

## **DEBT RESTRUCTURING PROBLEMS IN THE WORKOUT OF TROUBLED REAL ESTATE ASSETS**

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The 1980s saw an unprecedented growth in credit at the government level, the corporate level and consumer levels. The Wall Street financial entrepreneurs and innovators of the 1980s had the dangerous illusion that marketability and liquidity were equivalent and that market debt and resiliency could be assured regardless of credit quality. The leveraging of assets was sometimes referred to as financial engineering and the financial engineers were interested in one thing only, their ability to pile more and more debt onto a particular company or project. The merchants of debt marketed all types of securities and junk bonds in packaged form. Real Estate was no exception.

In real estate, overbuilding and overleveraging were pervasive. Institutional lenders were not immune to the credit binge of the last decade. Many of those who in the past financed real estate projects so freely, fell subject to severe capital constraints and the watchful eye of bank regulators. The need to increase loan loss reserves, limited many financial institutions in their capacity to lend and reinvest. The huge amount of debt that was incurred in the 1980s, partially on the assumption that real estate values and rentals would continue to increase into the '90s, came due, and developers had trouble obtaining refinancing for the "bullet loans" previously made to developers for developments whose principal incentive, in some cases, was to generate tax benefits.

This paper was revised for presentation at the 1997 Neumann College Second Annual Title Insurance Seminar entitled "Maximizing the Benefits of Title Insurance, Understanding the Policy Format and Available Coverage". It was originally presented at a seminar sponsored by the Land Title Institutes of Maryland and Virginia entitled "Working Out Troubled Real Estate Assets" October, 1991

Appreciation is given to Hugh A. Brodkey, Associate General Counsel, Chicago Title Insurance Company, for permission to include within this paper portions of a paper previously prepared by him and William A. Colavito and presented to the New York Law Journal entitled "Title Insurance Considerations in Dealing with the Troubled Loan".

I also want to acknowledge the help of Scott A. VanBuskirk, Vice President and General Corporate Counsel with Lawyers Title Insurance Corp., for his editing assistance and suggestions to an early draft of this paper before his death. His expertise on creditors rights issues was widely respected. In the March-April Issue of Lawyers Title News an article appeared entitled "Caution is Watchword in Loan Workouts". I have quoted from portions of that article.

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The fallout generated by the debt excess of the 1980s was not pretty. The slowing economy contributed to: the decline of commercial real estate values in major metropolitan markets; volatile financial markets; the collapse or seizure of financial institutions; lower asset values and, increasingly rigorous credit evaluations. In the aftermath, the lending institutions had to find ways of "shoring-up" their assets. These dramatic changes in the economy presented new problems for successful business reorganization and/or liquidation in the 1990s. The structure and handling of out of court workouts has become the subject matter of numerous "troubled asset" conferences and programs currently offered to real estate professionals of all types - including bankers, lenders, developers and lawyers.

Many developers who previously leveraged their assets are now candidates for workouts because they are unable to meet or refinance their existing obligations. With the downturn in the commercial real estate market, title insurance companies received more and more requests for endorsements or new policies as the lender and borrower renegotiated the financing on troubled real estate projects. This paper is an overview of the significant title issues related to workout situations, including a discussion of policy coverage and other considerations which influence a title insurers ability to deal with the various options available to the lender. For a more detailed discussion of the issue review Collier, Real Estate Transactions and the Bankruptcy, Matthew Bender, Chapter 5.

For those of you unfamiliar with the term "workout", it refers to real estate projects which have failed to meet the lenders debt service or other covenantal requirements and are either on the verge of, or in actual default. As an alternative to foreclosure, a lender may choose to restructure the debt and rehabilitate the debtor through "non-judicial reorganization" and private agreements. The negotiations which take place between the lender and the developer explore the possibilities of restructuring the loan. The lender wants to stop the project from hemorrhaging, without violating his regulatory responsibilities to an assortment of governmental agencies, while the developer tries to buy time in order to reduce or, in some cases, eliminate his cashflow responsibilities to the lender. The parties to the workout are acutely aware that failure to satisfy all the creditors can lead to formal bankruptcy proceedings and thereby undo the plan.

Workout transactions are fraught with risk. Financial distress can result in unequal bargaining positions between the parties, with unfair terms being forced upon the borrowing entity. For this reason, title insurers approach default and rescue operations cautiously.

#### **SPECIAL TITLE INSURANCE CONSIDERATIONS IN WORKOUTS**

An insured lender considering a workout arrangement with a defaulting debtor should be aware that its title insurance coverage could be affected. When the lender realizes that it is dealing with a problem loan, the lender already has in its file a title insurance policy. One consideration which is all too often overlooked by the parties to a loan workout is the need to involve the title insurer at the onset of the negotiations. A lender should contact the title insurer when the real estate becomes distressed and the borrower goes into default. Lenders need to be aware of what protection the existing title insurance does and does not provide in these situations. Any action which the lender takes to change its relationship with the borrower may result in either one of two possibilities: (i) it may have an impact on the rights of the lender under the existing title insurance policy and/or, (ii) it may create new title problems. In the case of a problem loan the lender and its counsel are concerned with the defenses which a borrower or an aggrieved third party may raise based upon the conduct of the lender.

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There are two policy condition and stipulation clauses and one exclusion clause which must be considered. First, condition 8(c) of the 1987, 1990 and 1992 ALTA loan policies and clause 9(c) of the owner's policy state: "The company shall not be liable for loss or damage to any insured for liability voluntarily assumed by the insured in settling any claim or suit without the prior consent of the company." The same provision in the 1970 ALTA Loan Policies was in Condition and Stipulation 7(c). If an insured lender makes concessions in a workout with a defaulting debtor because the lender's position is weakened by defects in the transfer of the insured interest, this clause will probably prevent the title insurer from being liable for the insured lender's loss.

