

Real Estate Bulletin

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Lenders Title Insurance: What It Is and What It Covers

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For many years it has been common practice among lenders to require title insurance as part of their underwriting for loans secured by real property. It is surprising, however, how many real estate professionals know so little about what type of risks the title insurance covers, the difference between the “lender’s” policies and “owner’s” policies and other fundamental title insurance issues. In addition, many borrowers do not understand the purposes and limitations of lender’s policies and, as such, fail to realize that the covered risks enjoyed by lenders are not always available to borrowers. Sometimes, improvident borrowers will attempt to forego the cost of obtaining their own title insurance in the mistaken belief that a lender’s policy will provide them with adequate coverage.

In response to the ubiquitous demand for lender’s title insurance in real estate financing transactions and the growth of the demand for securitization of real estate loans (which demands as much uniformity as possible in the transactions), the title insurance industry has developed certain policy forms in the attempt to standardize policies that can be utilized in multiple jurisdictions, and through the joint cooperative efforts of the American Land Title Association and the mortgage banking industry, there is now a standard form of title policy utilized in most jurisdictions. The availability of “standard” policies does not mean, however, that a lender should feel secure in obtaining title insurance coverage without careful scrutiny of the policy itself and utilizing endorsements in appropriate circumstances to expanded coverage.

In general, a lender will have the prospective borrower obtain a preliminary title report or a binding commitment (collectively, “PTR”) for the real property intended to be used as security for the lender’s loan. Since an initial PTR will be limited to matters appearing in the public records, many lenders will require an ALTA survey of the real property to be conducted and for the exceptions referenced in the PTR that are “plottable” to appear on the survey. In addition, after the survey is completed, the lender will require that the PTR be updated to show any additional title defects that appear on the survey and to verify the description of the property. Finally, in order to analyze the potential risk of the exceptions to coverage in the PTR, lenders and their counsel will need to undertake an in depth review of the underlying recorded documentation identified as exhibits to the PTR.

After the lender and its counsel have scrutinized the exceptions on the policy and the survey to identify potential title issues, they will approach the title insurer to request that the title insurer expand or modify the proposed coverage to insure over issues of concern to the lender, and the lender and its counsel will work with the title insurance underwriter to expand the protection afforded by the title policy. This usually occurs by working with the underwriter to remove certain exclusions and have the title company issue specific endorsements that significantly expand coverage or have the effect of removing (“endorsing over”) exceptions appearing on the policy. In fact, given the unique nature of the limited scope of coverage

afforded by lender’s policies, often the endorsements issued with the lender’s policy are the most significant (in terms of likelihood to trigger coverage) elements of the policy.

Knowing what to ask for and how to word policy changes requires a thorough knowledge of the nature of title insurance to prevent frustrated expectations about what the policy covers and, more importantly, what a lender’s policy does not cover.

Lender’s Policies Do Not Automatically Become Owner’s Policies After Foreclosure

It is surprising how few real estate professionals understand the fundamental characteristic of the coverage afforded to a lender through a lender’s policy. More often than not, even seasoned real estate professionals assume that a lender’s policy will “convert” to an owner’s policy upon the insured lender obtaining fee title to the property. This is not the case.

What Type of Protection Does Lender Get With Title Insurance?

In the event of a covered loss, title insurance provides two distinct forms of protection.

Duty to Defend

The first duty imposed on a title insurer under a lender’s policy is the promise to pay legal expenses, such as attorney’s fees, court costs, and expert witness fees, in the event of an adverse claim

that threatens the lender's insured interest. Title insurers sometimes call this their "duty to defend." A title policy will not place a monetary limit on its duty to defend and any legal expenses paid by the insurer under its duty to defend do not reduce the policy amount; provided, however, that if the maximum amount of the lender's exposure under the duty to indemnify, as addressed below, exceeds the anticipated costs to be spent by the insurer under its duty to defend, a title insurer may, in its sole discretion, settle the matter by paying the full amount of the lender's exposure under the duty to indemnify.

