

A Lender's Guide to Obtaining Title Insurance Benefits

By

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I.

INTRODUCTION

One of the most important aspects of a secured loan is the security which is provided by title insurance. This paper will provide a guide for lenders as to how to obtain title insurance benefits relative to a secured loan. There are numerous unique aspects to any loan. Therefore, this paper merely provides a general overview of recommended measures for obtaining title insurance benefits relative to a secured loan. A valid title insurance claim starts with an appropriately documented and insured loan. Therefore, the author¹ recommends that knowledgeable counsel be retained by the lender.

II.

THE DOCUMENTATION PHASE OF THE LOAN

A. Introduction

The loan documentation phase of the loan is, from the lender's perspective, the most important phase of the loan. It is at this point that the lender obtains the security and other enhancements, including title insurance, which will provide the collateral for the loan. While it is commonplace for lenders to use standard forms of documents, it must be realized that each loan and each borrower are unique and the loan documents and the title insurance must be appropriately modified to conform with the unique aspects of the particular loan.

B. Identification Of The Parties (i.e. Borrower, Guarantor)

A key issue in the loan process is the proper identification of the borrower, guarantor and others who will participate in the loan. An error by the lender at this phase of the loan can prove to be very damaging, because the lender may find that it does not have an enforceable obligation, nor does it have an enforceable lien. Similarly, the lender's failure to properly identify the parties may result in loss of title insurance coverage.

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C. Type of Borrower

1. Individual
 - (A) Married
 - (B) Single
2. Corporation
 - (A) Domestic
 - (B) Foreign
3. Partnership
 - (A) General Partnership
 - (B) Limited Partnership
4. Limited Liability Company
5. Trust
6. Other Borrowers

D. Identification Of The Security For The Loan

1. Introduction

Another critical factor at the document phase of the loan is the proper identification of the security for the loan. It is assumed that the principal security for the loan will be real property. In many instances (particularly in loans on hotels and similar properties) the personal property will also be critical to the lender receiving meaningful security. Title insurance companies offer policies of insurance which will allow the lender to insure the validity and enforceability of its lien on both the real property and the personal property which is provided as security for the loan.

2. Real Property Security

It is commonplace to identify real property security by a street address (i.e. 1000 Wilshire Boulevard, Los Angeles, California). However, street addresses provide inexact descriptions of real property because they may have been assigned by the post office or are selected by the borrower.

In much of the United States, it is commonplace to obtain a survey of the proposed real property security. However, the surveys are not frequently used in California, especially in urban areas. Even if a survey were to be obtained, it is important to know that the surveyor is competent, acceptable to the proposed title insurer, has adequate errors and omissions insurance and is familiar with the Minimum Standard Detail Requirements and Classification for ALTA/ACSM Land Title Surveys.

If a survey is obtained, the policy of title insurance should be appropriately endorsed (i.e. a CLTA Form 116.1 endorsement) to reflect that the property described in the survey is the same property as is described in the policy of title insurance.

In addition to the identification of the basic real property security, there may be additional real property rights (i.e. easements) which are necessary or useful to the lender for the utilization of the real property security. The title insurer can assist the lender in this regard by insuring that the lender has a lien on the easement.

3. Personal Property Security

With the exception of a loan, which is secured by raw land, most real property security has personal property which is located on the property and may be necessary or useful to the lender for the utilization of the real property security. One of the better examples of the necessity of personal property security is found where a loan is made based upon the security of property which is used as a hotel. The furniture and equipment utilized in the hotel will be essential to the meaningful ability of the lender to realize upon the real property security. Historically, title insurance was not available on personal property. However, recently title insurers have started to provide insurance which insures the lender against loss or damage of its security in personal property. If a lender is considering making a loan where personal property is an integral aspect of the security, consideration should be made to obtaining a policy of insurance which insures the lender against loss or damage with respect to its security in the personal property.

III.

LOAN DOCUMENTATION

A. Introduction

It is at the document phase of the loan that the lender obtains the security and creates the other rights, including rights on title insurance, which are required as collateral for the loan. Since each loan is unique, the appropriate loan documentation will vary depending upon the specifics of the loan. However, there are certain techniques by which the lender may enhance its rights at this phase of the loan.

B. The Loan Agreement

Depending upon the size and the complexity of the loan, a loan agreement may be a necessity or might merely be an additional document which is desirable, but is not required. However, no matter how well drafted the loan agreement might be, it will be of limited value if it is not appropriately executed by the borrower. While many lenders prefer to have the loan agreement and other loan documents executed by the borrower at the lender's office, this procedure can create a risk for the lender if there are issues with regard to the identity, authority, capacity, etc. of the borrower. Therefore, the lender should consider having the borrower execute all of the loan documents at the office of the settlement agent. In addition, documents such as the deed of trust, which must be acknowledged, should be acknowledged by a notary public who is employed or selected by the settlement agent, not by the lender. Otherwise, the lender may find itself in a situation where a valid security interest was not created and the title insurer and the settlement agent may be able to avoid liability on the grounds that the problem was "created" by the lender.

C. The Promissory Note

The above comments applicable to the loan agreement are equally applicable to the borrower's promissory note.

D. The Deed of Trust

The above comments applicable to the loan agreement are equally applicable to the borrower's deed of trust.

In view of the ready availability of title insurance, a lender should not make a loan without the lien on the real property collateral being insured by a policy of title insurance. While there are limits to the protection which will be provided by a policy of title insurance to a lender, in general the policy provides a substantial enhancement to the lender's security.

E. The Financing Statement

When personal property may have a significant role in the lender's ability to realize upon the real property collateral, a financing statement should be obtained and filed on the personal property collateral. In addition, depending upon the importance of the personal property security, a policy of insurance should be obtained which insures the lender's lien on the personal property security.

F. Loan Guaranties

Loan guaranties present issues similar to the execution and delivery of other loan documents. In addition to the proper authority, capacity, identification, etc. of the guarantor to execute the guaranty, the lender should give appropriate attention to whether the guarantor received consideration for executing the loan guaranty. If the guarantor is to provide security to support the loan guaranty, the lender should obtain policies of title insurance on any real or personal property security.

IV.

COMMON EXAMPLES OF FRAUD OF WHICH THE LENDER SHOULD BE AWARE

A. Introduction

There are a number of risks from fraud which can beset the mortgage lender. The examples cited in this paper are only a few of those potential risks faced by the mortgage lender. The following risks are certain of the more common risks which the mortgage lender should be aware of and take the appropriate measures to minimize these risks.

B. The Borrower, Trustor and/or Guarantor are not the Person(s) They Claim to Be

If the loan is not made to a borrower with whom the lender has an established "track record" and whom the lender personally knows, the lender runs the risk that the person(s) who

executes the loan documents, including, but not limited to the Promissory Note, Deed Of Trust, Loan Guaranty, etc., may not be the person(s) that they claim to be. False identification, including birth certificates, driver's licenses and social security cards, are all readily obtainable. Accordingly, the lender has a very limited ability to determine whether the person with whom it is dealing is in fact the person whom they claim to be. Whether described as impersonation, forgery, identity theft or a similar description, the net result is the same -- the person with whom you dealt and who signed your loan documents is not the person that they claimed to be – and your loan documents may be void and not covered by your policy of title insurance.