Second, title insurance policies provide that the insurer is subrogated to all rights and remedies of the insured. The insurer's right of subrogation is set forth in Conditions and Stipulation 10 of the 1970 ALTA Loan Policy and Condition and Stipulation 12(b) of the 1987, 1990 and 1992 loan policies. All policies specifically state that the insurer's right of subrogation does not prevent an insured lender from (i) releasing or substituting the personal liability of any debtor or guarantor; (ii) extending or otherwise modifying the terms of payment; (iii) releasing a portion of the estate or interest from the lien of the insured mortgage or (iv) releasing any collateral as security for the indebtedness, but only so long as the priority and enforceability of the insured lien are not affected and the insured has no knowledge of any claim of title or interest adverse to the insured's estate or interest (emphasis mine). The clause goes on to state the following:

When the permitted act of the insured occurs and the insured has knowledge of any claim of title or interest adverse to the title to the estate or interest or the priority or enforceability of the lien of the insured mortgage as insured, the Company shall be required to pay only that part of any losses insured against hereunder which shall exceed the amount, if any, lost to the Company by reason of the impairment by the insured claimant of the Company's right of subrogation.

In a workout situation, a lender will frequently be asked to release or substitute the liability of a debtor or guarantor, to extend or modify payment of terms, or to release a portion of the lender's interest or collateral from the lien of the insured mortgage. If, after the workout, a third party makes a claim against the lender's insured interest and the title insurer is called upon to defend title or indemnify, the title insurer will not have to pay any amount it cannot collect through subrogation that it could have collected if **the insured had not relinquished certain rights. Therefore, before** an insured lender waives any rights in a workout agreement with a defaulting borrower, the lender should first contact the title insurer for either a determination of the effect of such acts upon its title coverage or for approval of the settlement agreement.

To summarize, when the lender is exploring or negotiating a "non-judicial" reorganization plan with the borrower it must remain cognizant of the following points:

- (a) Many actions which would jeopardize the insurer's right of subrogation may jeopardize coverage under the existing policy;
- (b) The policy will not automatically insure the effectiveness of contemplated changes in the relationship between the borrower and the lender;

If a new policy is **issued after the change, it is important that** all relevant facts be disclosed to the title insurance company by the lender.

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(c)



In the two condition and stipulation clauses analyzed above we have emphasized the impact that actions agreed to by the lender relating to either concessions or releases may have upon its title coverage. That, however, is not the only concern. In a workout situation the lender may also require new collateral (often in the form of additional property be subjected to its mortgage lien) or an increase of payments. These concerns are addressed at greater length below. At this point, suffice it to say that such actions may be determined to impair the continued priority of the lien of the insured mortgage

Exclusion 3(a) and 3(b) of The American Land Title Association Loan Policy specifically excludes liability for "Defects, liens, encumbrances, adverse claims, or other matters (a) created, suffered, assumed or agreed to by the insured claimant; [or (b) not known to the Company and not shown by the public records but known to the insured claimant either at Date of Policy or at the date such claimant acquired an estate or interest insured by this policy or acquired the insured mortgage and not disclosed in writing by the insured claimant to the Company prior to the date such insured claimant became an insured hereunder . . ." as well as matters created subsequent to the date of the policy. These clauses would prevent liability for any loss of priority or unenforceability of the original mortgage lien that resulted from the later modification and the subsequent court determination that the modification constituted a novation or otherwise prejudiced the lien of junior creditors. Therefore, before attempting to change the relationship between the borrower and the lender, either through a transfer of title or modification of the loan the lenders counsel should give careful consideration to the Exclusions From Coverage and the Conditions and Stipulations set forth in the policy of title insurance.

It is not uncommon for the loan workout to fail and thereafter proceed to foreclosure litigation or bankruptcy, at which time allegations may be made that the lender is either a partner or a joint venturer with the borrower or is, indeed, liable under some other legal theory to the borrower for damages inflicted on it. Extensive involvement in such transactions might leave title insurers open to liability for damages unrelated to questions of title. Title insurers, therefore, should limit their involvement to advisory roles on real estate title matters, with participation only when the issue of insurable title is involved.

Loan workouts may reflect any one of the following steps and, indeed, the workout process may progress from one to the other and culminate in the bankruptcy court. Except in the case of bankruptcy, all of the following workout arrangements raise creditors rights problems. The first step in the workout process may involve the lender's modifying the existing loan in order to give the debtor some relief on payment terms or the interest rate under the loan, or it may advance the borrower additional funds to tide it over a difficult period. In either case the lender's original title insurance policy provides insufficient protection as it insures only the lender's lien on the real property as of the date set forth on Schedule A of the loan policy. The original loan policy does not insure the terms of a later modification unless an express endorsement is obtained to that effect because the subsequent action undertaken by the lender is a post policy event.

#### **MODIFICATIONS OF MORTGAGE ISSUE:**

Frequently, the borrower and lender will negotiate changes in the structure of the existing loan such that (i) unpaid interest may be capitalized; (ii) new money may be advanced; (iii) the interest rate may be changed; (iv) contingent interest may be added; (v) additional collateral may be added to the security; or (vi) collateral may be released as part of a reduction in the size of the project. Most of the types of modifications contemplated above would present serious priority questions. All of these modifications present questions as to the coverage provided under the existing title insurance policy.

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Bear in mind that any change which affects the subrogation position of the title insurer, other than those noted in the policy provisions, may prejudice continued coverage under the policy.

If existing mortgages are being modified, there may be priority problems which must be addressed under state law due to liens which have been filed or may have arisen since the recording of the original mortgage. In addition, lenders will often seek to obtain new collateral either because new monies are being advanced or the lender is feeling much less secure about the loan. Also, a decline in the value of existing, collateral may have left the lender under secured. This situation raises a clear danger, because the granting of new or additional security for an antecedent debt (that is, a debt created in the past) may very well create a preference under the Bankruptcy Code.