Duty to Indemnify

The second form of protection accorded by a lender's policy is the title insurer's promise to reimburse or indemnify the lender for damage to its security interest if the condition of title is not as insured (for instance, the insured lien does not have priority over intervening liens or if a monetary lien is not disclosed on the final title report). This protection is commonly referred to as the "duty to indemnify." The maximum exposure of the title insurer's duty to indemnify is limited by the policy amount of the insurance as set forth on Schedule A of the policy. As such, in certain circumstances, an insurer can simply terminate all of its coverage obligations by paying the stated policy amount, terminating policy coverage and ending its duty to defend.

Another feature of lender's insurance that lenders should be cognizant of is that absent an endorsement that provides to the contrary, the total amount of the insurer's exposure under the policy (and thus its duty to indemnity) decreases as the loan is paid down.

Policy Analysis/ How to Read a Policy of Title Insurance

The risks covered by title insurance are generally described by the insuring provisions appearing on the first page of the policy. The standard insuring provisions cover the risks of:

"1. Title to the Estate or Interest Described in Schedule A Being Vested Other Than as Stated Therein";

Among other things, Schedule A of the policy describes the interest in the land that is encumbered by the insured mortgage (typically the owner's "fee" or a lessee's "leasehold" estate), and the name of the person in whom that interest is "vested," or shown to be held, in the public records.

This first insuring provision simply insures against loss should the information shown in Schedule A be incorrect. If, for example, someone other than the person shown in Schedule A owns all or some portion of the interest shown, then coverage against resulting loss or damage exists for the lender. Likewise, if the person shown in Schedule A owns a less valuable interest in the land, such as a terminable estate rather than a fee estate, then coverage can be triggered.

"2. Any Defect in or Lien or Encumbrance on the Title";

In other words, any "cloud" on title, such as a prior recorded mortgage, judgment lien, tax lien, environmental lien, notice of pending legal action, easement, restriction, or burdensome covenant running with the land.

This insuring provision also covers adverse claims based on lack of mental or legal capacity of a grantor in the chain of title, as well as claims based on forgery.

"3. Unmarketability of the Title";

This insuring provision covers the lender against title-related claims that actually disable or prevent the lender from selling its loan to another investor, or would require the lender to repurchase a mortgage.

This language does not cover circumstances resulting from physical condition of the land, such as contamination with hazardous waste or damage to improvements.

"4. Lack of a Right of Access to and from the Land";

This insuring provision has several

components. First, the term "access" is generally understood to mean a right to come and go from the land by a public road. Second, only the "right" to such access is covered. Problems presented by rough terrain, flooding and the like, are not included in the standard coverage. This provision does not in and of itself mean that the "right" of access is by means of a recorded easement.

If a lender is concerned that a specific right of way or easement interest be insured, it is advisable to make sure that either this access is included in the legal description of the insured property, or that an appropriate endorsement is issued.

"5. The Invalidity or Unenforceability of the Lien of the Insured Mortgage Upon Title";

This provision gives coverage against alleged defects in the insured lien (other than those occurring by the fault of the insured).

The provision expands upon the coverage provided by insuring provision number 2 since it covers the lender against risks such as unenforceability of the lien against the interest in the land of the borrower due to alleged failure of the borrower to qualify as a legal entity with a right to enter into contracts, lack of authority of a person to contract on behalf of the legal entity, failure to record the mortgage, and, in some cases, failure of a recorded mortgage document to become legally binding due to non-compliance with legal requirements (such as proper notary acknowledgment, payment of mortgage tax, etc.).

"6. The Priority of Any Lien or Encumbrance Over the Lien of the Insured Mortgage";

This provision also expands upon the coverage provided by insuring provision number 2, by covering the lender against adverse claims by holders of junior interests due to alleged failure of the insured mortgage to be properly recorded, mis-indexing of the insured mortgage in public records so that it may be difficult or impossible to find, and other such defects as may permit a junior interest to claim that the recorded document fails to impart constructive notice of its contents (such

as misspelling of names, erroneous or incomplete legal description, etc.).

