

A New Approach to Creditors' Rights

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The month of February 2010 changed the landscape of commercial real estate transactions, as national title insurances, such as Fidelity National Title Group, First American Title Insurance Company, Lawyers Title, Chicago Title, and Stewart Title announced that they would no longer be deleting the “creditor’s rights” exclusion, or providing a “creditors’ rights” endorsement in connection with any new policies of title insurance. The right of a creditor to set aside, void or unwind a particular transaction is a typical exclusion in a policy of title insurance. Accordingly, the deletion of the “creditors’ rights” exclusion or the issuance of a “creditors’ rights” endorsement has become staple endorsement in typical real estate transactions, as it insures the purchaser of real property insurance that the transaction will not be set aside or unwound by the seller’s creditor, or constitute a voidable preference or fraudulent conveyance under U.S. bankruptcy laws.

Naturally, the recent turbulence in the commercial real estate market has taken a toll on the title insurance industry, as the record number of real estate related bankruptcies have exposed national title companies to unforeseen costs and expenses arising out of their continued deletion of the “creditors’ rights” exclusion and issuance of a “creditors’ rights” endorsement. In response, the American Land Title Association (ALTA) announced that it would be decertifying or withdrawing the creditors’ rights endorsement (ALTA Form 21/21-06) from use, effective March 8, 2010, which prompted the recent changes in title insurance policies.

As a result of this change, purchasers of real property should conduct meaningful due diligence regarding the fiscal condition of a seller, and to determine whether the nature of a particular transaction provides any basis for a potential claim by a creditor. A successful claim by a creditor generally requires proof that the transaction was either: (i) made with the intent to hinder, delay or default a creditor, or (ii) for less than “reasonably equivalent value” when the seller was insolvent at the time of transfer or became insolvent as a result of it. Accordingly, any buyer should analyze whether there is any indication of the foregoing factors, by reviewing various data and information requested of seller or available to the public and taking actions such as:

- investigating the financial condition of the seller prior to entering into a transaction, or during the due diligence period, by analyzing financial statements, credit ratings and similar reports;
- performing detailed title analysis and conducting lien and judgment searches on the seller and its affiliated entities to determine the existence of any creditors;

- requiring comprehensive representations and warranties from a seller concerning its fiscal health, its creditors, and its confirmation that the sale will not lead to bankruptcy; and
- engaging an independent and reputable third-party appraisal to determine whether the purchase price represents “reasonably equivalent value”.

Buyers are encouraged to take action to fully investigate each transaction as thoroughly as possible to identify potential creditors and claims that may be made based on facts and circumstances specific to a particular transaction. While it may be impossible to identify and eliminate all potential claims, with appropriate due diligence, risks can be mitigated—and significant future costs and expenses dealing with claims of creditors may be avoided.