A preference is narrowly defined under Section 547 of the Bankruptcy Code, but involves a situation in which a transfer (which includes mortgaging of property) is made on account of an antecedent debt. Such a transfer may result in the recipient's being placed in a better position than he was prior to the transfer and in a better position against others who would be in his same class in the event of liquidation. Even if some new money is being advanced there may still be a preference problem if the lender was under secured before the transfer occurred. One court has ruled that there may be a partial preference if the value of the transferred property exceeds the new value given by the previously under secured lender. [In Re Kuner Bavishi & Associates, 906 F2d 942 (3rd Cir. 1990)].

In other words, the determination as to whether a preference has occurred may involve determinations of the current value of existing collateral compared to the value of new collateral being given to the lender and new money being provided to the borrower. Since courts focus on how junior liens may be prejudiced, caution in underwriting loan modifications involving borrowers who are in distress or in default under the loan terms is essential.

When it comes to mortgage modifications, some courts maintain that a modification may taint the whole mortgage relationship. Under this rationale, the tainted first mortgage - principal, interest and all - may lose priority to the junior lender. In that case, courts may reverse the normal mortgage priorities. Such a decision could completely nullify the senior lender's security. See Gluskin v. Atlantic Savings & Loan Association, 32 CaI.App.3d 307, 108 CaI.Rptr. 318 (1973); Giesen, "Routine" Mortgage Modifications: Lenders Beware, 17 Real Estate L.J. 22 (1989).

Courts justify this portion on the ground that a modification which increases the mortgage payments deprives the borrower of needed funds and leads to a default. Also, a modification that shortens the mortgage term could precipitate a foreclosure at a time when the property value is rock-bottom.

A corollary argument has been made when, instead of shortening the term, the senior lender extends it. See Citizens & Southern National Bank of South Carolina v. Smith, 277 S.C. 162, 284 S.E. 2d 770 (1987). But see Guleserian v. Fields, 351 Mass. 238, 218 N.E.2d 397 (1966). In that instance, junior lienholders may argue that the extension permitted the property's value to deteriorate until it was below the existing mortgage balance. They may contend that if the senior lender had taken action against the borrower on the unmodified due date, everybody might have been paid. A court may reject such attacks, but the expense and delay needed to defend against them are costly. Not only must the title insurer concern itself with its contractual defense obligations under the policy, it must also charge a premium commensurate with the risk.

Another tainting factor for reversing mortgage priorities may exist where the senior lender has gained its priority through a subordination agreement with the junior mortgage holder. In that case, the junior lender then has a contractual relationship with the senior lender, and may argue that the

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subordination agreement was violated by the modification. That would be particularly true if the subordination agreement required the senior lender to obtain consent from the junior lender before modifying the mortgage. This obligation may be either specified or implied by the original subordination agreement.

On the other hand, if the subordination agreement with the junior lender provides that the senior lender may modify the mortgage at any time, including increasing the interest rate or changing the maturity date, the junior lender will have more difficult time challenging the modification. However, some courts have questioned the enforceability of such an open-ended subordination agreement when the modification materially changes the junior lender's rights or ability to collect on its lien.

#### **AVAILABLE ENDORSEMENTS INSURING MODIFICATION**

In most jurisdictions the priority of a mortgage or trust deed depends upon the order of recordation. A modification of an existing mortgage - be it in the interest rate, the term of the mortgage, the principal amount, or some other change - may be found not to have the priority of the original mortgage but to be junior to interests in the real property of the original mortgage recorded after the original mortgage and before the modification. If, for example, the interest rate in an existing mortgage were increased from 8 percent to 13 percent, the additional 5 percent interest might not have priority over liens or encumbrances recorded after the mortgage but prior to the modification.

If a lender who has been involved in a workout of indebtedness wants its title insurer to insure the priority of both the mortgage and the modification, the lender must first record the settlement documents in the record office where the original mortgage is recorded. An insured lender may then work with the title insurance company to draft an endorsement which will provide the necessary coverage, or purchase one of the CLTA standard form endorsements which apply. CLTA Endorsement Form 110.5 provides coverage when a workout extends the maturity date of the loan and mortgage, reduces the interest rate, or defers interest. The endorsement insures that the settlement documents have modified the insured mortgage or trust deed as the parties intended, and that the insured mortgage is still prior to any other liens or encumbrances on the real property. A modified version of Endorsement Form 110.5 insures that the settlement agreement has resulted in additional collateral of the borrower being made subject to the lender's insured mortgage or trust deed and that both the original mortgage and the new obligations have priority over any other liens or encumbrances on the property.

A third CLTA endorsement, Form 108.8 is available, to protect a lender when further advances are to be made to the defaulting borrower as a part of a workout. Form 108.8 insures against loss by reason of title to the insured estate or interest being vested in anyone other than the borrowers at the time of the additional advance, and by reason of priority of any interest over the lender's mortgage insofar as it secures the additional advance.

In Pennsylvania the **TIRBOP recently approved Endorsement PA 500** (1999), which is the same as the ALTA Endorsement 11. This endorsement insures against loss arising from the invalidity of a lien of the insured mortgage resulting from modification to the insured mortgage. The charge for this endorsement is set forth in section 5.9 of the TIRBOP Manual along with examples.

The original title insurance policy also may be insufficient to protect the lender when a workout involves one of the many alternative mortgage forms or creative financing variations which have been devised in recent years. When the financing arrangement permits changes in the rate of interest with additions to the principal amount of the loan, the lender will want to be certain that its title insurance

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coverage equals the maximum amount of principal to be owed over the course of the loan. Several ALTA endorsements are available to provide additional protection to a lender using an alternative mortgage instrument. ALTA Endorsement Form 6 is a Variable Rate Mortgage Endorsement. It insures against loss by reason of the unenforceability of the lender's lien, or loss of its priority, as a result of provisions in the underlying loan for increases in the interest rate. A Variable Rate Mortgage Endorsement -Negative Amortization Form insures against loss because of provisions in the insured mortgage allowing for interest on interest, changes in the rate of interest, or the addition of interest to the principal balance of the loan.

