

# Distressed Properties & Title Insurance - Part 2: Managing the Stress When Insuring Distressed Commercial Properties

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**TITLE TENETS** Webinar Series

# Current State of the Market- Bankruptcy and Distressed Properties

## Commercial Real Estate and Bankruptcy Trends

- Analysts have reported that followed by a quick deflation – the \$2.9 trillion in commercial mortgages due will need to be renegotiated in the next two years. Epic June 14, 2023.
- The current dynamics indicate that a financial crisis affecting the commercial real estate market is on the horizon. Epic June 14, 2023.

## Bankruptcy filings surge in first half of 2023 in US

- March 2023 commercial bankruptcy filings were 79 percent higher compared to March 2022. Epic June 14, 2023.
- U.S. Chapter 11 bankruptcy filings jumped 68% in the first half of 2023 from a year earlier, with 2,973 commercial Chapter 11 bankruptcies compared to 1,766 in the same period last year. Reuters. July 3, 2023.
- Additionally, individual Chapter 13 filings also saw a 23% jump during the same time-period. Reuters. July 3, 2023.
- Bankruptcy filings for small business, categorized as Subchapter V elections within Chapter 11, jumped 55%, according to the data. Reuters. July 3, 2023.

# Bankruptcy Filings under Chapters 7, 13, 11 & 12 of the Bankruptcy Code.

**Chapter 7:** Liquidation. Fresh Start-Usually voluntarily filed by debtor, but Creditors can file an involuntary petition against debtor

**Chapter 13:** Wage earner plan. Used by individuals with regular income, but has limits on the amount of assets and liabilities.

**Chapter 11:** Business Reorganization. Usually used by a business entity whereby the Debtor remains in control of the assets rather than a Trustee. A plan is negotiated to reorganize debt and renegotiate or wipe out contracts.

- The Bankruptcy Code also allows small business debtors to file for relief under two different sub-categories of chapter 11 intended to streamline processes and reduce costs: (i) a small business case (by definition in 11 U.S.C. § 101(51C) or (ii) subchapter V, was created in 2019 by the Small Business Reorganization Act (SBRA).

**Chapter 12:** "Family farmers" or "Family fishermen". It enables financially distressed family farmers and fishermen to propose and carry out a plan to repay all or part of their debts.

# Title Issues with Bankruptcy Filings

- Is the Case still active? In a Chapter 11 or Chapter 13 case, has the Plan been confirmed by the Court?
- In the sale of the property, has a Motion to Modify the Automatic Stay (Section 362) been entered or a has a Motion to Sell been granted?
- If yes, has the appeal period expired and/or were there any objections to the Motion that were ruled upon by the Court.
- Are there any adversary proceedings pending?
- Has a discharge or has the Case been closed or has the Trustee abandoned the property?
- Are there any “special” Orders from the Court?

# Common Bankruptcy issues in commercial real estate transactions

- Motions to Sell Real Estate and Section 363 sales
- Court Orders and when they take effect
- Chapter 11 confirmed plans
- Effects of a Bankruptcy dismissal



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# Motions to Sell Real Estate out of Bankruptcy

When a property owner files for bankruptcy, legal title remains with the bankrupt owner, but authority to sell or refinance is held by the bankruptcy court.

A specific court order authorizing the sale or refinance is required unless:

1. The bankruptcy case is closed (not simply discharged); or
2. The property has been abandoned by the trustee; or
3. ALL of the property is exempted (not just part); or
4. In a Chapter 11 case, the sale or refinance is in the “ordinary course of business”, which is highly unlikely; or
5. The sale or refinance is contemplated by the Chapter 11 or Chapter 13 Plan in which case there will be a court order confirming the Plan.