C. Lack of Capacity to Execute Loan Documents

Even if the persons, with whom you are dealing, are in fact the persons who they claim to be, there are a variety of reasons why they may lack the required capacity to execute the loan documents, including, but not limited to, the following:

1. a married person;
2. an incompetent person;
3. a person under the age of majority;
4. lack of authority to execute documents on behalf of a corporation;
5. lack of authority to execute documents on behalf of a general partnership;
6. lack of authority to execute documents on behalf of a limited partnership;
7. lack of authority to execute documents on behalf of a limited liability company; and,
8. lack of authority to execute documents on behalf of a trust.

While you may receive a “certified” copy of a purported corporate resolution relative to the purported authority of the president of the corporation (partnership, limited liability company, etc.) to encumber the corporation's real property, the president of the corporation may have

fraudulently forged the documents which purport to authorize him to encumber the corporation's real property.

D. Forged Documents

There is no limit to the types of documents which can and will be forged to enable a person to obtain the loan funds which they are not entitled to receive. By way of example, a person can forge a grant deed (i.e. the "vesting deed") in their favor so it appears they are the owner of the property which is proposed to be security for the loan. In addition, a person can forge a Power of Attorney so that it appears that they have the authority to enter into a loan transaction on behalf of another person.

E. Wrong Property Received as Security

1. Introduction

A mortgage lender may receive the wrong property as the security for a real estate loan because of several reasons. First, the property which is to be encumbered may not be the property which was intended by the lender to be encumbered. Similarly, the property which is to be encumbered may not have the improvements which the lender thought existed on that property.

2. The Wrong Property is Encumbered

In California it is not common to obtain an ALTA survey of the property to be encumbered. Rather, it is more typical to describe the property by a street address, order a preliminary report and prepare the Deed of Trust based upon that street address. However, there is no guarantee that there is any correlation between the street address and the property proposed to be encumbered. While this risk can be eliminated by a complete and accurate survey of the property and an appropriate endorsement to the loan policy of title insurance (i.e., CLTA Form 116.1), due to the time and expense involved in obtaining a survey, most lenders do not obtain a survey. However, a CLTA Form 116 endorsement to the loan policy of title insurance can be obtained which will insure the mortgage lender against loss or damage if the property, which is described by a street address, is not the same property as is described in the title policy.

3. Lack of Improvements on the Property

There can be a material difference in value whether the property to be encumbered is vacant land or whether it is improved by a 20 unit apartment building. However, unless the mortgage lender obtains a complete and accurate survey of the property and the improvements, there is no guaranty that the property which is proposed to be security for the loan has the improvements which were believed to exist. As noted above, it is not common practice in California for lenders to obtain a survey of the property to be encumbered. However, this risk can be reduced, though not eliminated, by the mortgage lender obtaining a CLTA Form 116 endorsement to the loan policy of title insurance, which adequately describes the improvements (i.e. "A 20 unit apartment building commonly known as 123 Wilshire Boulevard, Los Angeles, California").

F. Fund Diversion

1. Introduction

In the event that the loan funds are not disbursed to the appropriate persons, the mortgage lender can anticipate that an attack will be made by the borrower upon the mortgage and in addition that the mortgage lender's title insurer may deny coverage. Accordingly, it is very important that the mortgage lender take the necessary measures to see that its loan funds are disbursed to the appropriate persons. While many lenders prefer to directly fund their loans to the borrowers and the other persons who are entitled to receive the loan proceeds, it must be recognized that this practice involves a high degree of risk to the mortgage lender and results in little, if any, financial benefit to the mortgage lender.

2. Fund Diversion by the Borrower

If the mortgage lender directly funds the loan to the purported borrower, the lender needlessly incurs a risk that the appropriate recipient of the loan funds will not receive them. It is a simple matter for a dishonest person to open a bank account in the name of the purported borrower, to forge an endorsement on a disbursement check, to provide inaccurate wire transfer information, etc. These risks are nearly impossible for the mortgage lender to detect.

3. Fund Diversion by the Settlement Agent

In the event that the loan funds have been deposited with a settlement agent, the mortgage lender incurs the risk that the settlement agent may embezzle the loan funds or otherwise fail to properly disburse those loan funds to the appropriate persons. While the vast majority of the employees of settlement agents are honest, there are always a few exceptions.

There have been several recent news reports of employees of settlement agents embezzling millions of dollars of customer's escrow deposits. In addition, at least one large underwritten title company has "closed its doors." In the event that the mortgage lender has deposited the loan funds with a major title insurer, there is a substantial probability that the title insurer will be financially able to reimburse the mortgage lender in the event of embezzlement or other fund diversion by an employee of the title insurer. However, should the mortgage lender deposit the loan funds with a settlement agent, which is not a major title insurer, and there is an embezzlement or other fund diversion, it is questionable as to whether any recovery can be obtained from the settlement agent. The risk of loan funds not being properly disbursed can be reduced, but not eliminated, when the funds are deposited with an underwritten title company by obtaining a closing protection letter from the underwriter. However, closing protection letters are not "bullet proof" and the mortgage lender is always better protected by dealing directly with the title insurer as the settlement agent.

4. Non-Existent Down Payments

In a purchase loan transaction, it is common for the mortgage lender to require that the borrower-buyer make a substantial down payment for the purchase of the property to be encumbered. However, in the event of a real estate fraud, it is a simple matter for the borrower or the settlement agent to falsify a receipt which reflects that a down payment was received by the settlement agent from the borrower-buyer, when in fact no down payment (or a smaller down payment) was received. In the alternative, a purported down payment can be received by the settlement agent, but those funds can immediately be returned to the borrower-buyer.

Typically, the non-existent down payment arises in a context where the borrower-buyer invests no personal funds into the purchase of the property. The borrower's down payment may

be non-existent because the purchase price has been overstated and the lender is financing 100% (or more) of the purchase price. In the alternative, the down payment can be obtained from third party sources, including, but not limited to, junior liens on the property which were not authorized by the mortgage lender.

If the mortgage lender requires that the borrower make a down payment, from the borrower's funds, to purchase the property, the mortgage lender should give a written instruction to the settlement agent that it must provide a written representation to the mortgage lender, before the close of escrow, that the borrower has made a down payment from its own funds and that the funds were not acquired by junior liens on the property, will not be returned to the borrower and will be used by the borrower to purchase the property.

V.

FRAUDULENT SERVICE PROVIDERS

Most mortgage lenders rely upon a number of service providers in making a real estate loan (i.e. an appraiser, escrow agent, notary public, underwritten title company, title insurer, etc.). All of these service providers are subject to being impersonated by persons who are intent on obtaining your loan funds by fraud. There is no loan document (i.e. appraisal, escrow instructions, employment verification, preliminary report, title insurance policy, etc.) which can not be forged. Depending upon the quality of the forgery, even a trained questioned documents examiner may not detect the forgery. Accordingly, it is quite important that you only deal with known service providers and verify that they are who they are. By way of example, information about title insurers can be obtained from the California Department of Insurance.

It is a simple matter for a fraudulent borrower to fabricate an escrow agent through the use of a "mail drop" and a telephone number. Indeed, even a visit to the purported office of the escrow agent is no guarantee that it is what it appears to be. In one of the more blatant examples of a fraudulent escrow agent, the purported "escrow agent" rented office space, hired purported "employees" and, when visitors were present, purported to go about the day to day business of closing escrows. However, the purported "escrow agent" was a complete fraud. It had even defrauded the California Department of Corporations into issuing an escrow license to it. No legitimate escrow activity was being conducted. Finally, when there were sufficient escrow

funds on deposit in the bank, the “employees” of the purported “escrow agent” walked (to avoid a security camera’s detection of an automobile license plate number) into the “escrow agent’s” bank and departed with all of the escrow funds in twenty dollar bills in suitcases.

