove insolvency by a preponderance of the evidence, which is a difficult task.

C. Determining Value – Going Concern or Deathbed.

1. Going concern vs. liquidation value. Which standard will be used? This is always the issue that the Courts must confront.

2. Typically, going concern is treated as the functional equivalent to the fair market value standard. The liquidation value is roughly equal to a forced sale value.

3. Premise or assumption is that the going concern value is higher than the liquidation value is not always correct. Look at the recent discussions concerning the valuation of GM and Chrysler.

4. Going concern is a much "softer" or subjective standard that depends on the synergies of such things as supply lines, customer relationships, the entity's brand, and other "intangible" assets.

5. Usually, a two-step process as a result of the above in which the Court must decide if the debtor was a "going concern" or was on its "deathbed." Then, the Court must value its assets.

6. Debtor wants the lower valuation method and the creditor will obviously argue for the higher valuation methodology.

7. Typically, the presumption is for going concern analysis to be applied.

8. Relevant date is 90 days prior to the filing date if a preference action and the date of the transfer in question if it is an avoidance action under Section 548.

9. The resulting filing of the bankruptcy petition is generally not dispositive of anything.

D. Going Concern Valuation.

1. Recognized valuation methodologies will be recognized.

   a. Income approach – discounted cash flow or capitalization of earnings.
   b. Market approach offers for the purpose of certain assets or replacement cost valuations.
   c. Future earnings (?) – Maybe.

2. Projections. – Usually treated with suspicion by the courts; the suspicion being that such figures are too speculative. Questions such as why were the projections prepared? For what purpose? When? By whom?

E. Liabilities.

1. Face value of debt – even if bankruptcy filing might result in the debt trading at less than face value.

2. Other types of debt – preferred stock or membership claims entitled to first distributions may be converted to equity. Debt or equity is always a question, particularly during the preference period.

3. Should also consider the liabilities (contingent and otherwise) of each guarantor of the debt. Oftentimes, it is the guarantor's cash flow problems that drive the borrowing entity into bankruptcy.

II. UNREASONABLY SMALL CAPITAL.

A. Test – Fraudulent transfer may be avoided if, among other things, at the time of transfer the debtor was "...engaged in business or a transaction...for which any property remaining with the debtor was an unreasonably small capital." 11 U.S.C. §548(A)(1)(b)(ii)(II) (West 2004) and Supp. 2008).

B. Unreasonably small capital not defined in the Bankruptcy Code.

C. Case law seems to say that the phrase refers to the inability to generate sufficient profits to sustain operations on a going forward basis.

D. Focuses on cash flow projections via information available at the time, and not by hindsight.

1. Were the projections reasonable and prudent?

2. Do not dwell on whether the projections ultimately proved to be incorrect.

E. All reasonably anticipated sources of operating funds must be analyzed.

1. Potential for equity infusions. Once again, take a hard look at all liabilities of the guarantor group. They will be unable to meet cash calls if they are being asked to satisfy other "contingent" liabilities associated with other deals.

2. Operating earnings.

3. Cash from secured or unsecured loans or available lines of credit at the time.

F. The availability of credit is a proper thing to consider when determining whether a business is adequately capitalized. Longview Aluminum, L.L.C., 2005 Bankr. LEXIS 1312

G. The test focuses on reasonable foreseeability.

H. But courts are very clear that the term adequate capitalization does not mean the enterprise must be sufficiently well capitalized to withstand any and all challenges to its business or the consequences of all poor business decisions.

III. ABILITY TO PAY DEBTS AS THEY COME DUE OR MATURE.

A. Avoidance of a transfer if, among other things, the debtor intended to incur debts that would be beyond the debtor's ability to pay as they came due. 11 U.S.C. §548(a)(I)(B)(III).

B. Very subjective test in that one must establish the debtor's intent as a result. This standard is rarely used or litigated.

C. Not sure the test for unreasonably small capital is very different from the ability to pay debts.

1. Future earnings – debt or equity.

2. Free cash flows (expected).

D. It seems, particularly based upon older Arkansas cases that take on a sort of "res ipsa loquitar" analysis. The thing (insolvency) speaks for itself – the debtor filed bankruptcy so the debtor was insolvent.

IV. HOW IS THIS ANALYSIS IMPORTANT?

A. Bankruptcy.

1. Preference.

2. Avoidance.

B. State Law – fraudulent transfers.

C. Law of Fiduciary Duties – as a company approaches a "zone of insolvency" its board of directors or governing officers' fiduciary responsibilities expand to cover creditors. Creditors become a primary party that maintains an interest in the future well being of the company and its assets.

D. Creditors, once a company is in an insolvency situation, have legitimate expectations that the board of directors will not act in an opportunistic manner in times of insolvency, such as selling assets at "fire-sale" prices or take any unreasonable risks.

E. Please note that the community or universe of persons to whom the governing board owes fiduciary responsibility expands, it does not create heightened fiduciary duties or obligations to any particular constituency over other constituencies.

Lesson: *"If I were you, I wouldn't start from here."* (From Ireland - directions to the lost traveler).