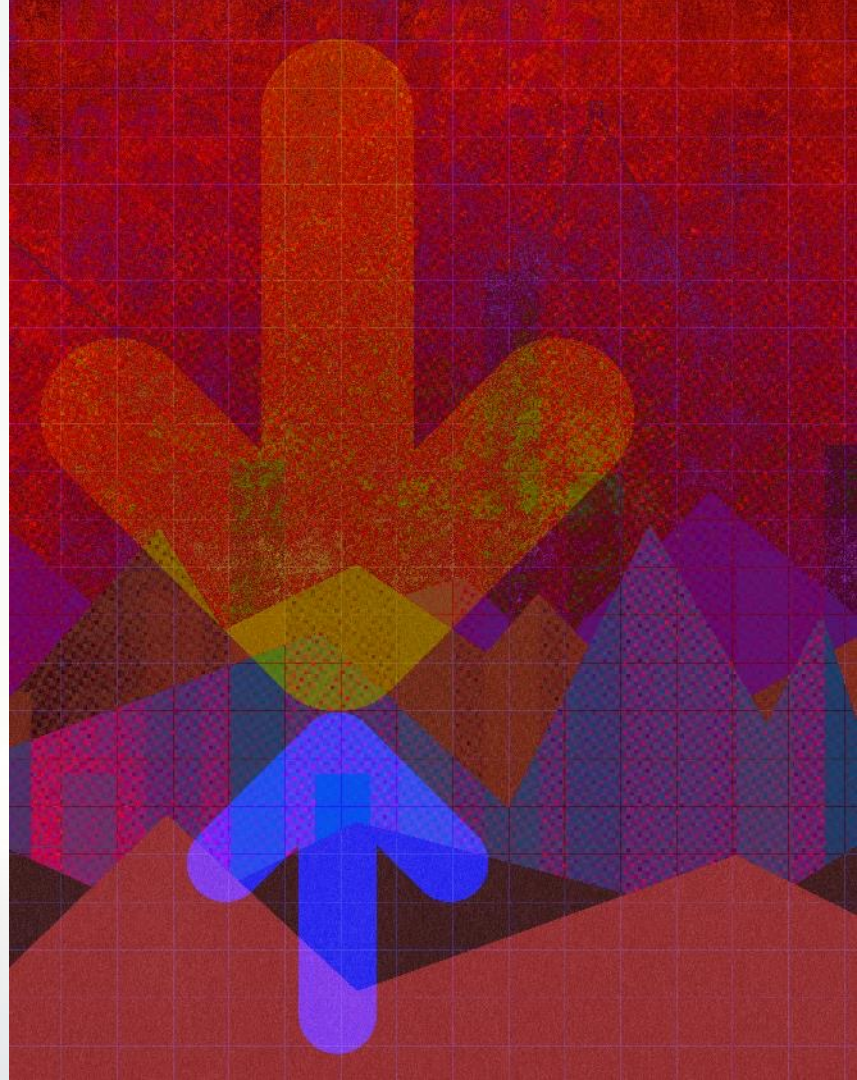


# Section 363 Sales- Sale free and clear of liens

- The process is a court-sanctioned sale process within the Bankruptcy Case after marketing, a due diligence and bidding procedure followed by an auction and court approval of the sale.
- One of the main benefits is that the real estate or asset will generally be sold “free and clear” of liens in most cases.



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# Title insurance concerns when underwriting a Section 363 sale

- Review Notice, Motion, Sale and Bidding Procedures, Court Docket and Order
- If co-owner does not consent, debtor/trustee must file adversary action against co-owner and obtain final Court Order
- Partnership property cannot be sold free and clear of rights of co-owner
- Review Court docket for Objections or Adversary Proceedings and Terms of final Court Order



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# When Bankruptcy Orders take effect

- Fed. R. Bankr. P. 6004(h). Order Stayed for 14 days unless waived by Court Order.
- Bankruptcy Rule 8002. Time for Filing Notice of Appeal. This is a separate and distinct order from Rule 6004 (h). The notice of appeal shall be filed with the clerk within 14 days of the date of the entry of the judgment, order, or decree appealed from. The 14 day appeal period under Rule 8002 cannot be waived.
- Final order to insure. Generally, title companies require a final order to insure. See *In Re PW, LLC*, 31 B.R. 25 (2008).

# Chapter 11 Plan of Reorganization/Confirmed Plans

- In addition to the sale of assets under Section 363(b), a Debtor in Possession (DIP) or Trustee may sell estate assets as part of a Chapter 11 plan. Section 1123(a)(5) of the Bankruptcy Code
- If the plan calls for Sale of all or substantially all of the assets of the Estate in a Chapter 11 proceeding, then a final Court Order is required.
- If the debtor does attempt to Reorganize debts within the terms of the confirmed plan, additional capital or financing by the DIP may be needed.