There is also a standard Shared Appreciation Mortgage Endorsement, as well as a Shared Appreciation Mortgage Endorsement Form specially designated for instruments which give the lender an interest in the borrower's cash flow. A Convertible Mortgage Endorsement Form protects the insured against loss by reason of the insured's inability to convert the lien interest to an equity interest as per the terms of a convertible mortgage. In some states such mortgages have been found to clog the debtor's equity of redemption and have thus been held to be unenforceable as a matter of public policy.

### **PREMIUM CHARGES APPLICABLE TO MORTGAGE MODIFICATION MATTERS**

There are specific rate provisions set forth in the Title Insurance Rating Bureau of Pennsylvania Rate Manual under section 5.12. There can be no deviation from these rates. In addition, the appropriate charge must also be made for any available endorsements above set forth if it is determined that the coverage can be granted.

### **FRAUDULENT CONVEYANCE ISSUES AND THE AVOIDANCE PRINCIPAL:**

The law of creditors rights has undergone radical change in the last decade. Through the application of fraudulent conveyance law, bankruptcy courts have recharacterized various types of transfers as preferential or fraudulent under the Bankruptcy code and under state insolvency laws.

Under the Bankruptcy Reform Act of 1978, the Uniform Fraudulent Conveyance Act and many state fraudulent transfer acts, a transfer that is made by an insolvent debtor for consideration below the asset's market value may be deemed constructively fraudulent and, therefore, avoidable in an appropriate court proceeding. Both Acts permit present and (in some cases) future creditors to set aside or ignore not only a conveyance made with "actual intent" to hinder, delay or defraud creditors, but also conveyances made without "fair consideration" if the conveyance occurs when the debtor is insolvent (or would be made insolvent), where the debtor is left with unreasonably small capital to engage in business or where the debtor intends or believes that it will incur future debts beyond its ability to pay as they mature.

The avoidance principle has been extended to apply to deeds in lieu of foreclosure and necessarily requires the making of value determinations. Title insurers are not in the business of making determinations of value. That is the responsibility of a real estate appraiser. Title insurers are simply not equipped to make the financial analysis necessary to determine whether a foreclosed owner is solvent or that a future trustee in bankruptcy will move to set the sale aside as fraudulent because the bid price was less than for "reasonably equivalent value". The avoidance principal issue remains a genuine concern to the title insurer.

### **SPECIAL TITLE INSURANCE CONCERNS IN DEED-IN-LIEU-OF-FORECLOSURE AND THE ISSUE OF RECHARACTERIZATION**

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If the parties are unable to restructure or rescue the loan, the lender may demand the property of the debtor in (partial) satisfaction of the debtor's obligations. In real estate vernacular, these are referred to as deeds-in-lieu-of-foreclosure. In many such cases no foreclosure action is ever filed, but the threat thereof hangs over **the transaction should negotiations fail**. When the lender takes a deed-in-lieu-of-foreclosure instead of actually foreclosing, the liens of junior creditors will not be cut off. When a deed in lieu is delivered the title insurer will likely insist upon the inclusion of a "creditors' rights exception" in any endorsement issued to the existing policy. The principal creditors' rights issue is whether the mortgagee is paying or otherwise giving reasonably equivalent value for the conveyance. The creditors rights exception will protect the title insurer from any liability for claims of junior lienors whose rights would otherwise have been foreclosed had the lender taken the property through a foreclosure sale.

An insurer may be willing to delete that exception if the lender can provide a statement of loan balance and an appraisal which show that after the lender's claims are satisfied, there is no equity left in the property to which the liens of junior creditors could attach. However, such items may be subject to rebuttal. While complete disclosure may be helpful here the lender must understand that the title insurer is not in the business of making determinations of value nor are they able to determine that the appraisals offered as an inducement to remove the exception are reliable. On the other hand, what the title insurer is obligated to do is to disclose to the insured any action of which it (the insurer) has knowledge which may put the insured in a position of peril or subject them to litigation or serious financial loss. Therefore, before agreeing to insure a deed in lieu of foreclosure without exception, in reliance upon the foregoing, and in order to guard against a later determination that the deal was in fact a "recharacterization" of the debt, the insurer is also likely to require the absolute and unconditional release of any remaining liability of the debtor and the removal, if any, of any option of the debtor to repurchase. The title insurer should further insist upon receiving an estoppel affidavit which states that the conveyance of the deed in lieu was in exchange for the full satisfaction of the borrower's debt plus new value, that the borrower's mortgage is released, and that no other side agreements exist between the parties. These precautions should prevent a subsequent finding that the transfer was actually a loan-security device and not a conveyance of absolute fee title.

Even if the title insurer were to agree to remove the creditors rights exception in reliance upon a current statement of loan balance and appraisal, the question of value is not completely overcome. The existing title insurance policy may not protect the lender's title against claims of parties who have purchased an interest in the property subsequent to the lender's acquiring the fee by deed in lieu. Lender's counsel should address this concern in their loan documentation. Exclusion 3(e) of the ALTA loan policy excludes from coverage defects, liens, adverse claims, or other matters resulting in loss "which would not have been sustained if the insured claimant had paid value for" the estate or interest insured by the policy. In some jurisdictions, a lender's satisfaction of an antecedent debt is not considered to be new value in exchange for the deed. In those jurisdictions, the lender taking a deed in lieu would not be a bona fide purchaser at arms length for good and valuable consideration entitled to the protection of the recording acts against the claim of a subsequent lienor. Consequently, the lender would not be protected by its title insurance policy. The problem cannot be overcome by title endorsement in those states where there is statutory or regulatory prohibition which prohibits change to the policy boilerplate. Pennsylvania is such a jurisdiction. The rate rules promulgated by the Title Insurance Rating Bureau of Pennsylvania as approved by the Department of Insurance specifically prohibit such action. However, this problem may be overcome if the transactional documentation clearly establishes that there was new value given. This is another reason why the title insurer requests such a statement be included in any estoppel affidavit.

