



Initial Considerations in Evaluating Adversarial Claims Involving Insured Liens in Bankruptcy Proceedings

If an adversary proceeding in bankruptcy court is improperly resolved, an underwriter may be subject to downstream exposure.

Trustee's Increased Litigation

We are currently handling numerous bankruptcy specific claims. Ohio Bankruptcy Trustees have become increasingly litigious in attempts to strip or avoid insured's liens. There are several factors which give rise to this recent activity:

- an increase in bankruptcy filings;
- Trustee's plenary power to strip or avoid a bank's liens to pay unsecured creditors;
- favorable Ohio law with regard to the legal effect of minor defects in mortgages allowing Trustee's to invalidate or limit a lender's secured interest; and
- title insurance policies with no exceptions for bankruptcy stripping powers.

These factors often lead to underwriter settlement of adversarial proceedings.

Settling and Curing a Defect – A Must.

When settling adversary cases special considerations should be taken. First and foremost, the goal of the underwriter/counsel, when settling with a Trustee, should be to obtain a valid lien on the property in proper priority position. If the underwriter chooses to settle and does not correct the lien's defect the underwriter may be exposed to claims down the road.

Obtaining a valid lien in a bankruptcy proceeding may be accomplished one of two ways:

- reforming the bank's mortgage via judgment entry and then recording the judgment in the appropriate county recorder's office; or

- documenting that the insured is paid as first and best lien in any bankruptcy process.

How Much?

In order to determine whether settlement is a viable option, it is key to find a reasonable settlement number. That calculation is used as a back drop to better determine exposure under the title policy if the underwriter does not settle. In calculating a potential settlement it is important to understand that a Trustee is typically interested in three things:

- payment of the Trustee's distribution fee;
- payment for Trustee's counsel's attorney fees; and
- paying unsecured creditors.

Trustees who file adversary proceedings against an insured lender intend on receiving proceeds by selling a property which a purportedly defective lien encumbers.

The Trustee's decision to sell the subject property is at his/her discretion. If the Trustee intends on selling the property and the Trustee will pay the cost of the sale out of the sale proceeds, it makes no sense to pay the Trustee cost of sale in the settlement amount – the Trustee should not recover twice.

In addition, whether an underwriter is exposed for bankruptcy specific costs is an issue. Specifically, if the Trustee sells the property and bankruptcy specific costs, (Trustee distribution fees and the Trustee's attorney's fees) are paid out of the proceeds of the sale, this will inevitably reduce the amount paid to the insured. These are costs which wouldn't have been incurred but for the bankruptcy sale. Should the insured get reimbursed by the underwriter? It appears to be an open question.

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