# The Automatic Stay under Section 362 of the Bankruptcy Code

Upon the filing of a petition, the automatic stay goes into effect to preclude the commencement or continuation of any creditor efforts to collect or enforce a debt against the debtor or property of the estate. The automatic stay requires creditors to cease actions against the debtor and the debtor's property with some limitations described in 11 U.S.C. § 362(a).



# Bankruptcy Dismissal, Discharge and Closing of Bankruptcy Case.

**Dismissal of a Bankruptcy Case.** Dismissal ordinarily means that the court stopped all proceedings in the main bankruptcy case **AND** in all adversary proceedings, and a discharge order was not entered. Dismissal can occur because a debtor requested the dismissal and qualifies for voluntary dismissal. Dismissal can also occur without a debtor's consent if the court orders dismissal on its own, or a trustee or a creditor files a motion to dismiss the bankruptcy case and the court grants the motion.

**Bankruptcy Discharge.** A bankruptcy discharge releases the debtor from personal liability for certain specified types of debts whereby the debtor is no longer legally required to pay any debts that are discharged. The discharge is a permanent order prohibiting the creditors of the debtor from taking any form of collection action on discharged debts. However, valid liens against real property that are not avoided in Bankruptcy remain liens against the property.

**Closing of a Bankruptcy Case.** Closing means that all activity in the main bankruptcy case is completed, all motions have already been ruled upon, and if a trustee was appointed, the trustee has filed a statement that all trustee duties have been completed.





# Receiverships

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# Receiverships: The What, Why & Where

- **What is a Receivership?** Appointment of an individual to take control of, preserve & manage real or personal property on behalf of the court. Types vary. Focus of this discussion is Receiverships brought by a lender.
- **Why are we seeing an Increase in Receiverships?** Increased lender control, asset preservation, reduced costs & faster resolution
- **Where Does Authority Come From?**
  - Federal Codes/Rules of Procedure
  - State Statutes
  - Uniform Commercial Real Estate Receivership Act (UCRERA)\*\*
  - Case Law

\*\* UCRERA Adopted In Following States to Date (8/2023): Arizona, Connecticut, Maryland, Michigan, Nevada, Oregon, Rhode Island, Tennessee, Utah & West Virginia. Florida & North Carolina adopted similar but modified versions of UCRERA.

# Receiverships: Potential Risks

## Potential Risks

- Receivership Not as Structured or Defined as Bankruptcy = Potential Lack of Authority?
- Potential Contests to Appointment of or Sale By Receiver
- Failure to Comply With Statutory Grounds For Sale
- Potential to Clog Mortgagors Right of Redemption
- Reduced Ability to Clear Title & Provide Extended Coverage
- Automatically Stayed By Bankruptcy



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# Receiverships: Tips To Minimize Stress

- **Engage Title Insurer Early**
  - Provide Docket & Copies of Receivership Pleadings/Orders
  - What Title Coverage is Being Requested (Free & Clear; Extended)
  - Confirm Form of Order(s) Will Enable Title Coverage
  - Order Title Commitment
- **Identify Governing Jurisdiction & What Rights Granted**
- **Receiver's Compliance with Applicable Law: Dot "I's" & Cross "T's"**
- **Look for Cooperation of Borrower and Interested Parties**



# Receiverships: Docket, Pleadings & Court Orders

- **Docket, Pleadings & Court Orders:**
  - Clear Jurisdiction Established?
  - Authority for Appointment of Receiver and Sale of Real Property ?
  - Proof of Notice to All Interested Parties
  - Contested or Uncontested?
  - Final Non-Appealable Order of Appointment and Order of Sale?
  - Payment of Junior Lienholders?
  - Have Borrower and/or Interested Parties Consented?