"7. Lack of Priority of the Lien of the Insured Mortgage Over any Statutory Lien for Services, Labor or Material:

"(a) arising from an improvement or work related to the land which is contracted for or commenced prior to Date of Policy"; or

"(b) arising from an improvement or work related to the land which is contracted for or commenced subsequent to Date of Policy and which is financed in whole or in part by proceeds of the indebtedness secured by the insured mortgage which at Date of Policy the insured has advanced or is obligated to advance";

This is the so-called "mechanic's lien" coverage. A mechanic's lien is a claim created to secure payment for labor and material used to improve real property. Insuring provision number 7 covers the lender against mechanics' liens in most situations when the mechanic's lien claimant is asserting priority over the lien of the insured mortgage. No coverage for mechanics' liens is provided when the mechanic's lien claimant does not assert priority over the lien of the insured mortgage.

"8. Any Assessments for Street Improvements Under Construction or Completed at Date of Policy Which Now Have Gained or Hereafter May Gain Priority Over the Insured Mortgage;"

Some states have laws that permit assessments for street improvements to attach to real property and, to the extent street improvements began before the deed of trust is recorded, to gain priority over the mortgage. This insuring provision covers the lender against loss or damage resulting from loss of priority as against such assessments.

"9. The Invalidity or Unenforceability of Any Assignment of the Insured Mortgage, Provided the Assignment is Shown in Schedule A, or the Failure of the Assignment Shown in Schedule A to Vest Title to the Insured Mortgage in the Named Insured Assignee Free and Clear of all Liens."

This provision insures the validity and enforceability of an assignment of an insured mortgage as of the policy issue date, provided the assignment is shown in Schedule A of the policy. Such assignments are sometimes called "concurrent assignments."

Assignments made after the policy date may likewise be insured, by endorsement, at the discretion of the insurer. A CLTA Form 104.1 is an example of such an endorsement. Note that even without the endorsement a subsequent assignee may become an insured (see paragraph 1(a) of Conditions and Stipulations contained in the policy).

Generally, any claim against title that is adverse to the interest of an insured lender is covered by the lender's title policy, unless:

- > It is not covered by the insuring provisions, nor any modification or endorsement of the policy;
- > It is excluded from coverage by the printed Exclusions From Coverage contained in the policy; or
- > It is excepted from coverage by the Exceptions From Coverage contained in Schedule B of the policy.

Exclusions From Coverage

Exclusions From Coverage are intended to complement the insuring provisions. Without quoting them verbatim, in general, these exclusions deny coverage for matters arising from:

- > Exercise of governmental regulation or police power. This includes zoning and environmental protection laws, among others. This exclusion does not apply when a lien or some notice of violation related to the governmental regulation or police power has been recorded in the public records prior to the insured mortgage.
- > Governmental rights of eminent domain. Again, this exclusion does not apply when some notice of the adverse governmental claim has been recorded prior to the insured mortgage.

> Matters created, suffered, assumed or agreed to by the insured lender; matters not known by the title insurer nor shown in the public records, but known by the original lender and not disclosed in writing prior to the lender becoming the insured under the policy; matters resulting in no loss or damage to the insured; matters attaching after the policy issue date (except to the extent of mechanic's lien coverage discussed above); or matters resulting from failure of the insured lender to pay value for the insured mortgage (such as by failing to fund the subject loan).

> Unenforceability of an insured mortgage due to the failure of the mortgage holder to comply with state doing business laws.

> Invalidity or unenforceability of the insured mortgage based on usury or any consumer credit protection or truth-in-lending law.

> Any statutory lien for services, labor and materials (i.e., mechanics' liens) arising after the policy issue date, and unrelated to the loan secured by the insured mortgage.

> Any claim arising out of the transaction giving rise to the insured mortgage that involves federal bankruptcy laws, state fraudulent conveyance laws, or similar creditors' rights laws.