VI.

COMMON MISTAKES FOR LENDERS TO AVOID

A. Reliance on Notarized Documents

While a document which has purportedly been notarized may have a superficial appearance of authenticity, it is nearly impossible for the mortgage lender to know if the notarization is accurate unless both the notary and the signatory are known personally to the lender and the lender was present and observed the document being signed and notarized. Notary stamps are readily available and a lender should give no weight to a document merely because it is notarized.

If the lender has a document, such as a Deed of Trust, which must be notarized, that notarization should only be done by a Notary Public who has been selected by the title insurer. It is a very high risk for a lender to have a Notary Public selected by the mortgage lender perform the notarization because the Notary Public’s stamp is subject to being stolen or otherwise misused and it should be anticipated that the title insurer will deny the mortgage lender’s claim. While there may be business reasons to have a notary employed by the mortgage lender, the notary’s stamp and notary book should be kept in a secure, locked location which has limited access. In addition, there should be adequate insurance to cover in appropriate notarizations.

B. Reliance on Powers of Attorneys

While we can put a man on the moon, there is still a willingness on the part of some mortgage lenders to accept documents which have been executed based upon a power of attorney. Between overnight delivery and the numerous branches of major title insurers, the author is not aware of any reason that a prudent mortgage lender should rely upon a power of attorney. If there is an instance where it is necessary that one or more loan documents be executed based upon a power of attorney, the person who wants to execute the loan documents

utilizing the power of attorney should be sent to the title insurer's office and the title insurer should be instructed in writing by the mortgage lender that whether or not the power of attorney is accepted is solely the decision of the title insurer and that the lender does not express any opinion as to whether it should be accepted, but is relying solely upon the title insurer.

VII.

MEASURES TO BE TAKEN BY THE MORTGAGE LENDER BEFORE AND AFTER THE CLOSE OF THE LOAN TO REDUCE THE RISK OF LOSS DUE TO FRAUD, FORGERY AND FUND DIVERSION

- A. Most real estate prices, especially residential properties, have materially decreased during the last year. Accordingly, even an honest appraisal, which will be based on historic data, may be of limited value to the mortgage lender. In addition, it is quite easy for a purported "borrower" to "inflate" the apparent value of property by "flipping" the property at successively higher "purchase" prices. Therefore, you should require that your title insurer inform you in the preliminary report of all transfers or conveyances of the property within the last two years.
- B. Have all loan documents executed by the borrower, guarantor and/or trustor at the office of the title insurer utilizing a Notary Public selected by the title insurer.
- C. All loan funds to be disbursed should be paid directly to the title insurer (not the underwritten title company or an escrow agent) with written instructions as to how they are to be disbursed. The lender should never directly disburse any loan funds to anyone other than the title insurer.
- D. Select the correct policy of title insurance. The author is of the opinion that the [formerly] ALTA Loan Policy Form B – 1970 (Amended 10/17/70) is the best one to select.

- E. The lender should anticipate that upon submitting a claim, the title insurer will request a copy of the loan file to determine if there are grounds to deny your claim. However, if you have made a written disclosure to the title insurer of the matter which gave rise to the claim before the loan closed, the title insurer cannot use that matter to deny the claim.
- F. Obtain and review the original loan policy of title insurance within two weeks after the loan closed to determine if it is in strict conformance with your instructions.

VIII.

THE SELECTION AND THE DUTIES OF THE SETTLEMENT AGENT

A. Introduction

A lender, through the selection of an appropriate settlement agent and the delegation to the settlement agent of critical functions in the loan documentation phase, can materially enhance its security for the loan.

While many lenders prefer to conduct their own settlements, including obtaining signatures on loan documents and disbursing funds, it must be recognized that the lender, by undertaking to perform these functions, unnecessarily assumes risks which could be appropriately delegated to financially responsible third parties with the attendant enhancement of the security for the loan.

B. Types of Settlement Agents

The lender has a number of choices of people who can act as settlement agents. In California, it is commonplace for the settlement agent to be an independent escrow company, an underwritten title company or a title insurance company. Outside of California, it is common for lawyers to act as settlement agents.

While there are a variety of factors which may influence the lender's selection of the settlement agent, one of the most critical factors is the financial responsibility of the settlement agent in the event that the settlement agent has liability to the lender. Other factors for the lender to consider in the selection of a settlement agent include the competency and the accessibility of the settlement agent.

While highly competent people may be employed by an independent escrow company or an underwritten title company, neither of those potential settlement agents has the financial strength of any of the major title insurance companies. Therefore, it is the author's opinion, that whenever possible the lender should select a major title insurance company as the settlement agent.

C. Techniques to Minimize the Risk of Loss Caused by the Settlement Agent

If the lender should select a settlement agent which is not a title insurer, there are several ways that the lender can enhance its position with the settlement agent:

First, the loan proceeds should not be provided to a settlement agent which is not a major title insurer. Rather, the lender should "sub-escrow" the loan funds with the title insurer and the title insurer should disburse the loan funds in accordance with the instructions of the lender; and, Second, the lender should obtain a closing protection letter from the title insurer with respect to the actions of the settlement agent. There are three common varieties of closing protection letters. First, the American Land Title Association has promulgated a standard form of closing protection letter. Second, most major title insurance companies have promulgated their own form of standard closing protection letters. Third, a lender can prepare its own form of closing protection letter and request that the title insurer utilized that form. Since the title insurer, in executing a closing protection letter, is taking on substantial liability for the conduct of the settlement agent, the lender should anticipate that it may not be able to have a title insurer accept its form of closing protection letter unless it does a very substantial amount of business with that title insurer. As an alternative to the closing protection letter prepared by the lender, the lender should give consideration to the modification of the closing protection letter proposed by the title insurer.

D. Duties Commonly Performed By the Settlement Agent

Functions which can be performed by the settlement agent include the correct identification of the borrower (guarantor, etc.) the due execution of the loan documents, the acknowledgement of the deed of trust and other security instruments and the recordation and/or filing of the security interests. If the settlement agent is the title insurer, it may well be disbursing the lender's funds. However, as noted above, if the settlement agent is not the title insurer, those

loan funds should have been “sub-escrowed” with the title insurer, not with the settlement agent, and disbursed by the title insurer in accordance with the lender’s instructions.

While the settlement agent may order the policy of title insurance, the author recommends that the lender directly order the policy from the title insurer to avoid any problems with the settlement agent making a mistake in ordering the policy of title insurance.

IX.

REDUCING THE RISK TO THE LENDER OF FUND DIVERSION

If loan funds are not disbursed appropriately, the lender should anticipate that the title insurer will take the position that its liability has been reduced or eliminated by the fund diversion. Therefore, it is advantageous to the lender to have the title insurer disburse the loan funds in accordance with the lender’s written instructions. In the alternative, if the loan funds are disbursed by the settlement agent and the lender has received a closing protection letter from the title insurer, the lender will be in a position to contend that the title insurer is responsible, pursuant to the terms of the closing protection letter, for the diversion of the loan funds by the settlement agent. If the lender should elect to disburse the loan funds itself, and it fails to appropriately disburse those loan funds, it should anticipate that the title insurer will take the position that any damage or loss occasioned by that loan disbursement was created by the lender and the title insurer is relieved of liability by reason of the act of the lender, or the title insurer’s liability is proportionately reduced.

X.

