2009 CLE – Complex Closing Stories
I. Foreclosures/Bankruptcy/Creditors' Rights

Story – In 2007, a developer (Big D, Inc.) and a group of investors (High Return, LLC) decide threats of a weakening real estate market are unfounded and formed a joint venture (Uptown Condos, LLC) to construct and sell a high rise condominium complex in a desirable location in a large NC city. Both Big D and High Return loan funds to the new LLC. They also obtain a large construction loan with future advance provisions and begin construction. A number of potential purchasers enter into purchase agreements for individual units and each place a $100,000 deposit with either Uptown Condos or a title company, which acts as escrow agent under the purchase agreements. By August of 2008, construction is 80% complete, but sales have completely stopped and Uptown Condos is having problems paying its contractors. After some claims of liens are filed by contractors, the lender refuses to advance any more funds under the construction loan. By October, construction is pretty much at a standstill, more claims of liens are being filed and perfected, the lender is threatening foreclosure, and Uptown Condos is searching for a new lender while considering filing for bankruptcy. A few of the contract purchasers are demanding their units be completed, but most want their deposits returned.

Issues –

A. What will happen to the competing interests in the property if the lender forecloses?
B. What will happen if Uptown Condos files for Bankruptcy?
C. Will a workout with the current lender or a refinance with a new lender resolve the issues?
D. What type of creditors' rights title coverage issue exist?

Discussion –

A. **Foreclosure Issues** – The lender files a foreclosure proceeding against Uptown Condos. The following discusses some basics on priority based upon foreclosure and relationship with bankruptcy. Although not related to our fact situation, the subprime lending disaster has created a foreclosure explosion and North Carolina's legislative response is addressed below.

   1. Effect of Foreclosure – A foreclosure of a deed of trust will extinguish the interests of the borrower/owner and junior lienholders in the property. The buyer at foreclosure obtains title free of subordinate interests, i.e. those interests with a lesser record priority because the lien (deed of trust, judgment,…) was established of record sometime after the recording of the deed of trust which is being foreclosed, or was subordinated by a recorded subordination agreement. Junior interests which are extinguished will not be shown as exceptions on a title policy following foreclosure. Certain matters can prevent a junior lien from being extinguished, including: (1) noncompliance with a request for notice, (2) failure to give notice to the IRS at least 25 days prior to the sale date with respect to junior IRS liens which are of record 30 days prior to the foreclosure sale date, and (3) rights of redemption (Borrower's and IRS's). *(More on information on rights of redemption is available at* *www.northcarolina..ctt.com* *Bulls, Bulletins, Articles & Forms – Foreclosure of Deeds of Trust p.14)* Additionally, where grantor in the deed of trust is the grantee in the substitute trustee's deed, any subordinate liens created by that grantor will reattach by operation of law ("feeding the estoppel"). Dixieland Realty Co. v. Wysor, 272 N.C. 172, 158 S.E. 2d 7 (1967). In other words, a debtor cannot purchase through a foreclosure of its own property in order to extinguish liens.

A prior lien will not be extinguished by foreclosure of a junior deed of trust, including pre-existing easements, restrictions, deeds of trust or judgments, unless previously subordinated. As a result, such prior liens will be shown as exceptions on a title policy unless satisfied outside the foreclosure. Additionally, liens for ad valorem property taxes and assessments enjoy "super priority" lien status and are superior to all other liens and interests, regardless of when they attach. These will need to be addressed or they will appear as exceptions on a title policy.

2. Foreclosure Reform/Relief – In light of the foreclosure epidemic, numerous efforts have been made to create some form of foreclosure relief or reform. Some programs have been created to help avoid foreclosures by modifying loans. One such program is the FDIC IndyMac Loan Modification Model ("Mod in a Box"). According to the FDIC new release, "the Program is designed to achieve affordable and sustainable mortgage payments for borrowers and increase the value of distressed mortgages." More can be found at http://www.fdic.gov/consumers/loans/loanmod/loanmodguide.html.