Exception From Coverage

Exceptions from coverage are set forth in Schedule B contained in the policy. Generally, these include regional exceptions for matters known to affect land areas including the insured property, as well as matters solely affecting the insured property.

Exceptions to coverage may be removed, and affirmative coverage provided against them, by endorsement or special language added to the policy, at the discretion of the insurer.

Conditions and Stipulations

An insurance policy is essentially a contract. Aside from the insuring provisions, exclusions and exceptions discussed above,

the Conditions and Stipulations contain the remaining terms and provisions governing the rights of the parties to the insurance contract.

The Conditions and Stipulations may be highlighted as follows:

> *Definition of Terms.* This section explains that the definition of “insured” includes any successor in interest of the original insured lender. Therefore, any assignee, receiver, or other successor in ownership of the insured mortgage will normally have the benefit of the policy coverage. Note that this definition of insured does not include the successful bidder at a foreclosure sale, or an obligor under the loan who succeeds to ownership of the insured mortgage.

This section also defines “marketability,” for purposes of clarifying insuring provision number 3 (“unmarketability of the title”). This definition is important to an originating lender wishing to sell the insured mortgage. Under this definition, title to the insured mortgage is generally considered unmarketable if a perceived defect, or “cloud” on title, becomes so serious as to provide a legal excuse for a buyer to back out of an agreement to purchase the mortgage.

> *Continuation of Insurance.* This section explains that policy coverage continues in favor of an insured lender in cases where the lender acquires the insured property through foreclosure, or through acceptance of a deed in lieu of foreclosure. It also explains that coverage continues in most circumstances where the insured lender transfers its interest to its parent or wholly-owned subsidiary, where the interest is acquired by a successor corporation by operation of law (such as by FDIC or RTC), or where the interest is acquired by a governmental agency in connection with a mortgage guarantee program (such as HUD’s FHA program).

In cases where the insured lender acquires title, such as by a deed in lieu of foreclosure, and then resells to a third party, coverage continues for the lender to the extent the lender continues to hold any interest in the property, such as with a purchase money mortgage given back to the lender by the

third party buyer.

Finally, this section explains that when the insured lender’s coverage continues after acquisition of the insured property, the amount of insurance will be the lesser of: (i) the original policy amount; (ii) the unpaid balance of principal, interest and reasonable advances secured by the insured mortgage; or (iii) the amount paid by a governmental agency in connection with its mortgage guarantee program.

In other words, the loan policy does not convert to an owner’s policy upon acquisition of property by an insured lender. In the event of a covered loss, the amount of insurance under a loan policy will always be limited to the lender’s unpaid balance, or to a governmental agency’s acquisition cost, or to the stated policy amount shown in Schedule A of the policy, whichever is less.

> *Notice of Claim to be Given by Insured Claimant.* In the event of a potential covered loss, the lender is required to promptly notify its insurer, in writing. Unreasonable delay may adversely affect coverage if the delay results in prejudice to the insurer.

> *Defense and Prosecution of Actions: Duty of Insured Claimant to Cooperate.* Upon receipt of a notice of claim triggering coverage, and subject to its option to pay or settle under Section 6 below, the insurer must provide for legal defense of the insured title. This duty to defend is generally limited to claims covered by the policy, and it does not include non-covered issues that the insured and adverse claimant may seek to include in litigation.

Where an insurer reasonably provides for defense of title, the lender is obligated to provide reasonable cooperation and assistance until the adverse claim is finally resolved.

> *Proof of Loss or Damage.* Once existence of a covered loss is determined, the lender must within ninety (90) days furnish to the insurer a written calculation of the lender’s damages. The lender is obligated to cooperate with the insurer’s reasonable investigation of the lender’s records and related evidence, and the

insurer is obligated to cooperate with the lender’s reasonable request to maintain confidentiality of its records.

> *Options to Pay or Otherwise Settle Claim; Termination of Liability.* In the event of a claim, and subject to Section 4 above, the insurer has the following options: to pay the policy amount together with due legal expenses; to purchase the insured mortgage and pay due legal expenses; to settle the adverse claim(s) and pay due legal expenses; or to settle with the insured lender and to pay due legal expenses.

