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Creditors' Rights Risk Under Title Insurance Policies

The creditors' rights exclusion under a title insurance policy is intended to make clear that a title insurance policy does not provide protection for post-policy challenges to the insured title or to the validity, enforceability, or priority of the lien of the insured mortgage arising solely out of the insured transaction (not one in the past chain of title), whereby the transfer to the insured owner or lender of its interest in the land is determined to be a fraudulent transfer or conveyance, or a preferential transfer, under either state or federal law. With respect to the loan policy only, the creditors' rights exclusion also confirms that no protection is provided to the insured lender if a challenge is made to the priority of the lien of the insured mortgage based on the bankruptcy doctrine of equitable subordination.

Over the past decade, the request by owners and lenders to delete the creditors' rights exclusion under a title insurance policy has become standard practice. In 2004, ALTA adopted Endorsement Form 21, which insures against loss under an owner's or loan policy because of the occurrence, on or before the date of the policy, of a fraudulent transfer or preference under federal bankruptcy law or state insolvency or creditors' rights laws. It also confirms that the title insurer will pay all costs, expenses and attorneys' fees to defend the insured against such claims. It expressly excludes coverage for such loss, however, if the insured knew that the transfer was fraudulent or was not a purchaser in good faith. The benefit of this endorsement is that it expressly provides affirmative coverage for creditors' rights matters.

The ALTA 2006 Loan Policy does give some limited coverage with respect to preferences for the insured mortgage itself. Covered Risk, Section 13(a) of the ALTA 2006 Loan Policy insures against "The invalidity, unenforceability, lack of priority, or avoidance of the lien of the Insured Mortgage" resulting from a prior transfer constituting a fraudulent or preferential transfer, but does not cover that risk for the "transaction creating the lien of the Insured Mortgage." Exclusion 6 of the ALTA 2006 Loan Policy makes it clear that it only applies to those creditors rights' issues affecting "the transaction creating the lien of the Insured Mortgage" that are not stated in Covered Risk 13(b). Lender's generally will not find comfort with this limited protection against creditor's rights matters from prior transactions and require affirmative coverage against the invalidity, unenforceability, lack of priority, or avoidance of the lien of the insured mortgage. To fill the "gap" created by Covered Risk 13(a) and Exclusion 6, when available the title company will issue affirmative coverage under a Creditors' Rights Endorsement with respect to the transaction.

Creditors' rights coverage places additional risk on the title insurer and therefore an additional risk premium for the endorsement is required. Normally, in a deed-in-lieu transaction, reasonably equivalent value will have been given for the deed because the value of the property will have been established by appraisal (supplied to the title insurer) to be less than the amount of the outstanding mortgage debt. Where a creditors' rights issue has been identified because a transfer is being made without the transferor receiving reasonably equivalent value, the title insurer is required to conduct non-title-related due diligence with respect to underwriting the transaction, including an analysis of the transferor's business and financial statements; its capitalization both before and after the transfer; the amount of secured and unsecured credit obtained by the transferor both before and after the transfer; and a determination of whether the delivery of the deed in lieu of foreclosure will render the borrower insolvent. If the title insurer is willing to issue creditors' rights coverage in such a situation, it may need to charge a significant additional risk premium to cover the potential liability. In addition, the title company may require that an independent third party with a demonstrated and substantial net worth indemnify the title insurer for the costs of defending an action based on a creditors' rights defense.

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