Other programs have been passed to help lenders in general, such as the Troubled Assets Relief Program (TARP) and the Temporary Liquidity Guarantee Program (TLGP). TARP is designed to strengthen lenders capital positions/financial strength and ability make credit available in lending markets. TLGP was also designed to allow increased lending to consumers and businesses by decreasing the cost of bank funding. The program guarantees newly issued senior unsecured debt of banks and provides full coverage on non-interest bearing deposit transaction accounts. More information on TARP and TLGP can be found at www.fdic.gov.

A proposed Senate Bill involving expanding cram down provisions is discussed below (Bankruptcy – Workouts).

North Carolina has acted by passing House Bill 2623, The Emergency Foreclosure Reduction Program. The bill was designed to reduce foreclosures and to authorize the Commissioner of Banks to use funds for home foreclosure prevention. It became effective on November 1, 2008 and will expire on October 31, 2010. It establishes Article 11 under Chapter 45 of the NC General Statutes.

The Act focuses on subprime loans, which are defined under NCGS § 45-101 as

> "A loan, originated on or after January 1, 2005, but before December 31, 2007, that would meet the definition of a rate spread home loan under NCGS § 24-1.1 F(a)(7), if that section had been in effect when the loan was originated."

The statute allows mortgage servicers to rely on a chart to be prepared by the Office of the Commissioner of Banks reflecting rate triggers for rate spread home loans in determining whether or not a loan falls under the definition of a subprime loan.

If a loan falls within the definition of a subprime loan, then the following must be complied with in bringing a foreclosure proceeding:

NCGS § 45-102 requires that the servicer notify the borrower in writing of following matters 45 days prior to the filing of a Notice of Hearing:

(1) An Itemization of all past due amounts causing the loan to be in default;
(2) An itemization of any other charges that must be paid in order to bring the loan current;
(3) A statement that the borrower may have options available other than foreclosure and with whom the borrower could discuss those options;
(4) Contact information for the mortgage lender and mortgage servicer or an agent for either who is authorized to work with the borrower to avoid foreclosure;
(5) Contact information for one or more HUD approved counseling agencies to assist borrowers in NC to avoid foreclosure;
(6) Contact information for the Consumer Complaint section of the Office of the Commissioner of Banks.

NCGS § 45-103 requires the servicer, within in 3 days of sending the notice required under NCGS § 45-102 to the borrower, to file certain information with respect to the borrower with the Administrative Office of the Courts (The "AOC"). The AOC is to establish a database of this information. Under NCGS § 45-105, the Commissioner of Banks is to review this database and determine which loans are appropriate for efforts to avoid foreclosure. If the Commissioner reasonably believes that further efforts may avoid foreclosure, then the Commissioner has the authority to extend (one time) the allowable filing date for any foreclosure proceeding up to 30 days beyond the earliest filing date established by the pre-foreclosure notice.

NCGS § 45 – 107 requires that foreclosure notices filed during the duration of the program include a certification that the notice under NCGS S 45-102 and the information required by NCGS § 45-103 were provided and the applicable time periods have elapsed. A material inaccurate statement in the certification shall be cause for dismissal without prejudice of the foreclosure proceeding and payment of the costs incurred by the borrower in defending the proceeding.

Another significant change under the Act, is the addition of a fifth element under NCGS § 45-21.16(d) regarding matters a Clerk of Court must consider at hearing and find to order a foreclosure sale under a power of sale. The new element is

> "(v) that the underlying mortgage debt is not a subprime loan as defined in NCGS § 45-101(4), or if the loan is a subprime loan under NCGS § 45-101(4) that the pre-foreclosure notice under NCGS § 45-102 was provided in all material respects, and that the periods of time established by Article 11 of this Chapter have elapsed."

It is important to note that some foreclosing parties (servicers, trustees, attorneys…) are submitting information on all loans scheduled for foreclosure to the AOC, even if they do not believe the loan will fall under the definition of a subprime loan. They are then able to confirm from the database that the loan is not a subprime loan, print and sign "Non-Subprime Loan Certificate".