Upon exercise of any of its options, the obligations of the insurer to the lender terminate, at least with respect to the subject claim, including the obligation to defend.

> *Determination and Extent of Liability.* This section expands upon Section 2, above, by explaining the measure of damages in the event of a covered loss where the insured lender has not acquired the insured property.

Where a covered loss threatens the security interest represented by the insured mortgage, the lender’s amount of insurance is the lesser of: (i) the policy amount; (ii) the amount provided under Sections 8 or 9, below, together with interest calculated from the time the loss or damage occurs until payment is made; or (iii) the difference in value of the insured property with and without the covered title defect.

> *Limitation of Liability.* If the insurer defeats an adverse claim or removes a title defect, with reasonable diligence and by whatever reasonable method, it is deemed to have fully performed its obligations under the policy.

In the event of litigation which is unsuccessful, the insurer’s obligation to reimburse the lender arises when the litigation is finally concluded.

The insurer is not liable for loss or damage voluntarily assumed by the lender in settling any claim without prior written consent of the insurer.

Finally, the insurer is not liable for any "optional" advance subsequent to the policy date, except for advances reasonably made to protect the lender's security interest or to prevent deterioration of improvements.

> *Reduction of Insurance; Reduction or Termination of Liability.* This section clarifies Sections 2 and 7, above, by explaining that payments that reduce the unpaid balance secured by the insured mortgage will also reduce the policy amount. As mentioned above, the amount of insurance under a loan policy is calculated to equal the lender's unpaid balance (or a governmental agency's acquisition cost).

> *Liability Non-Cumulative.* In the event that the lender acquires title to insured property, subject to a prior mortgage for which an exception was taken under Schedule B of the lender's policy, then any payment by the insurer in satisfaction of the prior mortgage will be deemed to be a payment under the policy and will reduce the policy amount accordingly.

> *Payment of Loss.* Before making any payment under the policy, the insurer may require that the original policy be produced for endorsement reflecting the payment and reducing the policy amount accordingly. If the original policy is lost or destroyed, the insurer may require proof of loss or destruction to its satisfaction. When the amount of a compensable loss has been determined, the insurer has thirty (30) days in which to make payment to the insured lender.

> *Subrogation Upon Payment or Settlement.* Upon payment of any claim, the insurer is subrogated to the rights of its insured as against third parties. In other words, upon any payment the insurer automatically acquires any rights or remedies that the lender may have against parties responsible for the loss.

If a claim payment does not fully reimburse the lender, then the lender's right to pursue responsible parties continues to the extent of its remaining loss, and the insurer is not entitled to any recovery under its subrogation rights until the lender has been paid in full.

Notwithstanding the insurer's subrogation rights, the lender may release personal guarantors, modify payment terms, give partial releases, or release collateral security, in most instances.

> *Arbitration.* In the event of a dispute between the insurer and the insured, either party may require that the dispute be submitted for binding arbitration. This option of either party applies only when the policy amount is \$1 million or less. If the policy amount is more than \$1 million, both parties must agree to binding arbitration before this litigation alternative may be employed.

> *Liability Limited to This Policy; Policy Entire Contract.* The insurance policy represents the entire contract between the parties. In interpreting any provision of the policy, the policy must be read and construed as a whole.

Any claim arising between insurer and insured, involving the subject matter of the insurance policy, is restricted to the terms of the policy.

No amendment of the policy is to be made other than by written endorsement signed by an authorized representative of the insurer.

> *Severability.* If any provision of the policy is held invalid or unenforceable by law, the policy is deemed not to include that provision and all other provisions remain in full force and effect.

> *Notices, Where Sent.* This section gives directions for mailing notices to the insurer. These directions vary from company to company, and any policy involved in a given claim should be consulted for particulars.

