

Underwriting Considerations Related to Distressed Properties

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Today We Will Discuss...

- Mortgage Modifications
 - Not all mortgage modifications involve distressed properties
- Receiverships
- Mortgage Foreclosures
- Deeds in Lieu of Foreclosure
- UCC Foreclosures

Mortgage Modifications

- Modification vs. novation
- Impact on the priority of the Insured Mortgage
- Are there new encumbrances or interests affecting title?
- Is there “new money” or an additional advance?
- New loan policy vs. endorsement to existing loan policy

ALTA 11 MORTGAGE MODIFICATION ENDORSEMENT

1. The Company insures against loss or damage sustained by the Insured by reason of:
 - a. The invalidity or unenforceability of the lien of the Insured Mortgage upon the Title at the Date of Endorsement as a result of the agreement dated _____, recorded _____ ("Modification"); and
 - b. The lack of priority of the lien of the Insured Mortgage, at the Date of Endorsement, over defects in or liens or encumbrances on the Title, except for those shown in the policy or any prior endorsement and except: *[Drafting Instruction: Specify exceptions, if any]*

2. This endorsement does not insure against loss or damage, and the Company will not pay costs, attorneys' fees, or expenses, by reason of any claim that arises out of the transaction creating the Modification by reason of the operation of federal bankruptcy, state insolvency, or similar creditors' rights law that is based on the Modification being a:
 - a. fraudulent conveyance or fraudulent transfer;
 - b. voidable transfer under the Uniform Voidable Transactions Act; or
 - c. preferential transfer to the extent the Modification is not a transfer made as a contemporaneous exchange for new value or for any other reason unless the preferential transfer results solely from the failure:
 - i. to timely record the Modification in the Public Records after execution and delivery of the Modification to the Insured; or
 - ii. of the recording of the Modification in the Public Records to impart notice of its existence to a purchaser for value or to a judgment or lien creditor.

ALTA 11.1 MORTGAGE MODIFICATION WITH SUBORDINATION ENDORSEMENT

1. The Company insures against loss or damage sustained by the Insured by reason of:
 - a. The invalidity or unenforceability of the lien of the Insured Mortgage upon the Title at the Date of Endorsement as a result of the agreement dated _____, recorded _____ (“Modification”); and
 - b. The lack of priority of the lien of the Insured Mortgage, at the Date of Endorsement, over defects in or liens or encumbrances on the Title, except for those shown in the policy or any prior endorsement and except: *[Drafting Instruction: Specify exceptions, if any]*
 - c. **The following matters not being subordinate to the lien of the Insured Mortgage:** *[Drafting Instruction: Specify subordinate matters, if any]*

2. This endorsement does not insure against loss or damage, and the Company will not pay costs, attorneys’ fees, or expenses, by reason of any claim that arises out of the transaction creating the Modification by reason of the operation of federal bankruptcy, state insolvency, or similar creditors’ rights law that is based on the Modification being a:
 - a. fraudulent conveyance or fraudulent transfer;
 - b. voidable transfer under the Uniform Voidable Transactions Act; or
 - c. preferential transfer to the extent the Modification is not a transfer made as a contemporaneous exchange for new value or for any other reason, unless the preferential transfer results solely from the failure:
 - i. to timely record the Modification in the Public Records after execution and delivery of the Modification to the Insured; or
 - ii. of the recording of the Modification in the Public Records to impart notice of its existence to a purchaser for value or to a judgment or lien creditor.