3. **Deeds in Lieu of Foreclosure** – Story: Borrower agrees to give lender a deed in lieu in order to have the note and deed of trust canceled while avoiding foreclosure. Prior the conveying the property, borrower is instructed by lender to convey the property to a third party LLC. Shortly after the conveyance, the borrower files for bankruptcy.

    a. Deed in Lieu Requirements – The courts have recognized that the granting of deed in lieu of foreclosure is a situation ripe for undue duress. To assure that the lender does not take advantage of the borrower in this situation, the courts have required that a deed in lieu include a statement that the grantor is conveying the property of his/her own free will and is receiving adequate consideration . As a result, title companies will require that such a statement be included in the deed. The following is a sample of such language:

    > This deed is an absolute conveyance, the grantor having sold said land to the grantee for a fair and adequate consideration, such consideration, in addition to that above recited, being full

satisfaction of all obligations secured by the deed of trust executed by ____________________________ to _____________________, Trustee, for the benefit of ________________________________, Beneficiary, recorded in Book _____, Page _____, ______________________ County Registry. Grantor declares that this conveyance is freely and fairly made, that there are no agreements, oral or written, or other than this deed between Grantor and Grantee with respect to said land.

[Deed must contain tax stamps applicable to the amount of the obligations released plus any additional consideration paid to the Grantor-borrower.]

Most title companies also require an affidavit from the grantor setting forth matters such as:

(1) the conveyance is for adequate consideration;
(2) value of property;
(3) outstanding indebtedness;
(4) grantor is not insolvent or bankrupt; and,
(5) grantor is making the conveying voluntarily and is not under duress, undue influence or coercion by the lender.

In addition, title companies will require that the lender agree to cancel the underlying deed of trust.

In is important to note that a deed in lieu of foreclosure will not cut off any intervening matters of record. As a result, title to the property must be updated and any intervening matters must be addressed.

b. Potential to be Set Aside by Bankruptcy – If the grantor of deed in lieu files for bankruptcy, can the conveyance be set aside as a preference? The key to avoiding being set aside is adequate consideration being given to the grantor. As long as the forgiveness of the debt is significant, then the conveyance is not likely to be set aside. An old bankruptcy rule of thumb was that the amount of the outstanding loan must be at least 80% of the appraised value of the property.

c. Effect of Lender Instructing Conveyance to Third Party – In the facts above the lender instructs the borrower to convey the property to a third party LLC. This LLC is most likely a subsidiary of the lender designed to hold and convey foreclosed property. On the face of the transaction, the LLC would not likely being paying any consideration for the property. Luckily, Bankruptcy courts focus on the consideration given to the grantor. As the debt is still being forgiven, although not by the grantee of record, the conveyance should be acceptable. The LLC could also be an unrelated party that is essentially buying the property from the lender. Again, the conveyance should be acceptable. If the buyer requests a creditors' rights endorsement, the parties would need to prove that there was no equity in the property. This will likely require current appraisals of the property.

B. **Bankruptcy** – Assume Uptown Condos files for bankruptcy. Under the bankruptcy plan some of the units are to be sold. The parties want to close on the units as soon as possible. Later, the bankruptcy court orders some sales under § 363(f) of the Bankruptcy Code.

1. **Transfer Taxes** – Do county excise stamps apply when a Bankruptcy Court orders that property be sold or otherwise conveyed? In a Chapter 11 bankruptcy it is common for a plan to approve the conveyance of the debtor's real property. Pursuant to §1146(a) of the Bankruptcy Code, the plan often directs that these conveyances be made without the imposition of transfer or excise stamp taxes. §1146 (a) provides:

> The issuance, transfer or exchange of a security, or the making or delivery of an instrument of transfer under a plan confirmed under section 1129 of this title, may not be taxed under any law imposing a stamp tax or similar tax.

Title insurers are often asked to cover a transaction in which transfer taxes are not paid pursuant to this section. A recent U.S. Supreme Court case addressed this section and its application. In <u>Florida Department of Revenue v. Piccadilly Cafeterias, Inc</u>; U.S. Supreme Court No. 07-312 (decided June 16, 2008); the court addressed the issue of whether or not a plan must be confirmed prior to a conveyance receiving the exemption from transfer tax. Various Federal Judicial Circuits had taken differing views on this issue creating confusion. The Supreme Court clearly required that the plan be confirmed before the transaction is exempt from transfer/recording/mortgage taxes or fees.

