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No Creditors' Rights Endorsement - Alternatives

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Now that the American Land Title Association ("ALTA") has withdrawn the ALTA Form 21-06 Creditor's Rights Endorsement, what steps can a lender take to protect itself?

To recap, the Creditors' Rights Endorsement provided protection against loss or damage sustained by the lender in the event that the lender's mortgage was set aside due to a fraudulent conveyance or preference under the U.S. Bankruptcy Code, state insolvency statutes or other creditor's rights laws.

In a routine re-financing transaction or a purchase money loan, where (i) the loan proceeds are provided by a third party lender in an arm's length transaction and (ii) the proceeds are used to pay off a prior loan or purchase the real estate from an unrelated seller, the risk that the lender's mortgage interest would be impaired due to a creditor's rights claim is low. In general, a lender that gives *reasonably equivalent value* for its interest*, without knowledge that other creditors were being hindered or delayed* will have a valid defense against a creditor's rights claim.

Under different circumstances, however, a lender faces an increased risk.

Those circumstances may include, for example, the situation where a lender requires a borrower to provide additional property as security for an existing loan without advancing any new money. The lender has improved its position with regard to an *antecedent* debt without giving any new value. This improvement may be viewed as a *preference or a fraudulent conveyance*.

A lender also may face an increased risk when a new loan to a borrower is secured by the property of an affiliate or guarantor of the borrower. If the affiliate/guarantor files bankruptcy, a court may find that the affiliate/guarantor did not receive *reasonably equivalent value* for the granting of the mortgage, or *was insolvent at the time of, or render insolvent due to*, the transaction.

How does a lender address such creditors' rights issues without a title endorsement?

First, creditor's rights issues should be managed through underwriting. A lender must know the borrower and its financial condition, and should continue to monitor the borrower's financial condition throughout the term of a loan. Even in the case of a routine re-finance or purchase money loan, a lender should be thoroughly familiar with the borrower and the transaction. A court will consider what the lender "should have known" when evaluating whether or not a lender had knowledge that *other creditors were being hindered or delayed* at the time the lender's transaction was completed.

Second, the issues may be managed through the lender's loan documents. When a loan is to be secured by the property of an affiliate or guarantor of the borrower, the loan documents should clearly and concisely set forth (i) the relationship between the borrower and the affiliate/guarantor; (ii) an acknowledgement by the affiliate/guarantor that it will receive a direct benefit from the loan to the borrower; and (iii) the receipt by and sufficiency of the consideration received by the affiliate/guarantor. A lender may also require that the authorizing resolution of the affiliate/guarantor specifically affirm that the entity will be directly benefited by the loan transaction to the borrower.

For a non-recourse loan, a lender may include a non-recourse carve-out in its promissory note, and any guaranty of the carve-outs, for all loss or damage incurred by the lender due to any voluntary or involuntary bankruptcy of borrower.

Lenders should also be aware that a bankruptcy judge has held, among other things, that a fraudulent transfer savings clause is unenforceable (*See* In re TOUSA, Inc., Case No. 08-10928 (JKO)) ("TOUSA"). Prior to the TOUSA decision, a lender could seek protection by including a provision is its loan documents which automatically reduced the obligation owed and the liens granted by a debtor, to the extent necessary to prevent the debtor's insolvency. The TOUSA court held such a clause unenforceable where a debtor was insolvent prior to the transaction and received no value. The court further said that such a clause is unenforceable under 11 USC § 541(c)(1)(B) which states "an interest of the debtor in property becomes property of the estate, notwithstanding any 'provision in an agreement' that is 'conditioned on the insolvency or financial conditional of the debtor' that 'effects or gives an option to effect a forfeiture, modification, or termination in the debtor's interest in the property." (TOUSA, pg 60-62). Basically, the TOUSA court held that "efforts to contract around the core provisions of the Bankruptcy Code are invalid." (TOUSA quoting from *In re Sutton*, 324 B.R. 624,627 (Bankr.W.D.Ky 2005). While the TOUSA decision is under appeal, reliance on "bankruptcy saving clauses" should occur only with caution.