THE SELECTION OF THE TITLE INSURER

A. Introduction

The lender’s selection of the title insurer is a key consideration in documentation phase of the loan. There are more than 100 title insurers in the United States. However, most of those title insurers are small regional title insurers. The title insurance industry is dominated by four major title insurance companies and their affiliates which are as follows:

1. First American Title Insurance Company and Affiliates;
2. “The Fidelity Family” of Title Insurers
 - (A) Fidelity National Title Insurance Company
 - (B) Chicago Title Insurance Company
 - (C) Ticor Title Insurance Company
 - (D) Security Union Title Insurance Company
 - (E) Alamo Title Insurance Company
 - (F) Lawyer’s Title Insurance Corporation
 - (G) Commonwealth Land Title Insurance Company
 - (H) Transnation Title Insurance Company
3. Stewart Title Guaranty Company and Affiliates
4. Old Republic National Title Insurance Company and Affiliates

B. The Distinction Between Title Agents and Title Insurers

Title insurance companies have historically distributed title insurance through a combination of direct operations and through independently owned title agents. Traditionally, in California, title agents have operated on an exclusive basis for a single title insurance company. Outside of California, it is not uncommon to find that a title agent issues the policies of more than one title insurance company.

Several years ago most major title insurance companies established “captive” title agents which they owned and operated utilizing names which were substantially the same as the title insurer. By way of example, Fidelity National Title Insurance Company is affiliated with Fidelity Title Company. While these “captive” title agents have names similar to their title insurer “parent” the lender should not assume that the “captive” title agent and the “parent” title insurer are identical. One of the factors which led to the formation of the “captive” title agent was the desire by the title insurers to avoid or reduce liability to the insureds. The presence of a “captive” title agent between the insurer and the insured provides a degree of protection for the insurer against the claims of the insured because the title insurer can take the position that the responsibility, if any, for the claim of the insured is that of the “captive” title agent and not of the “parent” title insurer. Accordingly, the author is of the opinion that a lender is well-advised to deal directly with the title insurer and not with a “captive” title agent or any other type of agent.

The author recognizes that there are many title agents, including both “captive” title agents and “independent” title agents, which are well capitalized and quite competent to serve as a title agent in a loan transaction. However, should the lender decide to deal with a title agent, as opposed to a title insurer, the lender should remember that it is dealing with an agent and take appropriate measures to reduce or eliminate the problems which are attendant in dealing with an agent as opposed to dealing directly with the title insurer.

XI.

THE INITIAL TITLE PRODUCT

In California, the initial title product, which is typically obtained by a lender, is a preliminary report. It is important to remember that the preliminary report does not represent the current state of title to the property described in the preliminary report. Similarly, the policy of title insurance does not represent the current state of the title to the property described in the policy of title insurance. The preliminary report is only an offer to issue a policy of title insurance subject to specific exclusions and exceptions.

For a number of years the California courts held that a title company which issued a preliminary report had “abstractor’s liability” based on that preliminary report. However, in 1981 Section 12340.10 and 12340.11 were added to the California Insurance Code.

Insurance Code § 12340.10 provides as follows:

“Abstract of title” is a written representation, provided pursuant to a contract, whether written or oral, intended to be relied upon by the person who has contracted for the receipt of such representation, listing all recorded conveyances, instruments or documents which, under the laws of this State, impart constructive notice with respect to the chain of title to the real property described therein. An abstract of title is not a title policy as defined in Section 12340.2. (emphasis added)

Insurance Code § 12340.11 provides as follows:

“Preliminary report”, “commitment”, or “binder” are reports furnished in connection with an application for title insurance and are offers to issue a title policy subject to the stated exceptions set forth in the reports and such other matters as may be incorporated

by reference therein. The reports are not abstracts of title, nor are any of the rights, duties or responsibilities applicable to the preparation and issuance of an abstract of title applicable to the issuance of any report. *Any such report shall not be construed as, nor constitute, a representation as to the condition of title to real property*, but shall constitute a statement of the terms and conditions upon which the issuer is willing to issue its title policy, if such offer is accepted. (emphasis added)

The preliminary report may not disclose all matters which may affect title to the real property described in a preliminary report for a variety of reasons. First, the “title search” may have failed to identify a recorded document which affects title. Second, a recorded document which affects title that was identified may have erroneously been omitted from the preliminary report. Third, if the preliminary report is for a standard coverage policy, as opposed to an extended coverage policy, a recorded document may not be shown. Fourth, a recorded document which affects title may be covered by an indemnity agreement and may not be reflected. Fifth, the policy of title insurance may not provide any protection for a type of risk (i.e. building code violations) and a recorded item may not be reflected in a preliminary report. The preliminary report is a useful document to the lender in making decisions with respect to proposed real property collateral. However, the preliminary report does have substantial limitations and should be approached with caution.

When the lender orders the preliminary report copies of all of the recorded instruments, which are reflected as exceptions in the preliminary report, should also be obtained at the same time from the title company and reviewed before instructions are provided. Frequently, exceptions in preliminary reports will reference documents without a thorough explanation of the effect of the document upon the condition of title and it is necessary for the lender to review the referenced document to determine if it is willing to have its title insurance coverage be subject to that exception.

XII.

OTHER TITLE PRODUCTS

In addition to preliminary reports, there are other title products which may be provided to the lender before the loan is made. A Lot Book Guaranty is one example of a title product which may be provided to the lender. Some lenders who are making second trust deed loans who want

some title information about the property, but who do not want to pay for a title policy may order a Lot Book Guaranty on a “limited policy of title insurance.” However, the Lot Book Guaranty provides little protection to the lender and the author does not recommend utilizing a Lot Book Guaranty and the “limited policy of title insurance” as a basis for making a secured loan.

Similarly, a Trustee’s Sale Guaranty may appear to provide information with regard to the condition of the title to the property described in the guaranty, but that guaranty is intended by the title company to only provide information for the foreclosure of a deed of trust, not the making of a loan to be secured by a deed of trust. Therefore, the author does not recommend that a lender utilize a Trustee’s Sale Guaranty as the basis for making a loan to be secured by a lien on real property.

There are other title products known as “property profiles” and “farms” which title companies issue to provide limited information with respect to real property. Principally, these title products are used by real estate brokers who want to have some basic information about a property, but do not want to incur the expense (and the protection) of a policy of title insurance. Accordingly, the author does not recommend that a lender make a loan secured by real property based on a “property profile” or a “farm”.

In the case of home equity loans secured by second deeds of trust on a borrower’s home, limited policies of title insurance have become very popular because of the limited cost. However, the limited coverage policy title insurance provides very little protection to the lender. Accordingly, the author does not recommend that a lender utilize a limited policy of title insurance as the basis for making a loan secured by real property.

XIII.

SELECTION OF A POLICY OF TITLE INSURANCE

A. Introduction

A prudent lender which is making a loan to be secured by real property will generally require that it obtain an [formerly] ALTA Loan Policy Form B - 1970 (Amended 10/17/70) of title insurance to insure that it has received a valid and enforceable lien with the appropriate priority upon the real property security.

B. Available Forms of Policies Which May Be Used By Lenders

A lender in California which intends to receive real property security as collateral for its loan has four principal policies among which it may select. First, is the California Land Title Association Standard Coverage Policy (1990). The CLTA Standard Coverage Policy is intended to cover only “record title” matters and does not insure against matters which involve “off-record” title risks, such as boundary problems, easements, encroachments and matters which could be ascertained by an inspection of the property. While the CLTA Standard Coverage Policy does ensure the validity and enforceability of the lien of the insured Deed of Trust, together with the priority of that lien, it does not, in the author’s opinion, provide the appropriate coverage for a loan to be secured by real property.

