THE BANKING LAW JOURNAL

VOLUME 127 NUMBER 5 MAY 2010

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POSTMASTER: Send address changes to The Banking Law Journal, A.S. Pratt & Sons, 805 Fifteenth Street, NW., Third Floor, Washington, DC 20005-2207.

Title Insurers to End Creditors' Rights Coverage Nationwide, But the Issues for Lenders Remain

PAUL G. MACKEY

Recently, several of the nation's largest title insurers announced that on a companywide, nationwide basis, they would no longer offer the type of creditors' rights insurance coverage previously embodied in the decertified American Land Title Association "Creditors' Rights Endorsement." This article discusses this important development.

On February 3, 2010 the Board of the American Land Title Association ("ALTA") approved "de-certification" of the "Creditors' Rights Endorsement" which ALTA had promulgated for use with its current forms of title insurance policy. In announcing this decision ALTA, the trade association for the title insurance industry, noted that "Each title insurer is free in each transaction to agree to issue any creditors' rights endorsement or other coverage or not to issue such an endorsement." Despite the fact that lack of a certified ALTA endorsement form by itself would not impair any title insurer's ability to issue policies with the formerly certified Creditors' Rights Endorsement or any similar form, several of the nation's largest title insurers, including the insurers in the Fidelity National Title, First American Title and Stewart Title insurance groups, promptly announced that on a companywide, nationwide basis, they would no longer offer the type of

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Published in the May 2010 issue of *The Banking Law Journal.*
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creditors' rights insurance coverage previously embodied in the de-certified ALTA endorsement.[1] It should be noted that certain states, including New York, Texas and New Mexico, in which title insurers are only permitted to issue endorsement forms approved by state regulators, title insurers have been precluded from issuing the Creditors' Rights Endorsement for a number of years. In those states, the recent actions of ALTA and certain title insurers do not change existing practice.

WHAT DOES (DID?) THE CREDITORS' RIGHTS ENDORSEMENT COVER?

Since 1990, ALTA title insurance policy forms, which are virtually the exclusive forms available in the United States[2] have *excluded* from the policy's coverage those losses suffered as a result of the insured transaction being undone through application of creditors' rights laws,[3] thus creating the need for a special policy endorsement if such coverage was to be issued. The ALTA 21-06 Creditors' Rights Endorsement provided the insured with coverage against:

> loss or damage by the Insured by reason of the avoidance, in whole or in part, of 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 the Date of Policy of a fraudulent transfer or a preference under federal bankruptcy, state insolvency, or similar creditors' rights laws.

Thus with respect to a loan title insurance policy, if after the closing the borrower filed for bankruptcy and the bankrupt estate or other creditors of the borrower sought to have the court set aside the insured mortgage as a fraudulent conveyance or preferential transfer under the Bankruptcy Code, a title insurer who had issued a policy insuring the mortgage which policy included a Creditors' Rights Endorsement would be required to pay the amount of the lender's loss if the insured mortgage was set aside as a fraudulent conveyance or preferential transfer. The Creditors' Rights Endorsement also obligated the insurer to defend the action attacking the mortgage, including payment

of legal fees for the litigation. Similarly, with respect to an owner's title insurance policy which included a Creditors' Rights Endorsement, the title insurer would be obligated to (1) defend any suit brought to set aside the transfer of the insured real property as a fraudulent conveyance or preferential transfer (such an action could be brought by creditors of the entity which conveyed the property to the insured, or such entity's bankrupt estate) and (2) pay the insured's loss, if the conveyance to the insured were ultimately to be set aside.

WHAT TRANSACTIONS ARE SUSCEPTIBLE TO ATTACK THROUGH "CREDITORS' RIGHTS"?

Fraudulent Conveyances

The principal statute delineating what constitutes the bankruptcy concept of "fraudulent conveyance" is § 548(a)(1) of the Bankruptcy Code, which provides as follows:[4]

"(a) (1) The trustee may avoid any transfer (including any transfer to or for the benefit of an insider under an employment contract) of an interest of the debtor in property, or any obligation (including any obligation to or for the benefit of an insider under an employment contract) incurred by the debtor, that was made or incurred on or within 2 years before the date of the filing of the petition, if the debtor voluntarily or involuntarily—

(A) made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted; or

(B) (i) received less than a reasonably equivalent value in exchange for such transfer or obligation; and

(ii) (I) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation;

(II) was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property re-

> maining with the debtor was an unreasonably small capital;
>
> (III) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured; or…"

As § 548 makes clear, even where a transfer involves no "actual intent to hinder, delay or defraud," parties to a real estate transfer must consider whether a contemplated transaction could constitute a constructive "fraudulent conveyance." The first part of the two-pronged test in § 548(a)(1)(B) is key: whether the transferor "received less than a reasonably equivalent value in exchange for such transfer or obligation." Common scenarios in which "reasonably equivalent value" is called into question include (i) loans in which the party granting a mortgage is not the borrower or is not the sole borrower, or (ii) loans in which the party granting a mortgage or other security interest is not really going to use all of the loan proceeds for its own benefit, such as when an entity grants a mortgage to secure a loan to its parent company and/or affiliates, and (iii) situations in which a purchase of real property is made for less than the fair market value of the property (but note that "reasonably equivalent value" is not a requirement that 100 percent of fair market value be paid in every transaction), including distressed sales, foreclosure sales and delivery of deeds-in-lieu of foreclosure. In evaluating whether "reasonably equivalent value" was given by a lender for a mortgage, the analysis must focus on what value was ultimately received by the specific entity granting the mortgage, not its affiliates and not its parent company.