ALTA 11.2 MORTGAGE MODIFICATION WITH ADDITIONAL AMOUNT OF INSURANCE ENDORSEMENT

1. For purposes of this endorsement only:
 - a. "Modification": The agreement between _____ and _____ dated _____ [and recorded _____ as document number _____].
 - b. "Date of Endorsement": _____.
2. **The Amount of Insurance is increased to \$ _____.**
3. Subject to the exclusions in Section[s] 4[and 5] of this endorsement, the Exclusions from Coverage, the Exceptions contained in Schedule B, and the Conditions contained in the policy, and any exclusion or exception in any prior endorsement, the Company insures as of the Date of Endorsement against loss or damage sustained by the Insured by reason of any of the following:
 - a. The invalidity or unenforceability of the lien of the Insured Mortgage upon the Title as a result of the Modification;
 - b. The lack of priority of the lien of the Insured Mortgage over defects in or liens or encumbrances on the Title, except: *[Drafting Instruction: Specify additional exceptions, if any]*;
 - c. The failure of the following matters to be subordinate to the lien of the Insured Mortgage: *[Drafting Instruction: Specify matters to be insured as subordinate, if any]*.
4. This endorsement does not insure against loss or damage, and the Company will not pay costs, attorneys' fees, or expenses, by reason of any claim that arises out of the transaction creating the Modification by reason of the operation of federal bankruptcy, state insolvency, or similar creditors' rights law that is based on the Modification being a:
 - a. fraudulent conveyance or fraudulent transfer;
 - b. voidable transfer under the Uniform Voidable Transactions Act; or
 - c. preferential transfer to the extent the Modification is not a transfer made as a contemporaneous exchange for new value or for any other reason unless the preferential transfer results solely from the failure:
 - i. to timely record the Modification in the Public Records after execution and delivery of the Modification to the Insured; or
 - ii. of the recording of the Modification in the Public Records to impart notice of its existence to a purchaser for value or to a judgment or lien creditor.
5. **This endorsement does not insure against loss or damage, and the Company will not pay costs, attorneys' fees, or expenses, by reason of the invalidity, unenforceability, or lack of priority of the lien of the Insured Mortgage because all applicable mortgage recording or similar intangible taxes were not paid at time of recording of the Modification].**

Mortgage Modifications

- Lenders may also request:
 - Update to Date of Policy or effective dates of previously issued endorsements
 - Increase or decrease the Amount of Insurance
 - Add or remove Schedule B-I or B-II exceptions
 - Add or remove property from the description of the Land
 - Amend or replace aggregation endorsements
- These requests require additional underwriting

Commercial Receiverships

- Federal law or state law?
- Do the loan documents authorize the appointment of a receiver?
- Do the loan documents or court orders restrict the receiver's authority or authorize the sale of real estate?
- Do the receiver's actions and sale terms comply with applicable court orders?
- Have all necessary parties consented or received sufficient notice and due process?
- Are the debtor and buyer related parties?
- Is there equity in the property?
- How are recorded and unrecorded "inchoate" interests addressed?
- Is the sale order appealable and has the appeal period lapsed without an appeal?

Commercial Receiverships: Federal Law

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- Authorized under 28 US Code § 3103
- Does the court have jurisdiction?
 - Federal question of law or an amount in controversy of at least \$75K and complete diversity of citizenship between each plaintiff and each defendant

Commercial Receiverships: Federal Law

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- Public Sales under 28 USC §§ 2001(a) & 2002
 - Conducted at the courthouse of the county, parish, or city in the state in which the greater part of the property is located, or upon the premises or some parcel thereof located therein, as the court directs
 - The sale shall be upon such terms and conditions as the court directs
 - Published notice once a week for at least four weeks prior to the sale in at least one newspaper regularly issued and of general circulation in the county, state, or judicial district of the United States wherein the real property is located
 - If the property is in more than county, state, or judicial district, the notice must be published as the court directs
 - The notice shall be substantially in such form and contain such description of the property by reference or otherwise as the court approves
 - The court may direct that the publication be made in other newspapers

