New Advances and Tools For Lenders and Counsel in Title Insurance

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As commercial real estate transactions today are more sophisticated and must close at a greater speed than ever before, lenders and real estate lawyers should be more sensitive to the utilization of a process which is available to quickly, efficiently and on a cost effective basis, obtain needed information about the property. Moreover, practitioners and client advisors should be familiar with the nature of the title insurance to be obtained and, most importantly, the means of acquiring the maximum coverage for their clients. This tool and process are the title company and the title search and insurance. Real estate lawyers who understand the following aspects of the title search process and title insurance will be able to deliver faster, more complete and professional service to their clients, whether owner or lender:

1. Negotiate the Deletion of the Creditors' Rights Exclusion.

The mortgaging or transferring of real property by debtors may create creditors' rights issues whenever the real estate transaction to be insured increases the amount of debt and/or decreases the assets of the debtor so as to potentially render the debtor insolvent. Sections 547 (preferences) and Section 548 (fraudulent conveyances) of the Bankruptcy Act grant certain protections to creditors. To protect title insurance companies from affording coverage in the face of creditors' rights issues, in 1990 (as later modified in 1992) the American Land Title Association added exclusions in both owners' and lenders' policies which excluded the effects of a bankruptcy arising out of the insured transaction. Each of these exclusions is limited to the specific transaction being insured and does not exclude problems created by prior transactions.The knowledgeable and experienced practitioner knows that the creditors' rights exclusion can sometimes be removed upon full disclosure (and satisfactory resolution) of any existing creditors' rights issues. If lender's or owner's counsel is planning to request the deletion of the creditors' rights exclusion from a policy or the issuance of a 1970 policy where available (which contains no creditors' rights exclusion), the title insurance company should be allowed sufficient time to review the transaction to be insured, its structure, the operative documents of the transaction (even in draft form) and the parties' financial information, together with all additional facts necessary to understand the transaction. Whereas, generally speaking, it is easier for the title insurance company to justify eliminating the creditors' rights exclusion in a real estate transaction where the business is the real estate than it is in a business transaction which only incidentally involves some real estate, the following specific transactional structures frequently give rise to creditors' rights issues:

(a) An asset transfer to an insider to repay an obligation owed to the insider;

(b) Using new secured loan proceeds to repay an existing unsecured loan with the same lender;

(c) Giving substitute security of greater value than the existing security when the lender is undersecured;

(d) A leveraged buy-out, where the ownership interests in the entity are redeemed, repurchased, eliminated or acquired with the proceeds of a loan secured by a mortgage on the acquired entity's real estate assets and a security interest in its personal property. In a leveraged buy-out, the interest holders' equity is replaced by debt, significantly increasing the entity's debt to equity ratio. Only the equity holders who are cashed out realize the benefit of such a transaction. The business itself does not receive reasonably equivalent value, and the increased risk arising out of the increased debt is borne mostly by the unsecured creditor; and

(e) Guaranty transactions where the loan proceeds go to a borrower with the loan guaranteed by the borrower's parent, subsidiary or affiliate pledging its assets as security.

Where facts and circumstances allow, an owner's or lender's counsel should consider requesting the deletion of the creditors' rights exclusion from the title insurance policy (or, in the alternative, requesting the issuance of a 1970 form policy). Information about the transaction required to be disclosed to the title company will be held in confidence and the added protection obtained by the deletion of the creditors' rights exception could greatly benefit one's client. Bear in mind, however, that, due to the higher threshold for proof of damages and the lower likelihood of loss, a title insurer is more likely to agree to delete the creditors' rights exclusion from a lender's policy than from an owner's.

2. Certain Endorsements Can Add Significant Coverage.

Although a wide range of endorsements are available in most states for commercial transactions, each of the following endorsements can add critical coverage where the facts and circumstances of the insured transaction warrant them:

(a) Fairway and Successor Insured Endorsements

The Uniform Partnership Act and most states' statutes governing limited liability companies provide that the partnership or the LLC, as the case may be, will dissolve when only one partner or member remains or when any partner or member dies, withdraws or becomes bankrupt, insolvent or incompetent. Nonetheless, under the Revised Uniform Partnership Act, which has been adopted in some states, and most state LLC statutes, the partnership agreement or the LLC operating agreement, as applicable, may expressly provide for the continuation of the business of the partnership or the LLC and permit all or a majority of the remaining partners or members to authorize continuation of the business. Under the "Fairway" rule , if less than the statutorily or contractually required number of partners or members, as the case may be, decides to reconstitute or continue the business of the partnership or LLC, coverage under such entity's owner's policy may be terminated. The definition of "named insured" in a title policy restricts the continuation of coverage under an owner's policy to situations where transfers of ownership interests are by operation of law, as distinguished from purchase or other voluntary transfer.In negotiating title insurance coverage, counsel representing a general partnership or an LLC should consider obtaining a Fairway endorsement protecting against any lapse of coverage resulting from a change in the ownership interests of the entity or from any resulting dissolution. The Fairway endorsement provides continuation of the policy coverage to the partnership or LLC after an ownership change, provided the change did not result in the dissolution or discontinuance of the entity under state law. Bear in mind that, except in states such as New York and Pennsylvania, where there is a promulgated endorsement from which there can be no deviation, there is no standard form of Fairway endorsement. If available, the endorsement's language, within certain parameters, may be negotiated for each transaction.

(b) Non-Imputation Endorsement

Whenever representing a client acquiring an ownership interest in an existing entity which owns a fee or leasehold interest in real property, one should consider obtaining a Non-Imputation endorsement if it is available in the state where the real property is located. A Non-Imputation endorsement assures the insured that the title insurer will not deny coverage under the title policy, based upon matters deemed known to the acquiring entity as of the policy date by imputation from its members, partners or officers, as the case may be. The Non-Imputation endorsement modifies the Exclusions from Coverage 3 (a) and (b) pertaining to matters "created, suffered, assumed or agreed to" by the insured and matters known to the insured. A Non-Imputation endorsement will apply if: (a) the insured is the purchaser of an interest in a corporation, partnership or limited liability company, (b) as of the policy date, there are acts or knowledge of the person or persons from whom the interest is being obtained of matters adverse to title, and (c) those acts or knowledge would be imputed to the owning entity. In this situation, the exclusion alone would cause the title insurer to disclaim coverage.A Non-Imputation endorsement can be issued as part of the title policy insuring the acquisition of the interest in the entity owning the real property. The title insurer will require satisfactory affidavits and indemnities from the person or persons against whose acts and knowledge the insured specifically requires non-imputation protection. The endorsement provides that, notwithstanding policy Exclusions from Coverage 3(a) and (b), liability will not be denied on the ground that the insured "has knowledge of any matter imputed solely by reason of notice imputed to it through [viz, a partner, shareholder or member, as the case may be] by operation of law." Except to the extent provided in the Mezzanine Financing endorsement described below, the Non-Imputation endorsement is not available for loan policies.

(c) Mezzanine Financing Endorsement

The Mezzanine Financing endorsement is a new form of endorsement, recently promulgated by TIRSA. It is available, with minor variations, in many states including New York.In today's complex real estate finance transactions, a lender will often place a mortgage on the property to secure a portion of its total loan and obtain a pledge of an individual's interest in the entity, which owns the property, to secure the balance of the loan, the so-called "mezzanine financing." For example, a total loan of $300,000,000.00 is to be made to ABC, LLC, whose members are individuals X and Y. $280,000,000.00 of this amount will be loaned to ABC, LLC and secured by a mortgage on real property with the title insurance company to issue a $280,000,000.00 mortgagee policy to the lender insuring the $280,000,000.00 mortgage made by ABC, LLC to the lender. The remaining $20,000,000.00 of the $300,000,000.00 will be loaned to X and Y and secured by the Pledge made by X and Y of their membership interests in ABC, LLC, with the title insurance company issuing a Mezzanine Financing endorsement, which will be attached to ABC, LLC's owner's policy. Accordingly, with respect to the mezzanine loan, the lender would have a claim against the equity interest in the mortgagor ABC, LLC, but would have no direct claim against the mortgaged property or the mortgagor and no right to make a claim against either in a first mortgage foreclosure.By its terms, the Mezzanine Financing endorsement does not insure the Pledge, any of the documents creating or perfecting the Pledge, or the effectiveness of any of these documents . Upon the agreement of the insured owner of the property, the endorsement provides that for as long as the mezzanine borrower (X and Y in our example) owes any part of the amount secured by its Pledge and the lender has not foreclosed on the Pledge, the title insurance company will pay any loss under the policy to the lender and not to the insured owner, up to the amount secured by the Pledge, but in no event greater than the amount due under the Stipulations and Conditions of the owner's policy. If there is no loss under the policy, no payments are made to the lender, even if the loan is in default.If the lender has foreclosed on the Pledge, and, as a result, become a member of the LLC, any loss under the owner's policy will be paid to the named insured.If there is a loss under the owner's policy by reason of any matter known to the insured owner, but not known to the lender at the policy date and not excepted in the policy, and such matter created a lien or defect as of the policy date, then the title insurance company will not impute the knowledge of the insured owner to the lender and will not deny liability to the lender as to that portion of the loss which represents the lender's interest in the LLC acquired pursuant to the Pledge foreclosure. This provision provides the lender with the same protection provided to an insured owner by a Non-Imputation endorsement.Additionally, the title insurance company will not raise as a defense that, because of the substitution of the lender as a member of the LLC (or as a partner of the partnership, as the case may be), the entity which owns the property is not the same entity as the insured under the owner's policy. This provision provides the lender with the same protection provided to an insured owner by a Fairway endorsement.As noted above, not all endorsements are available in all states, nor are the costs of endorsements uniform.