## **RECHARACTERIZATION**

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One area of concern when considering deeds-in-lieu-of-foreclosure is that of "recharacterization". This issue is framed by many old cases that have held such deeds to be nothing more than disguised mortgages. The courts have found the intent of the parties to be that the conveyance was not absolute but rather a further loan modification or new security instrument. For example, in some commercial transaction, property may be deeded to the lender, but the borrower is allowed to remain as the property manager and has some option to buy back into the property at a future date. Another concern is the effect of the deed on the mortgagors right or equity of redemption. For this reason, title insurers insist that such conveyances be in fact absolute, and also insist upon evidence of satisfaction of the debt and an absence of "side deals" between borrower and lender.

The risk of recharacterization may also arise in any situation where the lender is later determined to have an ownership interest in the borrowing entity because of (i) its capital contribution or (ii) its direct participation in the management and/or operation of the property. This is especially true in loan restructuring and "workout" arrangements, where the lender, in return for further concessions by the borrower in default, modifies the terms of the existing mortgage. As stated earlier, virtually any action which the lender takes to change its relationship with the borrower can have an impact on the rights of the lender under the existing title policy and could generate new title problems. For this reason, the documents must be thoroughly reviewed so as to determine the extent of controls the lender exercises over the borrower's day to day actions.

Many times the deed-in-lieu-of-foreclosure is not a viable option either because there are intervening liens which will not be cut off by the deed-in-lieu or because a lender and borrower cannot reach a resolution as to all matters between them. Under those circumstances, the parties must resolve the issue through non-judicial or judicial foreclosure means. While judicial foreclosure may address and resolve the liens of junior creditors, formally undertaking such action may likely result in the debtor's seeking relief in the bankruptcy court.

#### **BANKRUPTCY ALTERNATIVE:**

The final chapter in the workout process may occur in the Bankruptcy Court. Many times this is the forum in which issues are resolved because of the broad powers and jurisdiction granted under the Bankruptcy Code.

Bankruptcy offers unique opportunities not available outside of that system. The filing of a bankruptcy petition results in the creation of an "automatic stay" or statutorily created injunction against pursuing creditor actions against the debtor. This gives the debtor some breathing space while halting all further runs on the debtor's assets so that they may be distributed more equally. Furthermore, bankruptcy offers the means to order a reorganization or liquidation of a debtor's affairs in a fairly complete fashion while preserving a record of the existence of jurisdictional facts.

One of the latest wrinkles in bankruptcy is the "prepackaged" Chapter 11 plan. Under this arrangement a debtor files its bankruptcy petition with a plan already agreed upon by the requisite number of creditors in order to "cram down" the plan. This is particularly important if the debtor has a lot of debt represented by bonds (junk or otherwise). Under normal circumstances, the bond covenants may require nearly unanimous approval. In one sense, the intervention of the Bankruptcy Court levels the playing field between the debtor and its secured and unsecured creditors, so that a resolution of all the debtor-creditor issues can be had among the parties in one forum.

#### **NEW CREDITORS RIGHTS EXCLUSION**

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In recognition of the complexity of many of the issues raised in this article, the 1990 version of the American Land Title Association policies introduced a blanket exclusion for creditors' right matters. This exclusion is intended to confirm that these matters go far beyond the typical title insurance policies in general. It is important to remember that the exclusion applies to the instant transaction only, i.e., the original loan as insured. The exclusion does not apply to post policy events. Thus, where a 1992 ALTA title insurance loan policy is issued to a lender, creditors rights issues are excluded from coverage. However, if the lender were thereafter to receive a deed in lieu of foreclosure from the borrower and the title insurer was asked to issue an endorsement to the "existing" loan policy, the exclusionary coverage would not apply because the subsequent event was not part of the "original instant transaction". The same concern would equally apply to a situation where the lender received the 1992 loan policy and thereafter requested an endorsement providing for the continued priority of the exiting mortgage following the recordation of the mortgage modification agreement. In that case, once again, the act of mortgage modification was not part of the "original instant transaction" and, therefore, the creditors rights exclusion contained in the original loan policy would not be applicable to or for the benefit of the subsequent mortgage modification endorsement. A special creditors rights exception would therefore have to be added to the endorsement. If the title insurer or its agent were to fail to include such an exception in the mortgage modification endorsement the insured thereafter could argue that coverage over any creditors rights issues was provided.

### **SHOULD THE LENDER OBTAIN AN OWNERS POLICY?**

Past Experience has shown that lenders whom are insured under a 1970 form ALTA Loan Policy sometimes fail to recognize the continuing coverage provisions of that policy as of its effective date, if title is acquired by a deed-in-lieu of foreclosure. Paragraph 2(a) of the Conditions and Stipulations of the 1970 ALTA Loan Policy states:

This policy shall continue in force as of Date of Policy in favor of an insured who acquires all or any part of the estate or interest in the land described in Schedule A by foreclosure, trustee's sale, conveyance in lieu of foreclosure, or other legal manner which discharges the lien of the insured mortgage (emphasis mine), and if the insured is a corporation, its transferee of the estate or interest so acquired, provided the transferee is the parent or wholly owned subsidiary of the insured.