Commercial Receiverships: Federal Law

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- Private Sales under 28 USC § 2001(b)
 - A hearing based upon notice being provided by publication or as required by the courts
 - Issuance of a court order directing that the property be sold at a private sale for cash or other consideration upon such terms and conditions as the court approves
 - Finding that a private sale is in the best interest of the estate
 - Court appointment of three disinterested persons to appraise the property
 - If property is in different localities, the Court appoints groups of three appraisers for each such property
 - The terms of the private sale must be published in such newspaper or newspapers of general circulation as the court directs at least ten days before confirmation
 - Court order confirming the sale
 - A private sale **shall not** be confirmed:
 - At a price less than two-thirds of the appraised value
 - If a bona fide offer is made, under conditions prescribed by the court, which guarantees at least a 10% increase over the price offered in the private sale

Commercial Receiverships: State Law

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- Uniform Commercial Real Estate Receivership Act (UCRERA)
 - Enacted in 16 states since 2017
 - Many states lack a developed body of caselaw
- State receivership statutes not based on UCRERA are often general in nature and defer to a court's general powers
 - Many states lack a developed body of caselaw
- State courts have jurisdiction over real estate located within that state
 - Ancillary proceedings are necessary to authorize the sale of real estate in other states

Commercial Mortgage Foreclosures

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- Judicial vs. non-judicial foreclosures
- Compliance with requirements related to due process, notice (by mail and/or publication), timing, and content
- Expiration of applicable appeal periods and rights of redemption
- Recorded or unrecorded interests may be divested

Deeds in Lieu of Foreclosure (“DIL”)

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- Common Requirements
 - Authority and consent by all necessary parties
 - Review of the DIL, DIL Agreement, and estoppel affidavit
 - DIL granted in consideration for discharge of the debt
 - Absolute and unconditional conveyance, not as security for a debt
 - Whether the mortgage will “merge” into the estate acquired by the lender
 - No parties in possession or unrecorded interests
 - “Underwater” property with no equity
- Liens, encumbrances, and other interests are not divested

Deeds in Lieu of Foreclosure (“DIL”)

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- Common Risks and Areas of Concern
 - DIL placed in escrow (a/k/a “DIL in a box”)
 - Rights retained by the grantor
 - Significant equity in the property
 - Rights of other creditors including mezzanine lenders
 - Recharacterization as an equitable mortgage
 - Claims of “clogging” the equity of redemption

Deeds in Lieu of Foreclosure: Bankruptcy & Creditors' Rights

- Fraudulent Transfers
 - Debtor receives less than reasonably equivalent value for the transfer of the property.
 - Lookback period is 2-6 years depending on state law
- Preferential Transfers
 - Lender/transferee receives more than it would have received in a Chapter 7 liquidation.
 - Lookback period is 90 days, or 1 year if the transferee is an insider
- ALTA Owner's and Loan Policies exclude coverage for the transaction creating the insured interest, but there is "back-chain" coverage (and risk)
 - 2021 ALTA Owner's Policy: Covered Risk 9 & Exclusion 4
 - 2021 ALTA Loan Policy: Covered Risk 13 & Exclusion 6

Bankruptcy Sales Under Ch. 11 US Code § 363

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- Section 363(f) authorizes sales “free and clear”
- Jurisdictional requirement
 - Is the property part of the bankruptcy estate?
 - Has it been abandoned?
- Review of the petition, notices, orders, and other filings
- Sale order must:
 - Identify liens or interest to be removed
 - Identify the holder and value of each lien or interest
 - Specify the applicable subsection of Section 363(f) that authorizes the sale “free and clear”
 - Include a statement that completion of the sale vests title in the purchase “free and clear”
- Lower courts are split on whether non-lien interests (such as leases, CC&Rs, and options) can be eliminated