One typical loan scenario which raises fraudulent conveyance concerns is a credit facility in which multiple affiliates each grant a mortgage on their property to secure the full amount of a single combined credit facility for which all such affiliates are jointly and severally liable. In this situation, even if the proceeds of the credit facility are being used to repay existing debt of each of the borrowing affiliates, there is still a substantial issue of "reasonably equivalent value" because by strictly following the money and looking at each mortgagor separately, the mortgagor has often granted a mortgage securing a very large amount (the full amount of the credit facility, perhaps) and received the direct monetary benefit of a relatively small amount (the amount actually applied to repay that subsidiary's existing debt). In a multiple mort-

gage loan transaction in which the funds were not being used directly by the mortgagor but were instead upstreamed to be used by a parent company for the parent's use (or used by certain of the co-borrowers disproportionately) so that a mortgagor affiliate received little or no direct monetary benefit, the likelihood of a finding of fraudulent conveyance increases.

In cases in which little or no direct monetary benefit is received by the transferor, parties seeking to defend the transfer have argued that the indirect benefits of the transaction be considered in determining whether or not "reasonably equivalent value" has been received. Indirect benefits could include the benefits of being part of a corporate group (the ability to obtain favorable financing as part of a larger organization, coordinated marketing benefits, the ability to use centralized accounting, billing and other services, etc.). While some court decisions have accepted such indirect benefits as constituting "reasonably equivalent value," the reliance on any indirect benefits to establish the receipt of reasonably equivalent value is necessarily fact specific, thereby making it difficult to predict how a court might rule in the future. When faced with those situations in the past, if the mortgage lender could persuade a title insurer to issue a Creditors' Rights Endorsement, the risk of loss due to a later finding of a fraudulent conveyance was assumed by the title insurer.

The second prong of the test for establishing a constructive fraudulent conveyance under § 548(a)(1)(B)(ii) of the Bankruptcy Code requires a financial analysis of the transferor to determine if any one of three alternative problems is present: (I) the transferor was insolvent on the date of the transfer or became insolvent as a result of the transfer; (II) the transferor was, or was about to, engage in a business or transaction for which the property remaining with transferor was unreasonably small; or (III) the transferor intended to incur, or believed that it would incur, indebtedness which it would not be able to pay as it matured. As each of the three alternative tests involve a distinct evaluation of the financial health of the transferor, each will be fact specific and nuanced. For purposes of this article, it should be sufficient to note that if a party is the subject of a bankruptcy proceeding and has been found to have made a transfer for less than reasonably equivalent value, there is a good chance it can be demonstrated that such party, at the time of the transfer, was insolvent, undercapitalized or unlikely to be able to pay its debts as they became due (any one of which circumstances will support a finding

of constructive fraudulent conveyance under § 548(a)(1)(B)(ii) of the Bankruptcy Code).

Preferential Transfers

Bankruptcy Code § 547 provides that a bankruptcy trustee can set aside any transfer of property by a debtor to or for the benefit of a creditor (i) "for or on the account of antecedent debt;"[5] (ii) made while the transferor is insolvent; (iii) made on or within 90 days before the filing of the bankruptcy petition (or one year in the case of transfers to insiders); and (iv) that enables the creditor to receive more than it otherwise would have received in a bankruptcy liquidation of the debtor had such transfer not been made. Thus a mortgage lender which obtains additional mortgage collateral for an existing debt (for example, as means of curing a loan covenant default or as a condition to extension of the maturity of the loan when the value of the initial collateral has declined) faces the risk of having its mortgage avoided as a preferential transfer should the mortgagor file a bankruptcy petition within 90 days of the granting of the mortgage.

HOW WAS THE CREDITORS' RIGHTS ENDORSEMENT USED IN PRACTICE?