A similar provision exists in paragraph 2(a) of the Conditions and Stipulations of the 1987, 1990 and 1992 ALTA Policy forms. What happens if the insured refuses to "discharge the lien of the insured mortgage"? Does that mean the coverage lapse? **NB many lenders and their counsel refuse to surrender and cancel the note or other evidence of indebtedness or to cancel, discharge or release the mortgage of record in order to preserve their priority position in the event the delivery of a deed-in-lieu of foreclosure is successfully collaterally attacked.**

### **RISKS IN RELIANCE ON ORIGINAL LOAN POLICY**

**Lenders concern one:** Does this precaution obviate the policy's continued coverage provision for failure to discharge the debt?

Let us assume for the moment that the loan workout fails and the lender thereafter proceeds to either foreclose or take a deed in lieu of foreclosure, thereby becoming the fee owner. Let us further assume there is no bankruptcy issue present and the lender undertakes to discharge the debt in

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accordance with the condition attached to the stipulation. Should the lender obtain an owners policy? As mentioned, Condition 2 of the 1992 ALTA loan policy provides that the policy will continue to protect a lender who becomes the owner of the insured estate as a result of foreclosure of the lender's mortgage or acceptance of a deed in lieu of foreclosure. However, the lender who becomes owner will only be covered in accordance with the terms and provisions of the loan policy; the loan policy does not convert to an owner's policy. The pertinent language in the Conditions and Stipulations of the current **1992 ALTA** loan policy for providing continued coverage reads as follows:

(a) After Acquisition of Title. The coverage of this policy shall continue in force as of Date of Policy in favor of (i) an insured who acquires all or any part of the estate or interest in the land by foreclosure, trustee's sale, conveyance in lieu of foreclosure, or other legal manner which discharges the lien of the insured mortgage; (ii) a transferee of the estate or interest so acquired from an insured corporation, provided the transferee is the parent or wholly-owned subsidiary of the insured corporation, and their corporate successors by operation of law and not by purchase, subject to any rights or defenses the Company may have against any predecessor insureds; and (iii) any governmental agency or governmental instrumentality which acquires all or any part of the estate or interest pursuant to a contract of insurance or guaranty insuring or guaranteeing the indebtedness secured by the insured mortgage.

(b) After Conveyance of Title. The coverage of this policy shall continue in force as of Date of Policy in favor of an insured only so long as the insured retains an estate or interest in the land, or holds an indebtedness secured by a purchase money mortgage given by a purchaser from the insured, or only so long as the insured shall have liability by reason of covenants of warranty made by the insured in any transfer or conveyance of the estate or interest. This policy shall not continue in force in favor of any purchaser from the insured of either (i) an estate or interest in the land, or (ii) an indebtedness secured by a purchase money mortgage given to the insured.

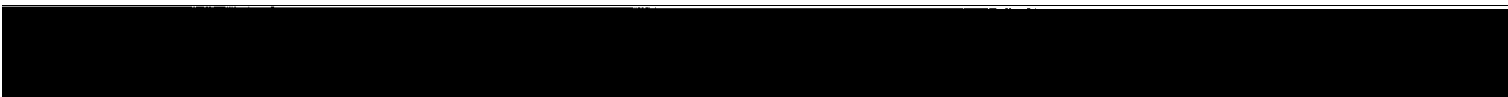
(c) Amount of Insurance. The amount of insurance after the acquisition or after the conveyance shall in neither event exceed the least of:

(i) the Amount of Insurance stated in Schedule A;

(ii) the amount of the principal of the indebtedness secured by the insured mortgage as of Date of Policy, interest thereon, expenses of foreclosure, amounts advanced pursuant to the insured mortgage to assure compliance with laws or to protect the lien of the insured mortgage prior to the time of acquisition of the estate or interest in land and secured thereby and reasonable amounts expended to prevent deteriorating of improvements, but reduced by the amount of all payments made; or

(iii) the amount paid by any governmental agency or governmental instrumentality, if the agency or instrumentality is the insured claimant, in the acquisition of the estate or interest in satisfaction of its insurance contract or guaranty.

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## COMMENT

COMMENT 1: Although paragraph (a) provides continued policy coverage to the lender who becomes an owner, the lender will have no policy coverage against title defects that arise after the effective date of the loan policy. This is common to title insurance in general. Title insurance does not insure against defects that arise after the effective date of the policy. Yet it is during this very period of time that, whether by reason of the lender's subsequent conduct and actions or through no fault of the lender, conditions can arise that can be detrimental to the lender's coverage, and will generally not be made known until at some later date when the lender finds a buyer for the property. This problem area will be covered more fully later in this article.

COMMENT 2: Paragraph (a) also gives continued coverage to a parent or wholly owned subsidiary who acquires the estate or interest from the insured corporation. This provision presents several caveats. First, if the transferee is a subsidiary and is only 99% owned by the insured corporate lender, all coverage may terminate since the transferee is not wholly owned. On the other hand, since a "parent" corporation is not defined it would seem that the "parent" would not necessarily have to own all of the stock of the insured corporation. Secondly, if the insured lender is a limited partnership or entity other than a corporation, then paragraph (a) (ii) has no application whatsoever. These limitations should be kept in mind by lenders who routinely convey title to subsidiaries or parent corporations after foreclosure.

COMMENT 3: Paragraph (b) provides continued limited coverage to a lender even after the lender sells the property if the lender takes back a purchase money mortgage, or if the lender is liable for any covenants of warranty having been breached in the transfer of title out of the insured lender. But for the title insurer to be liable the title defect giving rise to the loss must be one that existed before the date of the policy which in many instances could be quite a few years before the foreclosure or deed in lieu and sale by the lender. A claim based on breach of covenant of warranty would very rarely occur in those instances where the lender follows the usual practice of only providing special warranty deeds to purchasers.