The 11th Circuit Court of Appeals addressed another issue under §1146 (c) of the Bankruptcy Code. In <u>State of Florida v. T.H. Orlando, Ltd</u>; 2004 U.S. App. LEXIS 24692 (11th Cir.) (decided

Nov. 30, 2008), the 11th Circuit allowed the exemption to be applied to a mortgage tax where the mortgager was not the debtor. The facts of the case were very unusual in that an adjoining property owner was required to refinance an existing loan in order that the debtor may refinance their loan. The Court based it's holding on the fact that the plan "expressly authorized the non-debtor transaction, which the bankruptcy court found was necessary to consummation of the debtor's plan" and the lack of plain language in the Code that restricts the exemption to the debtor's property. Expect title companies to be wary in relying on this case due to its unusual set of facts.

2. **Sales Free and Clear before Expiration of Appeal Period** – A favorite section of the Bankruptcy Code for title insurers is § 363(f). This section allows real property to be sold free and clear of all liens. Property in bankruptcy is often encumbered by several liens. If the bankruptcy court will enter an order allowing the property to be sold and referencing this section along with the phrase "free and clear," then title to that property can be insured without exception to the liens.

   Sales under § 363(f) are subject to a 10 day appeal period. In the past title companies have agreed to insure such a sale prior to expiration of the appeal period, in reliance on statements in the order which transform liens on the property into liens on the proceeds. This approach treats § 363 (f)(3) as meaning that lien holders' interests are limited to the economic value of their lien, not the face value. The U.S. Bankruptcy Appellate Panel for the Ninth Circuit decided against that treatment of liens. Clear Channel Outdoor, Inc v. Nancy Kupfer, Chapter 11 Trustee, DB Burbank, LLC (391 B.R. 25 (9th Cir. BAP (Cal)). The case found that such sales are not free and clear if timely appealed, even if the appellant did not obtain a stay of such sale. As a result, Chicago Title will not insure a sale pursuant to § 363(f) that has been timely appealed without an exception for said appeal.

3. **Effect on Contract Purchasers** – In our story above, a number of the potential purchasers still have $100,000 deposits being held by Uptown Condos or a title company acting as escrow agent. The purchase agreements are not recorded. As a result, the buyers are unsecured and have no priority over the lender or other lien holders. For the deposits placed with an escrow agent, the terms of the agreement should control. If Uptown Condos cannot deliver the unit pursuant to the terms of the agreement, then the escrow agent should be able to return the deposit. If the terms are not completely clear,

then the escrow agent will require both the buyer and the seller, which now involves the bankruptcy court or trustee, to consent to the release of the funds. If the funds were being held by Uptown Condos and Uptown Condos used the funds to further construction, then the buyer is an unsecured creditor under the bankruptcy action. Can they make claims in the court under theories of unjust enrichment or quantum meruit?

4. **Workouts** – Under the threats of foreclosure by the lender or bankruptcy by the borrower, parties are often willing to agree to some form of workout. This usually involves a modification of the loan terms and a forbearance agreement. The main concern is whether or not the changes will change the priority of the loan/deed of trust. The lender is likely to request an endorsement, such as an ALTA 11, to there existing loan policy. This endorsement acknowledges an amendment to the terms of the loan and states the priority has not changed. In order to issue an ALTA 11 or similar endorsement, title companies will require (1) verification of recordation of satisfactory modification agreement regarding the deed of trust insured, and (2) an attorney's certification of title to the land including any amendments, modifications, assignments or other matters affecting the insured deed of trust through and including proposed effective date of endorsement.

   If there are any intervening matters (even potential intervening matters), then the changes to loan must be considered to determine whether or not they create a novation of the loan. North Carolina case law defines a novation as "a substitution of a new contract or obligation for an old one which is thereby extinguished… novation implies the extinguishment of one obligation by the substitution of another." Tomberlin v. Long, 250 N.C. 640 at 644, 109 S.E. 2d 365 at 368 (1959). "The essential requisites of a novation are a previous valid obligation, the agreement of all parties to a new contract, the extinguishment of an old contract, and the validity of the new contract." Anthony Marano Co. v. Jones, 165 N.C. App. 266 at 269, 598 S.E. 2d 393 at 395 (2004) (quoting Tomberlin, 250 N.C. at 644, 109 S.E. 2d at 367-68). These courts have also noted that they will consider the intent of the parties.