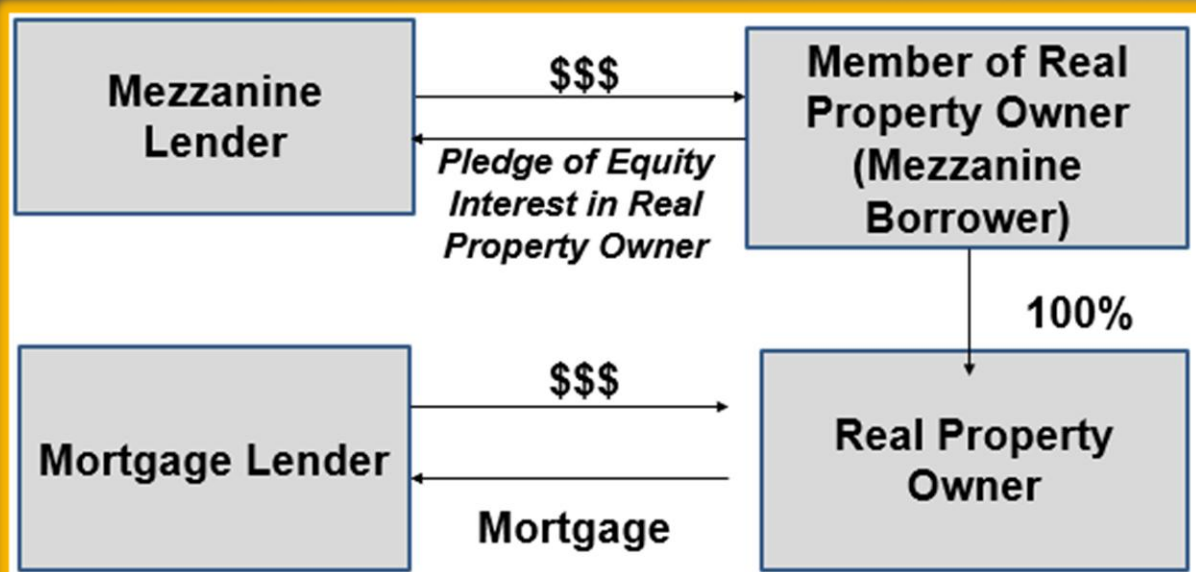
Bankruptcy Sales Under Ch. 11 US Code § 363

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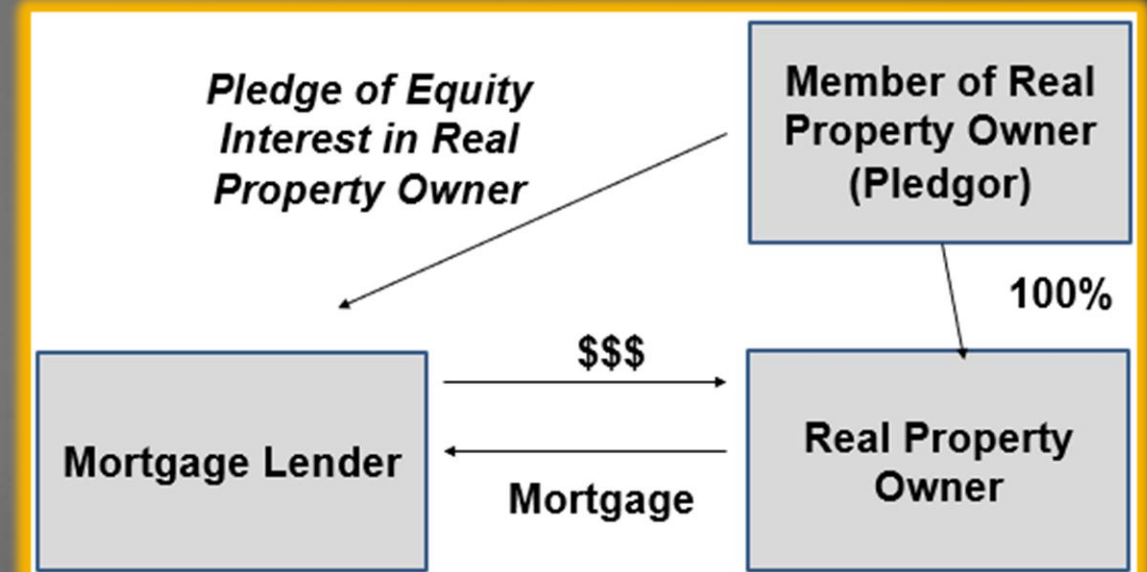
- Fourteen-day appeal period (Fed. R. Bankr. P. 8002(a)(1))
 - *Except as (b) and (c) provide otherwise, a notice of appeal must be filed with the bankruptcy clerk within 14 days after the judgment, order, or decree to be appealed is entered.*
 - The right of appeal is jurisdictional and not waivable
- Fourteen-day automatic stay (Fed. R. Bankr. P. 6004(h))
 - *Unless the court orders otherwise, an order authorizing the use, sale, or lease of property (other than cash collateral) is stayed for 14 days after the order is entered.*
 - The automatic stay is often waived. This does not waive the right of appeal.
- Ch. 11 US Code § 363(m) and the “mootness” argument
 - *The reversal or modification on appeal of an authorization under subsection (b) or (c) of this section of a sale or lease of property does not affect the validity of a sale or lease under such authorization to an entity that purchased or leased such property in good faith, whether or not such entity knew of the pendency of the appeal, unless such authorization and such sale or lease were stayed pending appeal.*
 - Litigation risk and a title insurer’s duty to defend
 - Section 363(m) does not prevent appeals and would need to be argued as a defense