The American Land Title Association offers several forms of loan policies which may be selected by a lender. The current version of the loan policy was promulgated in 2006 by the ALTA. Both of the ALTA Loan 1970 and 2006 Policy are intended to provide protection to the lender for certain “off-record” risks, whereby the title insurer assumes the risks of matters which would be ascertained from an inspection or a survey of the property. Both of these ALTA loan policies provide substantially more coverage than the CLTA Standard Coverage Policy. However, there are several differences between the 1970 and the 2006 forms of the ALTA loan policies.

One principal difference is that the 2006 ALTA Loan Policy includes a creditor’s rights exclusion which is not in the 1970 loan policy. Many lenders are of the opinion that the absence of the creditor’s rights exclusion in the 1970 ALTA Loan Policy provides coverage for creditor’s claims. However, it is the position of the title insurance industry that the 1970 ALTA Loan Policy does not provide coverage against creditor’s claims and that the creditor’s rights exclusion was added to the 2006 ALTA Loan Policy to make explicit the fact that no coverage was provided for creditor’s claims.

A second principal difference between the 1970 and the 2006 ALTA loan policies is the fact that the 2006 policy has a provision for arbitration, at the option of the insurer or the insured, if the amount of the insurance is under \$1,000,000.00. If the amount of the insurance is more than \$1,000,000.00, arbitration will require the consent of both the insurer and the insured. Since

many lenders objected to the inclusion of the arbitration clause in the 2006 ALTA Loan Policy, the arbitration clause may be removed by an appropriate endorsement.

A third principal difference is that the 2006 ALTA Loan Policy contains a specific reference to environmental protection liens as a part of the governmental regulation exclusion from policy coverage. It is the position of the title insurance industry that the 1970 ALTA Loan Policy, which does not have an environmental regulation exclusion, does not provide any coverage for environmental risks and that the environmental regulation exclusion, which is contained in the 2006 policy, only makes explicit the fact that the policy does not provide coverage for environmental regulation. There are other differences between the 1970 and 2006 ALTA Loan Policies and the ALTA makes available a chart which compares the two policies.

The ALTA also offers for lenders on one-to-four family residential properties a 2006 ALTA Residential Loan Policy. The ALTA 2006 Residential Loan Policy contains a number of coverages which are not available in the ALTA 1970 and 2006 Loan Policies. However, it is the author's opinion that those additional coverages will, in general, be of limited value to the lender and the 1970 ALTA Loan Policy will, in general, provide better protection to the lender.

While the ALTA has formally withdrawn the 1970 ALTA Loan Policy, that policy remains popular among lenders and all major title insurance companies continue to issue it. However, when ordering this policy it may be necessary to describe it as the "[formerly] ALTA 1970 Loan Policy" because it has been withdrawn as a policy promulgated by the ALTA.

XIV.

ENDORSEMENTS

A. Introduction

The CLTA has promulgated more than 100 standard endorsements for policies of title insurance. The ALTA has promulgated more than 20 standard endorsements for policies of title insurance. Title insurance companies and insureds have developed hundreds of additional endorsements for loan policies. Since the purpose of an endorsement is to modify the policy of title insurance to appropriately address the risks which are faced by the lender, it is beyond the scope of this paper to be able to address all of the endorsements which may be necessary or

appropriate in a particular situation. However, this paper will note certain of the endorsements which are typically issued with a loan policy.

B. Types Of Endorsements

1. Introduction. In California a lender can avail itself of a vast number of endorsements which are promulgated by the American Land Title Association (“ALTA”), The California Land Title Association (“CLTA”), the title insurer or the lender.

Depending upon the endorsement and the title insurer, the endorsement may be issued without charge or it may cost nearly as much as the policy. Title insurers in California file their rates for the California Department of Insurance (“DOI”) and are obligated to charge their customers the rates which they filed with the DOI. However, in California a title insurer is also free to draft a unique endorsement, which is not filed with the DOI, and can impose any charge agreed upon by the insurer and the insured.

2. ALTA Forms of Endorsements. The ALTA issues more than 20 endorsements, most of which can be used in a loan policy.

3. CLTA Forms of Endorsements. The CLTA issues more than 100 endorsements, many of which can be used in a loan policy. Frequently, there are several endorsements which address similar risks. Accordingly, in deciding which endorsement is most appropriate for you policy of title insurance, you may need to consult your counsel or the title insurer’s underwriter to determine the appropriate endorsement to cover the risk in issue.

4. Title Insurer Forms of Endorsements. Most major title insurers have their own proprietary forms of endorsements which they have developed for use by their customers.

Frequently, these endorsements are developed in conjunction with their customers to cover unique risks which those customers foresee in their transactions.

5. Borrower's Endorsements. It is not uncommon for major lenders to develop their own forms of proprietary endorsements. Frequently, these are modifications of existing ALTA and CLTA forms of endorsements.

6. Special Endorsements. In California, as noted above, the insurer and the insured are free to draft any endorsement which they wish to address unique risks in a particular transaction.

C. Zoning Endorsements (ALTA Forms 3 [Zoning-Unimproved Land] And 3.1 [Zoning-Improved Land])

An insured lender should have insurance against loss or damage in the event it is determined that the use of the property is not permitted by the applicable zoning ordinances. These endorsements reflect the applicable zoning classifications and the uses permitted under these classifications.

D. Environmental Protection Lien Endorsement (ALTA Form 8.1)

A recorded environmental lien may not be reflected in a preliminary report and covered by a loan policy of title insurance on the ground that it relates to the condition of the real property, not the condition of the title to the real property. However, a recorded environmental lien can be a serious threat to a lender's real property security. Accordingly, this endorsement provides protection against any existing environmental protection liens which were either recorded in the County Recorder's Office or filed with the Clerk of the United States District Court.

E. “Comprehensive” Endorsements (ALTA Forms 9, 9.1 And 9.2)

Most title insurers prefer the term “REM” (i.e., “Restrictions, Encroachments & Minerals”) and avoid the use of the word “comprehensive” to describe these endorsements. However, this is the term frequently used by most insureds. The endorsements protect the lender against loss or damage which is the result of violations of existing covenants, conditions and restrictions.

F. Access Endorsements (CLTA Forms 103.4 And 103.7)

The standard form of loan policy does not provide coverage for loss or damage as the result of a practical and usable means of access to the property. Rather, it provides insurance for loss or damage sustained where there is a lack of a legal right of access to the property. Access endorsements provide coverage: (1) with respect to there being a right of access to a specifically identified physically open street or (2) the land abuts upon a physically open street.

G. Tie-In/Aggregation Endorsement (ALTA Form 12)

When a lender makes a loan to a borrower, secured by mortgages on multiple parcels of real property, there typically are values assigned to each of the policies on the various parcels. This endorsement enables the lender to aggregate coverage so that the cumulative total of all of the policies of title insurance are available to any one of the properties for a loss. This coverage is particularly important where is the potential for an increase in the value of one or more of the parcels of property.

H. Designation Of Improvements And Street Address Endorsement (CLTA Form 116)

It is not common in California to obtain a survey for a loan transaction. Frequently, the proposed real property collateral is identified by a street address. However, in the absence of this

endorsement, there is no coverage in the policy of title insurance if it develops that the presumed collateral and the improvements thereon (i.e., a 16 unit apartment house), which were identified by street address, are in a location which is different than that described in the policy.