COMMENT 4: Paragraph (c) provides a limitation on the amount of damages an insured lender can claim after acquiring the title through foreclosure, sale by trustees, or deed in lieu, which discharges the lien. If the deed to the lender is given only as additional security, or if there is no merger of the mortgage lien into the fee the continuation coverage provisions have no application But if the lien and the fee do not merge, the lender is still covered by the policy as the mortgagee rather than as owner.

**Lenders concern two:** the act of acquiring of the title by the lender does not convert the loan policy to an owner's policy. The two are to be distinguished. Even though the lender has subsequently become the owner, the lender does not have owner's policy coverage. The nature of the loan policy differs from the nature of an owner's policy. An owner's policy is an actual loss sustained policy. The exclusions and conditions and stipulations as set out in the loan policy form are very different from those in an owner policy. The insured under a lenders policy must prove that the value of its security diminished. In response to the appellant's contention that a loan policy converted to an owner policy under the policy provision that the policy would continue in force upon acquiring of title by the lender, the court in the case of CMEI. Inc. v. American Title Ins. Co., 447 So. 2d 427 (Fla. 5th DCA 1984) stated:

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However, contrary to appellant's contention this language is inadequate to convert this mortgage title policy into a standard owner's title policy when the insured mortgagee becomes the owner of the land by foreclosure. In substance the policy continues to provide the same coverage as before subject to all policy conditions and stipulations.

**Lenders concern three:** The result is that a title defect that would constitute a valid claim under an owner's policy may not be a claim under the loan policy form.

**Lenders concern four:** The lenders policy does not cover anything which may have affected title after the mortgage was recorded.

**Lenders concern five:** The existing loan policy does not insure the deed-in-lieu of foreclosure or that, in the event of foreclosure, the sheriff's deed and the underlying proceedings resulting therein were valid and proper as to form and content and in compliance with case law.

For these reasons the insured lender as owner may wish to purchase an owner's policy rather than rely on the extended coverage of the loan policy for several reasons. First, a new owner's policy allows the lender as owner to tailor the coverage to the current transactions. Second, the owner's policy excepts fewer defects than does the loan policy. In that case the insured will be able to broaden his or her coverage somewhat under an owner's policy. Under the original loan policy the insured also will only be covered against defects which existed before the date the loan policy was issued. Since there may have been a foreclosure sale or the deed in lieu, or other intervening matters between the effective date of the original loan policy and the date the insured lender takes title, the insured should at least update its coverage to the date the insured acquired the fee.

### **RECOMMENDED PROCEDURE**

Purchasing an owner's policy upon acquisition of the fee interest is the recommended way for the insured to update its coverage. When a lender obtains a new owner's policy following foreclosure the title company is passing upon the validity of the foreclosure and compliance with statutory case law. In the unlikely event the fee title of the lender were thereafter determined to be unmarketable by reason of a defective foreclosure the title company would be expected to either defend the title or settle. The title company would not be so bound if it merely updates the existing loan policy by endorsement.

In view of the limitations on the continuation of coverage as set out in the policy, more and more lenders are beginning to realize the benefits of obtaining an owner policy upon their acquiring title rather than relying on the continued limited coverage of the loan policy. For more information on this topic please refer to Rush, "What Mortgage Bankers Should Know About Title Insurance" published by First American Title Insurance Company (1994). The need for a lender to obtain an owners policy upon acquiring title is also recommended by John C. ("Jack") Murray, prior counsel for The Travelers Companies and present Special Counsel for First American, in his article entitled, "Deeds in Lieu of Foreclosure: Practical and Legal Considerations." Vol. 26, No 3 of Real Property, Probate and Trust Journal, Fall 1991. See also Werner, Differences Between New Fee Coverage and the Continuation of Coverage of Old Loan Policy, chapter 7, PLI Pub. no. 375 ©1991.

### **ACQUISITION OF TITLE BY LENDER - TITLE CHARGES**

This issue may be determined by statute and rate rule in filed rate states. In Pennsylvania the TIRBOP Rate Manual does not directly address this issue. However, the majority of title counsel

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agree that if the lender becomes the fee owner and chooses to obtain an owner's policy the appropriate rate is the reissue rate, up to the face amount of the original loan policy plus the basic rate for any amount in excess thereof. This reasoning is based on the premise that fee coverage must be paid for either the actual consideration or the fair market value. If either of these exceed the original loan coverage additional "basic" premium rate is due the underwriter.

## CONCLUSION

Workout transactions are fraught with risk. In their effort to reduce a borrowers financial distress and cashflow problems counsel have in the past to often "focused" upon restructuring the loan with little thought given to the affect of such actions upon the title insurance coverage provided in the initial loan policy or, their impact upon the rights of the lender under the existing loan policy. Any loan restructuring, mortgage modification, "non-judicial reorganization" or other action which the lender undertakes to change its relationship with the borrower is a post policy event and present the lender with serious priority issues! However well intentioned and "fair" these acts and subsequent private agreements between the parties may appear, the eventual outcome is never certain. There are four possibilities: One, lender restructures the debt, no one is prejudiced, the plan is successful, and the debtor and the project become profitable. Two, the plan is only partially successful and the lender eventually takes over the project and the property via a deed-in-lieu of foreclosure. Three, the lender forecloses upon the loan and becomes the owner. The fourth alternative is Bankruptcy.

