Back Chain Creditors' Rights Issues

Although the 2006 Owner's and Loan Policies exclude creditors' rights issues from coverage, they only do so relative to the specific transaction covered by the policy being issued. Unfortunately, unless an appropriate exception is raised in the policy, we continue to be liable for any creditors' rights issues that may be lurking in the chain of title leading up the current transaction.

Transfers that may be characterized as either preferential in nature or as a fraudulent conveyance create the most concern but are often overlooked. These issues arise when the underlying transaction leaves the debtor either undercapitalized or insolvent such as when the there is an increase in a borrower's debt obligation or a decrease in assets without adequate or full consideration.

Preferences

§547 of the Bankruptcy Code (11 U.S.C. §547) gives the bankruptcy trustee the power to avoid the transfer of any interest in property occurring within 90 days prior to the filing of the bankruptcy petition or 1 year if the transfer is made to an insider. The specific elements of what constitutes a preference are set out in §547(b) and are as follows:

> A transfer of an interest of the debtor in property (1) to or for the benefit of the creditor; (2) for or on account of an antecedent debt; (3) made while the debtor was insolvent; (4) made on or within 90 days before the date of the filing of the petition, and (5) one that enables the creditor to receive more than such creditor would receive in a Chapter 7 liquidation of the estate.

It is not necessary for the trustee in a §547 action to prove that the debtor is in fact insolvent, insolvency is simply presumed to be the case relative to any transfer made within the 90 day period. There is also no requirement for the trustee to prove that the benefitted creditor knew or should have known that the debtor was insolvent at the time of the transfer. Simply put, all transfers that occur within the 90 day period prior to the filing of the petition are at risk of being challenged.

In order to determine if the transfer occurred within the 90 day period, you must look at not only the date that the interest was created as stated in the instrument, but also when that instrument was recorded in the real estate records. A refinance or purchase money mortgage closed before the 90 day period and recorded within 30 days, even when recorded within the 90 day preference period, is deemed to have occurred prior to the 90 day period. Transactions recorded outside of this window, however, are at risk.

Fraudulent Transfers

§548 of the Bankruptcy Code (11 U.S.C. §548) governs fraudulent conveyances. This section allows the trustee or a creditor to avoid a transfer by the debtor that was made "with actual intent to hinder, delay, or defraud an entity to which the debtor was or became… indebted." §548(a)(1)(B) also allows an avoidance action for transfers for which the debtor "received less than a reasonably equivalent value in exchange for such transfer or obligation," and where the debtor "was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation," or as a result of the transfer or obligation, the debtor became undercapitalized. Unlike the shorter limitations provided in §547, the look back period for §548 actions is two years, and this period may be further extended by state law.

The primary concern and focus is whether the debtor received sufficient value (i.e., value for value), and whether the transaction rendered the debtor insolvent or undercapitalized. A common example of a §548 violation is when a debtor pledges its property as security for a loan, but the loan proceeds are disbursed in favor of a related, but different, entity. In this situation, the debtor has taken on a new obligation while receiving no benefit. Another example arises in the situation where an unsecured creditor attempts to strengthen its position by demanding the debtor pledge property as security for the loan. In this instance, one of the debtor's assets is encumbered, with the debtor receiving no additional value in return. In both examples, the debtor's equity in its assets declines, while its debt obligations increase.

§548 is particularly perilous when you see a transfer in the back chain of title as the lookback period applicable to fraudulent conveyances can extend well beyond the two years provided for in the Bankruptcy Code if the bankruptcy trustee chooses instead to use state law to attack the transaction. State law often provides an advantage to the trustee as state statutes frequently provide a longer statute of limitations than that afforded by §548. In some cases, states statutes allow for as long as a six (6) year lookback period. Accordingly, care should be taken whenever a questionable transaction is noted in the back chain.

Scenarios

1. Deed in Lieu Transactions

   When the value of the property transferred by a deed in lieu is greater than the outstanding balance owed on the loan that transfer may be challenged either as a preference under §547 or a fraudulent conveyance under §548. A trustee may still challenge the transaction even when the value of the property appears to be less than the loan amount if the trustee feels that property was not properly appraised.

2. No consideration transfers to a related party or an SPE

Since these transactions do not involve an exchange of "reasonably equivalent value", they are easily challenged as either actual or constructive fraud. Transactions in which there is an agreement not to record something; the transfer price is far below the market value; are done in the middle of litigation; or are done when the debtor was insolvent or when the debtor was made insolvent by the transfer, are all signs of a possible fraudulent transfer.

3. Up-Stream, Side Stream, and Leveraged Buy-Out Transactions

Up-stream transactions describe transactions between a parent and subsidiary while side-stream transactions are between sister companies. They can be identified when the loan proceeds do not go to the same party that has put the property up for collateral. In these situations, an interest in the real estate has been transferred by the fee owner without that same owner also receiving the proceeds of the loan. Leveraged buy-outs are generally associated with the acquisition of a business. In these transactions, the property being mortgaged is not owned by the business but by the owner of the business. Neither the excess cash nor the loan proceeds are set aside either for the operation of the business or for the creditors.

4. Mortgage Foreclosures

If the foreclosure bid amount is less than the reasonably equivalent value of the property, the foreclosure sale may be challenged if the former fee owner files for bankruptcy. The theory here is that the loss of equity in the real estate has deprived creditors of potential assets and consequently the sale is invalid.

It should be noted that the U.S. Supreme Court in <u>BFP v. Resolution Trust Corporation</u> held that a foreclosure sale is valid for §548 purposes, regardless of the bid price, so long as the foreclosure sale was pursuant to a noncollusive, regularly conducted nonjudicial sale. This decision, however, is limited to §548 challenges and such sales are still in danger of being found invalid as a preferential transfer under §547. (See, <u>In Re Villarreal</u>; and <u>In Re Whittle</u>).

Exception

If a back chain issue is noted, the following exception must be taken in Schedule B regarding the transfer:

Any claim which arises out of the transfer from ___________ to ___________, dated________ and recorded on _________in Book______, page _______, by reason of the operation of federal bankruptcy, state insolvency, or similar creditors' rights laws.