I. Survey Endorsement (CLTA Form 116.1)

Where a survey is obtained of the property, a survey endorsement should be obtained, so that the insurer will provide the lender with insurance protection that the land delineated in the survey is the same as the land which is described in the policy of title insurance.

J. Contiguity Endorsement (CLTA Forms 116.4 [Two Parcels] And 116.4.1 [Multiple Parcels])

Where the lender's security consists of two or more lots, which are adjacent to one another, a contiguity endorsement should be obtained to provide coverage against loss or damage which might be sustained in the event that it were determined that there were any "gaps, strips or gores" between the boundaries to the parcels of real property.

K. Encroachment Protection Endorsements (CLTA Forms 103.1, 103.3 Or 103.6)

Where easements in favor of third parties have been identified, the lender faces the risk that certain of the improvements, which comprise the lender's security, may encroach upon the easements and may impair the value of the security. Accordingly, the lender should consider obtaining CLTA Forms 103.1, 103.3 or 103.6 to provide coverage against this risk.

L. Subdivision Map Act Compliance Endorsement (CLTA Form 116.7)

The standard loan policies do not insure against loss or damage suffered by the insured lender where the property is not in compliance with the Subdivision Map Act. The CLTA Form 116.7 provides the insured lender with coverage against this risk.

M. Future Advance Endorsements (CLTA Forms 111.10, 111.14 And 111.14.1)

While most deeds of trust allow the lender to make advances under the terms of the deed of trust and further provide that the advances will be secured by the deed of trust, the issue arises as to whether or not those advances will in fact enjoy the same priority as the original lien of the deed of trust. Typically, this will involve issues of whether the advance is found to have been “obligatory” or “optional”. In addition, the issue of priority may be determined by whether the lender was on notice of the existence of a lien which was recorded after the date of recordation of the lender’s original deed of trust. There are a number of advance endorsements found in the CLTA 111 series. Specifically, the CLTA Form 111.10 is for an optional advance, and the CLTA Form 111.14.1 (Future Advance-Knowledge).

N. Usury Endorsement

The standard loan policy excludes loss caused by reason of usury. Accordingly, it is prudent for the lender to obtain an endorsement which insures against loss or damage because of the invalidity or unenforceability of the lien of the insured mortgage by reason of the violation of usury laws. Neither the ALTA nor the CLTA have promulgated a usury endorsement. However, most major title insurers have proprietary forms of usury endorsements. By way of example, it is First American Title Insurance Company’s Form numbers 57 and 57.1.

O. Tax Parcels Endorsements (ALTA Forms 18 And 18.1)

A lender does not want to risk the loss of its security, whether in whole or in part, because the property, including appurtenant easements, are taxed as separate parcels. The ALTA Form 18 (single tax parcel) provides coverage with respect to the land being separate tax parcel. The ALTA Form 18.1 (multiple tax parcels) provides similar coverage with respect to multiple

parcels and the loss of an appurtenant easement through a tax sale.

P. First Loss Endorsement (ALTA Form 20)

Where a lender has multiple parcels of property as security, it should obtain a First Loss Endorsement to provide coverage for a loss, without first having to foreclose on all of the parcels of property which are security for the loan. From the insurer's perspective, a title defect must exist which results in a claim under the policy, the borrower must be in default on the loan and the value of the property, as diminished by the title defect, must be less than the outstanding balance due on the loan.

Q. Leasehold Loan Endorsement (ALTA Form 13.1)

When a loan is to be secured by real property which is leased by the borrower, the standard form of the loan policy should be modified by a Leasehold Loan Endorsement.

R. Variable Rate Endorsement (ALTA Form 6)

If the loan provides for changes in the rate of interest, then the lender should obtain an ALTA Form 6 to provide coverage against loss or damage due to the change in interest rate provisions.

S. Creditor's Rights Exclusion Deletion

The 1970 Loan Policy does not contain an express Creditor's Right Exclusion. However, most of the subsequent loan policies do. Therefore, the lender should obtain an endorsement to delete the Creditor's Rights Exclusion, if any, in the policy.

T. Creditor's Rights Endorsement (ALTA Form 21)

In addition to the deletion of the "Creditor's Rights Exclusion", if any, in the loan policy, the lender should also obtain a ALTA Form 21 to provide affirmative coverage with respect to

the subject loan transaction.

U. “Seattle” Endorsement For Construction Loans

If the loan is a construction loan, then the lender should obtain a “Seattle” Endorsement to the loan policy to provide coverage for the issues presented by undisbursed loan proceeds and the insufficiency of the proceeds to complete construction. Typically, a construction lender will have advanced less money to the borrower than the borrower has spent on construction. In general, this is the result of the lender making its loan advances only after certain stages of construction have been completed. While this practice provides the lender with a “cushion” in the event of default, it also raises the issue of whether the lender has been unjustly enriched, should it foreclose on the improved property. The “true” “Seattle” endorsement provides that the title insurer will not raise the defense that the lender has not disbursed all of its construction funds, provided that the lender has complied with its loan documents. However, lenders are advised to be aware that there is a “phony” “Seattle” endorsement which provides that the title insurer will not raise the issue of the construction lender’s undisbursed loan funds provided that the construction lender pays those funds to the title insurer.

V. Arbitration Provision Deletion

The 1970 Loan Policy does not contain a provision for the arbitration of disputes between the insured and the insurer. However, most of the policies issued thereafter do contain an arbitration provision. Professor Barlow Burke, in his book on title insurance, expressed the opinion that title insurers included the arbitration provision in the policy in an effort to reduce their liability to their insureds. Accordingly, in the event that the policy proposed to be issued contains an arbitration provision, the lender should obtain an endorsement which deletes that provision.

W. Truth-In-Lending Endorsement (ALTA Form 2)

Any lender which makes a loan, which is subject to the Federal Truth-In-Lending Act, faces the risk that the borrower may challenge the lien of the insured mortgage based upon the rights conferred on the borrower by the Federal Truth-In-Lending Act. Accordingly, a lender making a loan of this type should obtain an ALTA Form 2 to provide coverage against this risk.

X. Modification Endorsement (CLTA Form 110.5)

It is common for a loan to be modified. However, any modification of the loan terms raises the issue of whether the modification has jeopardized insurance coverage. If there is a claim where the loan terms have been modified, the lender should anticipate that the insurer will treat the modification as a “post policy” risk and deny coverage. Accordingly, if a lender wants to make a modification to the terms of its loan, it should obtain a CLTA Form 110.5 to provide coverage of the lien, as modified.

XV.

UNIQUE ISSUES FOR CONSTRUCTION LOANS

Many construction loans do not have priority over mechanics liens because there has already been a “visible-to-the-eye” commencement of the work of improvement. This can create an issue for the lender if the lender has knowledge of the commencement of the work of improvement. Therefore, the lender and its standard form of instructions to the title insurer should include the following:

“Construction may have been commenced upon the site to be encumbered by the Bank’s deed of trust. Do not record the Bank’s deed of trust, disburse the Bank’s loan funds or issue the Bank’s policy of title insurance unless you are willing to do so with complete knowledge that the Bank is relying upon the policy of title insurance for protection against the claims of mechanics and material men to the same extent that the Bank would rely if work had not commenced upon the site. In addition, any endorsements issued to the policy, including upon the Bank’s assignment of the

loan, must not have any exceptions for mechanic's or material men's liens."