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# Receiverships: Reviewing the Proposed Order of Sale

- **Does Proposed Court Order of Sale Include:**
  - Description of the Real Property
  - Clear Basis of Authority to Sell & Receivers Compliance with Law
  - Approval of Terms of Sale and Transfer of Property
  - Authorize Receiver to Sign Deed/Closing Documents
  - Confirm Adequate Notice to All Interested Parties
  - Address the Disposition of All Liens (voluntary or involuntary; free & clear; whether satisfied from proceeds)
  - Require Lienors to Deliver Releases in Recordable Form



# Deeds In Lieu of Foreclosure

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# Deeds In Lieu of Foreclosure: General

- **What is a Deed in Lieu in Lieu of Foreclosure?**
  - Alternative to Foreclosure. Borrower & Lender Agree to Release of Borrower and Guarantors From Personal Liability In Exchange For Borrower Turning Over the Property to Lender
- **Risks Involved with Deed in Lieu**
  - Not Given To A Bona Fide Purchaser For Value
  - Existing Liens and Interests Remain/Grantee Subject to All Matters
  - Increased Grounds For Attack = Heightened Risk for Title Insurers



# Deeds In Lieu of Foreclosure: Possible Grounds For Attack

- **Possible Grounds for Attacking Deed In Lieu**
  - Intended As Additional Security for Debt/ Not Absolute Conveyance
  - Insolvent Mortgagor May = Preferential or Fraudulent Transfer
  - Lack of Consideration
  - Clogged Mortgagors Right of Redemption
  - Given Under Duress, Coercion, Undue Influence, Fraud
  - Increased Risk if Given With Mortgage or Loan Modification
  - Lack of Authority to Convey

# Deeds In Lieu of Foreclosure: Tips To Minimize Stress

- Engage Title Insurer Early In Transaction to Identify Their Requirements
- Plan to Provide Title Insurer With Copies of All Agreements Related to Deed in Lieu; Including Proposed Deed (Recorded and Off Record)
- Deed In Lieu & Owner's Affidavits from Borrower
- Confirm Authority of Party Signing Deed In Lieu for Grantor
- Address Potential Areas of Attack in Deed In Lieu Documents/Affidavits



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# Deeds In Lieu of Foreclosure: Agreements and Affidavits

- **Do the Deed In Lieu Agreements Contain the Following**
  - Agreement Borrower is In Default
  - Voluntary/Non-coercion Language
  - Recitation of Consideration
  - Description of Outstanding Debt vs Value of the Property/No Equity
  - Statement Grantor Has or Will Surrender Possession of Property
  - Waiver of Mortgagor's Right of Redemption
- **No Conditions, Right, Option or Obligation to Redeem or Reacquire the Property or Rescind Conveyance in Agreements or Deed In Lieu**
- **Deed In Lieu Affidavit Contains Many of the Same Representations**

# Deeds In Lieu of Foreclosure: Avoiding Potential Pitfalls

- **Avoid Escrow of Deeds In Lieu or Closing With Conditions**
- **Pending Foreclosure Proceedings Should Be Dismissed**
- **Release Mortgage Unless Lender Requires It to Survive Deed In Lieu**
  - Survival Requires Non-Merger Recital In Deed In Lieu
  - Considerations if Non-Merger Endorsement Requested By Lender
    - Conveyance to Separate Entity Related to Lender vs Lender
    - Non-Merger Language in Deed
    - Debt Should Not Be Extinguished
    - Releases Obtained From Subordinated Interests
    - Check Availability In State Where Property is Located





# Mortgage Modifications

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# Mortgage Modifications

A loan modification is often the most cost effective method of dealing with a Distressed Property instead of recasting an entirely new loan or declaring a default and foreclosing on the real estate.

Common loan modifications include the following:

- Extending the current maturity date
- Increasing or decreasing the loan amount
- Changing the interest rate or changing the method by which interest is calculated
- Modifying the payment provisions of the loan (interest only payments or deferred payments)
- Adding to or releasing the collateral securing the note
- Adding or removing guarantor(s)
- Amending or waiving covenants in the loan documents
- Adding or removing a revolving feature in an existing loan
- Allowing an assumption of the loan by a new borrowing entity

# Potential pitfalls of Mortgage Modifications, Priority and Title Insurance

- Loss of priority- record mortgage modification. Increased interest rate/ shorten maturity date/increase amount of debt
- Material modification- prejudice or adversely affect Junior lienholder
- NO NOVATIONS. Ok for extensions of maturity date, deferral of interest, reduction in interest rate or reduction in the amount of the loan
- Loan Policy does not provide coverage for subsequent modification, only effective as of the date of the policy
- Lenders request a mortgage modification endorsement such as the ALTA 11 series endorsements to insure the continuing validity and enforceability of the insured mortgage

# Thank You

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