3. Client Time and Money May Be Saved By Including a Title Commitment in the Seller's Marketing Materials

When representing a seller of real property, it can save time and effort (which translates into expense) to include a current title commitment as part of the seller's marketing materials along with a Phase I environmental survey, engineering report and other items. By reviewing title before going to market, the seller can clean up any unanticipated unfavorable title exceptions before a potential purchaser has the opportunity to capitalize on them for a purchase price reduction. Additionally, once a purchase and sale agreement is signed, the purchaser's due diligence period can be shorter if a clean title commitment has already been obtained. This will reduce legal fees on both sides. The cost of a title commitment is usually between $500 and $1,000 for a commercial property and should be even less for a residential property. Ordering and, to the extent possible, clearing title in advance of signing the purchase and sale agreement can result in significant transaction cost savings.

4. The Client May Be Entitled to a Reduced Loan Policy Premium

In most states, under certain circumstances, a discounted loan policy premium may be available with respect to a new mortgage loan or the outstanding principal balance of a loan being refinanced.In New York, for example, whenever an application for a loan policy for $250,000 or less is made within ten years from the date of closing of a previously insured mortgage or fee or leasehold interest, the premises to be insured are identical, and there has been no change in the fee or leasehold ownership, the title insurance premium is discounted. In such instances, the rate is fifty percent of the applicable loan rate, up to the largest amount of existing insurance (either the liability on the owner's policy issued to the current fee or leasehold owner or the present unpaid principal balance of the existing insured loan), plus the full applicable loan rate on any excess coverage. With respect to an application for a loan policy in an amount over $250,000 made within ten years from the date of closing of a previously insured mortgage or fee or leasehold interest, where the premises to be insured are identical, and there has been no change in the fee or leasehold ownership, the title insurance premium is seventy percent of the applicable loan rate, up to the largest amount of existing insurance, plus the full applicable scheduled rate on any excess coverage.Provided the conditions discussed above are satisfied, the loan policy premium discount will also apply to a subordinate mortgage.Similarly, in most states, under certain circumstances, a discounted loan policy premium may be available for endorsements to existing loan policies, or for policies insuring modifications of previously insured mortgages. For example, in New York, for endorsements to existing loan policies, or new policies insuring previously insured mortgages modified or assigned within ten years from the date of closing, where there has been no change of ownership of the mortgaged interest, the property is identical, and there has been no increase in the outstanding principal balance, the title insurance premium is fifty percent of the applicable loan rate based on the outstanding principal balance of the mortgage. Note, however, that this premium discount will not apply to the final conversion of a construction loan mortgage.In all instances, the discounted loan policy premium will be available whether or not the title insurance company insuring the new loan or loan modification is different than the title insurance company which insured the original transaction giving rise to the discounted rate.Moreover, in a state which imposes a mortgage recording tax, such as New York, the tax will only apply to the "new" money - amounts advanced in excess of the outstanding principal balance of the mortgage being modified. In such instances, the mortgage recording tax saved by keeping the existing mortgage alive by modifying it (or, in the case of a new lender, assigning, then modifying it) can be substantial.

In sum, today's world of complex and fast-paced real estate transactions requires optimum expertise and efficiency and maximum information on a cost effective basis. Properly negotiated, title insurance can offer a range of choices to enhance the value of its coverage and protect against a variety of losses.