   In Anthony Marano Co., a year after executing a first note to his lender, the defendant executed a second "demand note" to the same lender, which changed the terms of the original debt by reducing the interest rate. The court held the change was only a modification, and did not extinguish and replace the original obligation. Anthony Marano Co., 165 N.C. App at 269, 598 S.E 2d at 395. It is generally accepted that the advancement of new funds not cover by the original note/deed of trust, will result in a novation or at least a new priority for those new funds.

Title companies, lenders and borrowers should all closely consider whether a workout agreement creates a novation or otherwise changes the priority of a loan. Any doubt may open the window to a lawsuit attempting to declare a novation. As a result, title companies may require subordinations from any potential intervening lien holder.

Another consideration for lenders is whether or not their policy will cover concessions made in a workout. Condition 9(c) of the 2006 ALTA Loan Policy states that

> "The Company shall not be liable for loss or damage to the Insured for liability voluntarily assumed by the Insured in settling any claims or suit without prior written consent of the Company."

The same provision is included as Condition and Stipulation 8 (c) of the 1992 ALTA Loan Policy. If the modifications to the loan/deed of trust weaken or create defects in the insured title interest, then the title company may have defense to a later claim under the policy. If the title company consents to the modifications, for example by issuing an endorsement, then they would not have a defense based on this Condition.

It is important to note that various cram down and lien stripping provisions do exist in the Bankruptcy Code. Their existence is often the reason for a lender's willingness to enter a workout. The focus and time limits of this manuscript prevent an in depth review of cram down and lien stripping provisions. Title companies should be willing to insure interests that are consistent with a proper Bankruptcy Court order.

A proposed senate bill seeks to strengthen the ability of bankruptcy judges to impose cram downs by allowing them to modify terms of homes loans. Currently bankruptcy does not allow approval of reorganization plans which modify the terms of the primary loan on a home residence. Other loans such as car loans and second home loans can be modified. The new Bill would allow bankruptcy judges to lower interest rates, reduce principal, and/or shorten the term of the primary mortgage/deed of trust. This would give troubled homeowners leverage in negotiating with their lenders.

C. **Creditors' Rights Issues and Title Insurance** – There are a few occasions in our story above that various parties may ask for creditors' rights coverage. Most likely would be the lender on the initial construction loan. A lender may also ask for the coverage if the loan is refinanced. If the property is sold by Uptown Condos, then the new owner and their lender may also look for the coverage. Given the downturn in the real estate and market and the increase in bankruptcies, creditors' rights coverage may be more frequently requested and more difficult to provide.

Creditors' rights are those rights of unsecured creditors which may become superior to the rights of purchasers and secured creditors. These rights arise as a result of actions taken by a debtor prior to entering bankruptcy. These actions are seen as unreasonably harmful to unsecured creditors and may include certain transfers of property interests which become voidable by a court in a subsequent proceeding. Two categories of transfers are involved: fraudulent transfer and preference.

Fraudulent transfers can be either intentional or constructive. The intentional fraudulent transfer is done to hinder, defraud or delay a creditor. The constructive fraudulent transfer requires no intent to defraud, but occurs when a transfer is made for less than reasonably equivalent value and any of the following exists: (i) the transfer is made when the transferor is insolvent; (ii) the transfer renders the transferor insolvent; or (iii) the transfer leaves the transferor with unreasonably small capital to continue it's business.

A preference occurs when an insolvent grantor makes a transfer shortly before entering bankruptcy and that transfer favors fewer than all creditors. The time period prior to foreclosure is normally 90 days; however, if the transfer is made to a creditor considered to be an "insider", then the period is one year.