Generally a portion of the construction loan funds are retained by the lender until after construction is completed, the time for filing mechanic's liens has expired and a certificate of occupancy has been issued. A lender faced with mechanic's lien litigation may find that title insurance coverage is denied if the lender has not disbursed sufficient funds to pay for all the labor and materials which were furnished to the project (even if the borrower was in default and the loan documents authorized the lender to cease funding when the borrower was in default). Several Federal courts have considered this issue and two of them have held that the title insurer does not have a duty to the insured lender to defend or discharge mechanic's liens which were filed as a result of the lender's failure to disburse sufficient funds to pay for all of the labor and material furnished to the project. *Brown v. St. Paul Title Insurance Corporation* (8th Cir. 1980) 634 F.2d 1103 and *Bankers Trust Company v. Transamerica Title Insurance Company* (10th Cir. 1979) 594 F.2d 231. However, in *American Savings and Loan Association v. Lawyers Title Insurance Corporation* (6th Cir. 1986) 793 F.2d 780, the Court of Appeal distinguished *Brown* and *Bankers Trust* and held that the lender was entitled to insurance coverage.

The "Seattle" endorsement to a loan policy provides that in the event there are mechanic's liens, the title insurer will not raise as a defense the fact that the lender has not disbursed sufficient funds to pay for all of the labor and materials furnished to the project. See, 5 A.B.A. Real Prop. Fin Newsl. 19, 21 (1985). Therefore, a knowledgeable construction lender should obtain the "Seattle" endorsement to the loan policy.

When a construction lender is holding undisbursed loan proceeds and mechanics liens arise, if the lender did not obtain a "Seattle" endorsement to the loan policy, the title insurer may take the position that it has no liability for the mechanic's liens until those loan proceeds have been disbursed. The only California case which the author has found which deals with this issue is *Rosen v. Nations Title Insurance Company* (1997) 56 Cal.App.4th 1989. However, there are several cases and at least one article which deal with this issue, which are as follows:

1. “Mechanics Lien Title Insurance Coverage for Construction Projects,” 16 Real Estate Law Journal 291 (1988)
2. *Bankers Trust Co. v. Transamerica Title Ins. Co.* (10th Cir. 1979) 594 F.2d 231
3. *Brown v. St. Paul Title Ins. Corp.* (8th Cir. 1980) 634 F.2d 1103
4. *American Sav. & Loan Assn. v. Lawyers Title Ins. Corp.* (6th Cir. 1986) 793 F.2d 780
5. *Mid-South Title Ins. Corp. v. Resolution Trust Corp.* (W.D. Tenn. 1993) 840 Supp. 522
6. *Chicago Title Ins. Co. v. Resolution Trust Corp.* (8th Cir. 1995) 53 F.3d 899.

XVI.

THE “PRO FORMA” POLICY

If a lender is making a large loan or if the loan is particularly complex, the lender should consider requiring having a “pro forma” policy issued before the loan is closed. A “pro forma” policy is a draft of what the proposed policy will look like when it is issued. Obviously, the “pro forma” policy will not contain the recording information which can only be obtained after the loan has closed. Otherwise, the “pro forma” policy will reflect the coverages, including the endorsements, which have been requested by the lender. The lender should not expect that the title company will be willing to issue a “pro forma” policy on a small loan or on one which is not complex. However, since a “pro forma” policy is issued without cost, it can be a valuable way of the lender reducing the likelihood of a mistake in a large or complex transaction.

XVII.

CO-INSURANCE AND RE-INSURANCE

A. Introduction

In the event that the lender contemplates making a loan in excess of \$10,000,000 and it is dealing with one of the “Big 4” title insurers, it should give consideration to obtaining co-insurance and a direct right of access against any re-insurer. If the lender is dealing with a smaller title insurance company, co-insurance and re-insurance issues may arise with loans as small as \$500,000.

B. Co-Insurance

Co-insurance is a way by which the insured lender can look to more than one title insurer in the event that it has made a large loan and it encounters a loss. In a co-insurance situation, more than one insurer is liable for the identical risk. This can be accomplished through the issuance of more than one policy or by having the names of both insurers appear on the same policy. Since co-insurance involves a division of the title insurance premium among the various title insurers, it should be anticipated that initially the title insurer will want to have as a co-insurer another member of its “family” of title insurers. However, this would mean that the insured is looking at the same “pool” of money in the event of a claim. To be meaningful, if a lender has a situation which warrants obtaining co-insurance, the various title insurers who are co-insuring the loan should not be members of the same “family” of title insurers. The most common form of co-insurance is where two or more title insurers are both liable beginning with the “first dollar” of the insured’s loss and the insured is entitled to look to both co-insurers for the “first dollar” of the insured’s loss.

C. Re-Insurance

An alternative to co-insurance is re-insurance. Re-insurance can either be done on an automatic basis by the title insurer where it routinely transfers a portion of its liability to another title insurer. This type of re-insurance is referred to as “treaty” re-insurance because the re-insurance is automatically transferred to the other insurer based upon the agreement between the insurers.

An alternative to “treaty” re-insurance is facultative re-insurance where an agreement specific to a particular loan transaction is entered into whereby other insurers agree to bear a portion of the primary insurer’s loss. In general, an insured has no interest in the re-insurance contract and does not have direct access to the re-insurer in the event of a loss. However, the 1994 ALTA Facultative Re-Insurance Agreement contains a direct access provision which enables the insured lender to sue the re-insurer.

XVIII.

“ACCOMMODATION” RECORDINGS

It is not uncommon for lenders to request that a title insurance company record one or

more documents as an “accommodation” to the lender. Typically this will mean that the title insurer has not examined the document for insurability nor has a policy of title insurance been issued to the lender. While an “accommodation” recording can, in some instances, be of benefit to the title insurer, the lender should keep in mind that it will be the position of the title insurer that it has no liability to the lender for an “accommodation” recording.

XIX.

ESCROW INSTRUCTIONS

One of the most important documents which would be originated by the lender is the escrow instructions to the settlement agent. While oral escrow instructions are enforceable, it is better practice for the lender to provide comprehensive written escrow instructions to the settlement agent. If the settlement agent is not the title insurer, a copy of the escrow instructions should also be sent by the lender directly to the title insurer so that the title insurer will have actual knowledge of the lender’s instructions.

The lender’s instructions, among other things, should have a place for the settlement agent to sign and to agree that it has received and reviewed the lender’s instructions and will not close the escrow except in strict compliance with those instructions.

Many title insurance claims arise as a consequence of the breach by the settlement agent of the lender’s escrow instructions. Therefore, in the event of a problem with a secured loan, the lender may have claims against the settlement agent and in addition may have claims against the title insurer based upon the identical issue. A well drafted set of lender’s escrow instructions which are sent both to the settlement agent and to the title insurer (assuming that the title insurer is different than the settlement agent) will materially enhance the lender’s ability to recover in the event that there is a problem with the loan.

XX.

POST-CLOSING ACTIVITIES BY THE LENDER

A. Introduction

After the loan has closed and the loan proceeds have been disbursed, the lender still faces two significant risks:

First, were the security instruments recorded or filed in the right offices?

Second, does the policy of title insurance conform to the lender's instructions?

B. After the Loan Closes the Lender Should Review the Recorded and/or Filed Loan Documents

Generally loan documents are recorded and/or filed in the correct offices. However, from time to time this does not occur. Accordingly, the author recommends that when the lender receives copies of the loan documents after they have been recorded and/or filed, the lender should review those documents to confirm that they were recorded and/or filed in the correct offices.