In the second case, when the lender takes back a deed-in-lieu of foreclosure it is faced with the title problems discussed above and its title coverage is still based upon the Exclusions and Stipulations & Conditions set forth in the original **Loan Policy**. Exclusion 3 ["defects, liens, encumbrances, adverse claims or other matters: (a) created, suffered, assumed or agreed to by the insured] is of particular importance. If at the time of the transfer the lender undertakes to obtain a new **Owners Policy** it still must contend with the "Creditors' Rights Exclusion" [Excl. 4 of the 1990 and 1992 ALTA Owners Policy] and Code §544 claims unless it bargains for: (i) removal of the exclusion or, where such actions is not permitted by state insurance regulations, (ii) coverage afforded under the prior 1970 (rev. 10-17-84) Owners Policy. Take note that, notwithstanding the exclusion from coverage, the underwriter is well advised to take "special creditors' rights exception" for any §544(b) claims under the Bankruptcy Code [Code] where circumstance indicate the strong possibility that one or more junior creditors may challenge the transfer. While such claims are covered under the 1990 policy form exclusion they are not under the 1992 policy form exclusion. Under section 544(b), a trustee may avoid transfers that are voidable under applicable non-bankruptcy federal or state law if there is at least one creditor at the time who has standing under such law to challenge the transfer . . . . In re Colonial Realty Company, 168 BR 506 (B. Ct., D. Conn. 1994).

In the third instance the attempt fails and the lender commences foreclosure proceedings. This is likely to initiate protracted and concurrent litigation and proceedings. If litigation follows, the once cooperative parties will do whatever is necessary to prevail/survive. At that point resolution of the loans default may depend upon the actions, arguments, skill and wisdom of the parties respective counsel. If the court should thereafter determine that the attempted restructuring imposed unequal bargaining positions between the parties with unfair terms being forced upon the borrower, perhaps to the detriment of its junior creditors, the first mortgage becomes "tainted" [hence the origin of the **Antitaint Endorsement**] and the court may reverse the normal mortgage priorities resulting in the lenders partial or total loss of priority. In that case the foreclosure proceedings may be irretrievably altered and the lender will then turn to the title insurer and file a claim in an attempt to recover its loss as the insured under the Policy, which presumptively insured in loans priority. At this point is becomes

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crucial to be able to demonstrate the extent to which the title insurer was involved in the workout process.

In the event of the borrower filing bankruptcy proceedings the lender is faced not only with §547 and §548 arguments but also those allowed under §544 of the Code. This may prove to be significant to the lender's claim under the title policy if the bankruptcy proceedings were filed after an "insured" transfer and recordation of a deed-in-lieu of foreclosure by the lender, i.e., if the lender takes back a deed-in-lieu of foreclosure and simultaneously obtains a new 1992 ALTA owners policy, the creditors' rights exclusionary language [which applies only to the instant transaction] is limited to creditors' rights claims arising under sections 547 and 548 of the Bankruptcy Code. Claims arising under §544 of the Code are no longer covered by the exclusion in the 1992 Policy form as they were under the prior 1990 Policy form. In that case, should the lender's deed-in-lieu of foreclosure be set aside by the bankruptcy court within one year of the date of transfer and its original and unreleased or discharged lien priority [ remember what we said earlier, "many lenders and their counsel refuse to surrender and cancel the note or other evidence of indebtedness or to cancel discharge or release the mortgage of record in order to preserve their priority position in the event the delivery of a deed-in-lieu of foreclosure is successfully collaterally attacked" ] become subordinated to the claims of junior creditors, the lender may still have a cause of action under the new Owners Policy (even if the lien of the prior mortgage is shown and "insured over") if no prudent additional "special exception" were set forth in Schedule B of the Title Policy relating to Code §544 claims. Many title agents, title attorneys and title company employees fail to distinguish between the two forms of creditors' rights exclusion and recognize the difference in coverage. Following the adoption of the 1992 ALTA Policy Forms and the refusal of the New York State Department of Insurance to approve the ALTA form as adopted, the distinction resulted in what was originally then known as the New York Creditors Rights Endorsement which eventually became the 1992 Creditors' Rights Exclusion [see PLI Pub. no. 375 beginning at page 86 for more information].

The legal community and title insurance industry are well advised to be particularly cautious of the title insurance matters to be considered in dealing with the workout and modification of troubled loans.

#### **FURTHER READING**

For further material relating to the risk of mortgage modification and related transactions we refer the reader to the following selected articles:

Carpi, Title Insurance Following Foreclosure presented at the Third Annual Spring CLE and Committee Meeting, Real Property Law Program Beyond the Workout: Risks for Lenders Taking Back and Owning Real Estate, Section of Real Property Probate and Trust Law, American Bar Association, May 7-9, 1992, page A-3;

Brodkey and Colavito, Title Insurance Considerations in Dealing with the Troubled Loan, New York Law Journal;

Colavito, Modification of Mortgages in Default, NYLJ, Nov. 13, 1991;

Delaney, Beyond the Workout: Creditors' Rights Risks for Lenders Taking Back and Owning Real Estate, Lawyers Title News;

Giesen, "Routine" Mortgage Modifications: Lenders Beware, Real Estate Law Journal, Winter, 1989;

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Kratovil and Werner, Mortgage Extensions and Modifications, Lawyers Supplement to the Guarantor, CTIC, Summer, 1975;

McNearney, Title Risks of Real Estate Purchased Via Foreclosure and Deed-in-Lieu of Foreclosure, presented at the Third Annual Spring CLE and Committee Meeting, Real Property Law Program Beyond the Workout: Risks for Lenders Taking Back and Owning Real Estate, Section of Real Property Probate and Trust Law, American Bar Association, May 7-9, 1992, page A-11;

Murray, What you need to Know About Workout Strategies, 1989, published on the Firstam website;

Murray, Loan Foreclosures, Title Transfers, and Modification Structures, The Practical Real Estate Lawyer, July and September, 1996;

Palomar, Special Title Insurance Considerations in Foreclosure, Workouts and Bankruptcies, The Law of Distressed Real Estate, section 27B.4

Slesinger, A Lender's Perspective on Creditors' Rights When the Workout Fails, ALTA Title News;

VanBuskirk, Caution is Watchword in Loan Workouts, Lawyers Title News, March/April, 1991

Werner, Title Insurance in Workouts and Deeds in Lieu of Foreclosure: The Problem Areas, PLI Publication N4-4557, Title Insurance in Troubled Times: What You Need to Know;

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