1. **Basic Creditors' Rights coverage under the 2006 ALTA Policies** – There are two provisions under the 2006 that address creditors' rights coverages.

    a. Limited Current Transaction Coverage - Covered Risk 9(b) on the Owners Policy and Covered Risk 13(b) on the Loan Policy provide coverage for a current transaction being treated as preference under bankruptcy or similar laws as a result of (1) a failure to timely record or (2) a failure to impart notice to third parties.
    b. Prior Transactions Coverage – Covered Risk 9(a) on the Owners Policy and 13(a) on the Loan Policy provide coverage for challenges to prior transaction in the title chain based upon creditors' rights, including fraudulent and preferential transfers.

Creditors' rights coverage beyond the above will need to be addressed by an endorsement, such as an ALTA 21. This endorsement provides the following:

> The Company insures against loss or damage sustained by the Insured by reason of the avoidance, in whole or in part, or a court order providing some other remedy, based on the voidability of any estate or interest shown in Schedule A or the Insured Mortgage because of the occurrence on or before Date of Policy of a fraudulent transfer or a preference under federal bankruptcy, state insolvency, or similar creditors' rights laws.

2. **Issuing an ALTA 21** – Creditors' rights is a high risk coverage for title companies. It involves relying on information that is not of record and making a credit risk determination. As a result, Chicago Title requires prior approval to issuing an ALTA 21. The nature of the transaction must be reviewed and following information will be required, if applicable: (1) the structure of the transaction (antecedent debt, upstream and downstream financing, sale-leaseback, leverage buyout,…); (2) names and affiliations of the parties involved; (3) the consideration to be paid; (4) intended use of the proceeds of the loan to be insured; (5) any facts bearing upon the financial status of the borrower or the seller; and (6) any additional information which may materially affect the nature of the risk to be insured. The key is the structure of the transaction. In transactions were the funds can be followed into acquiring or improving the borrower's property, then approval is easier to obtain. If the parties are related or if the funds are being disbursed to shareholders or members, then more information will be required.

   Can creditors' rights coverage be issued to the insureds in the following scenarios:

   a. Owner's coverage at the time Uptown Condos acquires the property – Uptown Condos would need to demonstrate that the transaction is "arms-length" and for fair market value.
   b. Lender's coverage at time that Uptown Condos takes out the original construction loan – If Uptown Condos is able to confirm that all loan proceeds are being used to improve the property, then the structure is favorable for approval.
   c. Lender's Coverage at the time Uptown Condos refinances it construction loan – If the proceeds are being used to pay off the existing loan and further improve the property, then the structure is favorable.

However, the existence of the Uptown's financial difficulties may offset the structure. If the proceeds are being used to repay Big D, Inc. and High Return, LLC for their loans to Uptown, then more information will be required regarding the nature of the initial loans and the financial status of the parties.

d. Lender's coverage if lender forecloses, purchases at foreclosure, takes title (or has related entity take title), and requests a new policy – Lender would have to demonstrate that there was no equity (the loan balance equal to or greater than the property value) in the property.
e. Lender's coverage at the time Uptown Condos refinances and the funds are used to purchase other property for a related entity – Strong financials statements would be required for the parties involved (indemnitor would probably be required).

Transaction Structures

The following is a list of transaction structures that create creditors' rights risks and those that are less likely to create such risks.

Transaction Structure with Creditors' Rights Risk

- Leveraged Buyouts (Corporate or Partnership)
- Mortgages to pay dividends or partnership distributions
- Guarantee Mortgages
- Cross-collateralized Mortgages
- Mortgages cosigned by different entities
- Mortgages to repurchase corporate stock
- Partnership "Roll ups"
- Mortgages securing unsecured pre-existing debts to the same lender
- Cross-collateralizing mortgages from the same entity where they were previously independent
- Late recording of mortgages

- Substitution of mortgaged properties
- Deeds in lieu of foreclosure
- Mortgage modifications which increase the debt burden on the mortgaged property

Transactions with no Structural Problems (Usually)

- Refinances of existing mortgages
- Refinancing of existing unsecured debt by a different lender
- Purchase money mortgages

Resources:

www.northcarolina..ctt.com *Bulls, Bulletins, Articles & Forms – Foreclosure of Deeds of Trust*

http://www.fdic.gov/consumers/loans/loanmod/loanmodguide.html.

www.fdic.gov.