While the Creditors' Rights Endorsement required a material premium (often 10 percent of the premium for a full title insurance policy, although premiums vary widely by state and within regions of some states), the assurance it provided to mortgage lenders would on its face seem to warrant obtaining the coverage for any mortgage loan in which a title insurance policy was required. In practice however, title insurance companies have for many years recognized the substantial risk that they assumed in issuing an insurance policy with creditors' rights coverage and were only willing to provide the coverage after a detailed analysis of the transaction structure and financial health of the mortgagor to determine the likelihood of the mortgage being set aside as a fraudulent conveyance or preferential transfer. It was not uncommon for a title insurer to require indemnification from a creditworthy parent entity as a condition to issuing a title insurance policy with creditors' rights

coverage. Many within the title insurance industry have long argued that the type of credit analysis required for an insurer to be comfortable assuming the risks contemplated by issuance of a Creditors' Rights Endorsement in a mortgage loan transaction were not within their traditional area of expertise (and, indeed that credit risk analysis is an institutional lender's expertise). Those title insurance companies that have decided to completely cease offering the coverage have gone from arguing their position to effectively eliminating the availability of insurance over creditors' rights risks through title insurance. We should note that at least one major title insurance company contacted in recent weeks has indicated that it will still consider the coverage on a case by case basis, but noted an increased tightening of the standards for issuance of the endorsement to the point where if a mortgage or other transfer had any indicia of a possible creditors' rights issue, they would decline to provide the coverage.

CONCLUSION

The unavailability of creditors' rights coverage within title insurance policies for many years in a number of states, including New York, has proven to be no impediment to mortgage lending and other real estate transactional activity. While this would indicate that the near universal "ban" on such coverage will not in and of itself cause any substantial disruption in real estate transactional activity elsewhere,[6] it should serve as a stark warning to real estate professionals, and mortgage lenders in particular, of the substantial risks which creditors' rights laws can present in transactional structures which raise any question of whether or the granting of a mortgage could later be construed as a fraudulent conveyance or preferential transfer. Title insurance will, for the most part, no longer be an option in transactions which involve any "gray area." Given the current state of the real estate market, prudent commercial lenders hardly need a reminder to evaluate the creditworthiness of borrowers with the utmost care, but there are a couple of points which they should bear in mind in light of the abrupt actions of the title insurance industry. It is recommended that in any loan transaction under consideration which involves collateral given by more than one entity or collateral given by an entity which is not going to receive, contemporaneously with the granting

of the mortgage, all of the loan proceeds to use for its own purposes, detailed consideration be given to creditors' rights issues *before* a transaction structure is settled. In addition, where issues of fraudulent conveyance or preferential transfers are presented, lenders should consider requiring a guaranty or indemnity from an acceptable parent company of the borrower/mortgagor to cover any loss which might otherwise have been insured through a title insurance policy Creditors' Rights Endorsement.

NOTES

[1] The ban also applies to using other forms of title insurance policies which effectively provide the same creditors' rights insurance coverage, such as the ALTA 1970 policy forms still used in Florida in recent years to obtain creditors' rights coverage.

[2] An exception is Texas, where the Texas Department of Insurance promulgates the forms of title insurance policy used in Texas, which contain a creditors' rights exclusion nearly identical to that in the ALTA 2006 policies.

[3] Exclusion From Coverage number 6 of the ALTA 2006 loan policy is as follows:

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 [relating to the mortgage being found to be a preferential transfer as a result of failure of the title insurer to timely record the insured mortgage, *see* note 5, *infra*].

[4] In describing creditors' rights issues, this article focuses on the federal Bankruptcy Code, but readers should bear in mind that the Bankruptcy Code does not preempt state fraudulent transfer laws. As the text of the ALTA 21-06 endorsement itself recognizes, such state laws can present a similar basis for setting aside an otherwise valid transfer of an interest in real estate. Forty-three states and the District of Columbia have enacted a version of the Uniform Fraudulent Transfer Act (the "UFTA"). New York is in the overwhelming minority in retaining its version of the Uniform Fraudulent Conveyance Act, a predecessor to the UFTA. In analyzing any particular transaction, the applicable state laws must be taken into consideration as they present an independent basis for attacking a transaction as a fraudulent conveyance and such state laws often provide a period much longer than the two years of Bankruptcy Code § 548 in which to challenge any conveyance as fraudulent.

[5] § 547(e)(2) of the Bankruptcy Code provides that a transfer of real property is considered made "at the time such transfer takes effect between the transferor and the transferee, if such transfer is perfected [*e.g.*, the mortgage is recorded in the appropriate land records] at, or within thirty (30) days after, such time, except as provided in subsection (c)(3)(B) [which counts the 30-day period from the day the debtor receives possession of the property in the case of purchase money financing]." Thus a mortgage that is recorded more than 30 days after it is executed and delivered by the mortgagor could constitute or may be considered "on account of an antecedent debt." As noted above, if the mortgage in question were insured pursuant to a standard loan title policy, the policy would cover losses as a result of the mortgage being found to be a preferential transfer due to such delayed filing.

[6] Ironic evidence of the tangential role of the title insurance creditors' rights endorsement to the real estate industry as a whole can be seen in the position of Fannie Mae. In recent years, Fannie Mae had required a creditors' rights endorsement in all title insurance policies for all multifamily loans delivered to Fannie Mae for purchase or securitization. Soon after ALTA decertified the endorsement and most of the title insurance industry indicated that they would no longer issue it, Fannie Mae decided the endorsement would no longer be required.