Availability of Endorsements and Other Underwriting Extensions

Frequently, title insurers are able to underwrite certain risks for a lender's policy that the title insurer will not extend to a concurrent owner's policy. This is because of the decreased likelihood the insured will suffer any loss that will result in a claim under a lender's policy. For instance, as

a predicate to any claim, the borrower of the loan secured by the insured lien must be in default under the loan and after successfully taking title to the property, the value of the real property, as impaired by the insured title defect, must be less than the outstanding indebtedness of the loan.

The insured lender will also have a far greater selection of endorsements that it can obtain to buttress its policy at a reduced rate than what is available to owners. This expanded coverage is not only available because of the decreased potential for a lender's policy to trigger coverage, but because due to the nature of lender's policies certain sophisticated lenders may desire certain coverage (such as a "last dollar" endorsement when personal property is included in the loan amount or a "variable rate" endorsement to insure against any loss in priority due to a variable interest rate loan) to mitigate against restrictions inherent in lender's policies, and other endorsements designed for specific situations such as when a lender is acquiring a loan portfolio.

Effect of Deeds in Lieu of Foreclosure

When a loan becomes delinquent, the lender must often decide whether to foreclose or instead accept a deed from the borrower, in lieu of foreclosure. This is sometimes referred to as a "deed-in-lieu."

The advantages of accepting a deed-in-lieu are obvious: immediate acquisition of title, and the opportunity to protect property from deterioration while offering it for resale.

The potential disadvantage, however, is that by accepting a deed-in-lieu the lender may lose priority of its interest as established by the insured mortgage. In other words, by recording a deed-in-lieu the lender may render its ownership subject to any and all mortgages, liens or other interests that are recorded after the insured mortgage but before the deed-in-lieu.

Effect of a Foreclosure Sale

If a lender takes title to a secured property at a foreclosure sale, the vesting deed in the property will have priority over

all subsequent encumbrances. In other words, absent some other arrangement (such as a subordination agreement or a subordination non-disturbance and attornment agreement with a tenant) or a defect in recording (which is probably covered by the lender's title insurance), the lender will take title to the property with superior lien over any other document recorded against title, thus wiping out all junior liens and encumbrances.

New Coverage As a Result of Lender or It's Affiliate Becoming the Owner

As noted earlier, no matter how the lender (now owner) comes into title of the property, the lender will not automatically have title insurance as an owner by virtue of the fact that it had earlier lender's coverage. As such, the former owner will need to obtain an owner's policy of title insurance. This new coverage is often vital since not only will an owner's policy pick up new title matters that occur after the date of the lender's

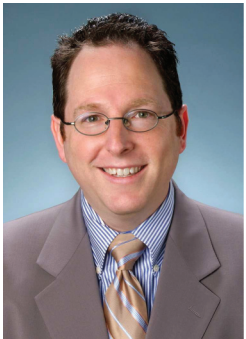
policy (the standard ALTA lender's policy form expressly excludes from coverage any matter attaching or created subsequent to the date of the policy), the owner's policy will insure the valid conveyance from the former borrower to the lender or its affiliate (for example, through a deed-in-lieu of foreclosure) and provide coverage for loss resulting in the diminution in value of the new estate.

Title Binders

The vast majority of institutional real estate lenders do not want to own and manage the real estate they acquire fee title to as a result of a foreclosure, deed-in-lieu of foreclosure or similar procedure. As such, lenders will attempt to spin-off or otherwise dispose of these properties or portfolios of properties as quickly as possible. These lenders do not want to have to pay two premiums for new title policies, one upon acquiring the property from the defaulting borrower, and another upon disposition.

In response to this need, title companies will agree to issue a "binder" (also referred to in some jurisdictions as an "open commitment"). The binder is more or less a pre-negotiated snapshot of what the policy, if ultimately issued, will insure. The lender or its assignee then has the right at any time within two years of the date the binder is issued to notify the title company to issue a policy that will become effective as of the date the binder is originally issued.

The binder allows the lender to avoid having to pay two title premiums, once when it acquires the property and again when it sells the property. The premium for a commitment is generally more than the premium for a single new policy, but less than the premium for two owner's policies.



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