UCC Foreclosures

Mezzanine Financing



Equity Pledges



UCC Foreclosures

- Why do UCC foreclosures create a “title” risk?
 - Authority for subsequent transactions
- Foreclosure remedies under Article 9 of the Uniform Commercial Code:
 - UCC § 9-610: Foreclosure by Public Sale
 - UCC § 9-610: Foreclosure by Private Sale
 - UCC § 9-620: Strict Foreclosure
 - UCC § 9-601: Judicial Enforcement
- The “commercially reasonable” standard under UCC § 9-627

UCC Foreclosures: Commercial Reasonableness

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- UCC § 9-610(b)
 - *Every aspect of a disposition of collateral, including the method, manner, time, place, and other terms, must be commercially reasonable. If commercially reasonable, a secured party may dispose of collateral by public or private proceedings, by one or more contracts, as a unit or in parcels, and at any time and place and on any terms.*
- UCC § 9-627(b)(3)
 - *A disposition of collateral is made in a commercially reasonable manner if the disposition is made...otherwise in conformity with reasonable commercial practices among dealers in the type of property that was the subject of the disposition.*
- UCC § 9-627(c)(1)
 - *A collection, enforcement, disposition, or acceptance is commercially reasonable if it has been approved...in a judicial proceeding;*

UCC Foreclosures: Common Challenges To Commercial Reasonableness

- Pre-sale temporary restraining order or post-sale challenge
- Insufficient amount of notice or marketing
 - UCC requires 10 days, but case law requires 60-90 days notice
- Failed to advertise properly or sufficiently
- Sale terms not maximizing number of bidders
 - Not finalized with enough notice
 - Required to sign an NDA
 - Restrictions on qualified bidders
 - High deposits or quick closings
 - No inspections
- Data room has outdated information

UCC Foreclosures: How To Find Them?

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- *Not recorded in the land records*
- Disclosure by the parties
- Internet searches
- Amendments to an entity's organizational documents
- Chain of assignments of membership interests
- Signature blocks (including signatory and organizational structure)
- Secretary of State's UCC records

In Conclusion...

- Transactions involving distressed properties are high-risk transactions that require fact-specific underwriting
- Underwriting coverage for “off record” matters can be challenging due to the lack of common due diligence materials such as current surveys and reliable affidavits and indemnities
- Involve underwriting early in the transaction to provide clients with the best opportunity for a successful outcome

THANK
YOU!

Have Questions?

Send Rich Halfmann an email at rhalfmann@firstam.com.