C. Review of Policy of Title Insurance

A lender may not receive the policy of title insurance for a few days to several months after the loan has closed. Therefore, the author recommends that the lender have a "tickler" system to make sure that the policy of title insurance is received within a reasonable period of time after the loan is closed. Once the policy of title insurance is received by the lender, it should be reviewed to determine if it were issued in strict compliance with the lender's instructions. If the title insurer failed to issue the policy in strict compliance with the lender's instructions, the lender should anticipate that the title insurer will claim that the lender should have promptly reviewed the policy and have gotten it corrected and any failure to promptly review and correct the policy will excuse the title insurer from any loss occasioned by the fact that the policy fails to conform with the lender's instructions.

XXI.

THE LOAN MODIFICATION/WORKOUT PHASE OF THE LOAN

A. Introduction

While many loans will perform in strict accordance with the provisions of the loan documents, it is not uncommon for the loan documents to be modified after the loan has been made. Modification of the loan documents can be the result of a variety of factors. The borrower may want to borrow more money. In the alternative, the borrower may not be able to make the payments due under the provisions of the original loan documents and a loan workout will be necessary. It is important for the lender to remember that the settlement agent and the title

insurer should be participants in the loan modification/workout phase of the loan. The printed forms of most policies of title insurance contain numerous provisions which restrict the ability of the lender to modify the loan documents without the written consent of the title insurer. By way of example, paragraph 8 of the Conditions and Stipulations provide that the insurer “. . . shall not be liable for loss or damage to any insured for liability voluntarily assumed by the insured in settling any claim or suit without the prior written consent of the insurer. Similarly, paragraph 3 of the Exclusions From Coverage excludes losses or damages which were “. . . created, suffered, assumed or agreed to by the insured . . . and those which attach or are created after the date of the policy of title insurance.”

B. The “Protocol” Agreement

In order to avoid potential claims by the borrower that the lender has agreed to a modification of the loan documents, many lenders will require, as a condition of engaging in negotiations for the proposed modification of the loan documents, that the borrower (and any interested party, such as guarantors, etc.) execute a “protocol” agreement, which provides that the parties are only discussing the potential of a proposed modification of the loan, and nothing will be effective unless and until the modified loan documents are signed.

While some modifications of the loan documents may be minor in nature (i.e. a brief extension of the maturity date of the loan) others may be more significant (i.e. a partial reconveyance of the lien of the deed of trust). The author recommends that the lender promptly advise the settlement agent and the title insurer that the loan has entered the modification/workout phase because if there is to be modification of the loan documents the title insurer’s written consent must be obtained or the lender will face a claim by the title insurer that the title insurer has been released from coverage by reason of the post-policy modification of the loan documents.

C. Waiver and Release of All Claims By the Borrower

When a lender is entering into a loan modification with a borrower, it should give consideration to requesting that the borrower, as partial consideration for the loan modification, agree to waive and release all claims, if any, which it might have against the lender. These waivers and releases can include such releases as claims for lender liability as well as the waiver

of the borrower's right to anti-deficiency protection.

D. Obtain a Modification Endorsement

If the lender and the borrower agree upon a modification of the loan documents, all interested parties (i.e. guarantors, title insurer, etc.) should consent in writing to the modification. In addition, the title insurer should issue, as a condition of the loan modification, a CLTA 110.5 Endorsement to insure the continued validity and priority of the lien of the deed of trust as modified.

XXII.

**THE USE OF TITLE INSURANCE TO PROVIDE PROTECTION
DURING THE DEFAULT AND FORECLOSURE PHASE**

A. Introduction

While most loans will not go into foreclosure, the lender should be aware of the measures which can be taken to utilize title insurance to maximize the lender's protection during the foreclosure process.

A secured lender may pursue both a judicial foreclosure and a non-judicial foreclosure. However, since the vast majority of foreclosures in California are non-judicial foreclosures, this paper will be limited to discussing certain of the issues which arise in a non-judicial foreclosure.

B. A Secured Lender Which Enters A Credit Bid At A Foreclosure Sale Should Make The Lowest Reasonable Credit Bid Possible

It is commonplace for secured lenders to acquire by a credit bid property at a foreclosure sale. However, the lender should keep in mind that the policy of title insurance will be reduced by the amount of the credit bid (just as the amount of the policy of title insurance was reduced by payments received by the lender). Accordingly, the lender should give due consideration to entering the lowest possible credit bid which is reasonable under the circumstances.

Before the foreclosure sale, the lender should obtain a valuation of the property. While an MAI appraisal would be best, this is not always necessary. This valuation will assist the lender in determining the amount of the credit bid which is appropriate. In the event of a title insurance claim, the valuation will provide a basis for proving the amount of the insured's loss.

While there is no precise amount which a lender should “credit bid” at a foreclosure sale, the lender should keep in mind that every dollar which is “credit bid” at the foreclosure sale may reduce the amount of coverage under the policy of title insurance.

The lender should personally attend the foreclosure sale rather than relying upon a third party to act on its behalf. While most foreclosure sales are routinely conducted, from time to time issues arise where prompt decisions by the lender are required.

C. The Continuation Of The Lender’s Policy Of Title Insurance After The Foreclosure Sale

If the lender acquires title to the property, which was the security for its loan, at the foreclosure sale, the loan policy continues in effect in favor of the lender. However, the amount of coverage under the policy may be reduced by the amount of the lender’s credit bid and the lender will only be insured to its extent as a lender in the property.

D. If The Lender Acquires Title To The Encumbered Property At Its Foreclosure Sale It Should Consider The Purchase Of An Owner’s Policy Of Title Insurance Or A Commitment To Issue A Policy Of Title Insurance

Since the lender which acquires title to the encumbered property at a foreclosure sale will only be insured as a lender under its loan policy, the lender should give consideration to purchasing an owner’s policy of title insurance or a commitment to issue a policy of title insurance. While many lenders do not want to incur the cost of a policy of title insurance after they have acquired title to the encumbered property at a foreclosure sale, due consideration should be given, at a minimum, to purchasing a commitment to issue a policy of title insurance. While a commitment is slightly more expensive than a policy of title insurance, in the event that the lender does not have grounds for making a claim on its policy of title insurance before the property is sold, it will be able to have the policy of title insurance provided for in the commitment issued to the new buyer and recoup most, though not all, of the cost of the commitment. Of course, there is always the risk to the lender that the buyer will insist that the policy of title insurance be issued by a title insurer other than the title insurer which issued the commitment.

XXIII.

INSURING DEEDS IN LIEU OF FORECLOSURE

It is not uncommon for a borrower who is in foreclosure to offer a deed in lieu of foreclosure to the lender to avoid a foreclosure sale. Frequently, this offer of a deed in lieu of foreclosure is done in conjunction with a request by the borrower that the borrower be relieved from any personal liability on the loan. It is not uncommon for lenders to conclude that a deed in lieu of foreclosure may be advantageous because it will avoid the time necessary for a foreclosure sale. However, there are several considerations which the lender should consider before it agrees to accept a deed in lieu of foreclosure:

- A. If a transaction is structured as a true deed in lieu of foreclosure, it may well result the elimination of all title insurance coverage because the lender has accepted the deed in satisfaction of the borrower's obligation. If this is to be the case, the lender should, as a condition of accepting the deed in lieu of foreclosure, obtain an owner's policy of title insurance insuring it as the owner of the property subject, to only those exceptions to coverage which was willing to accept as a lender.
- B. It is not uncommon for there to be junior liens upon the property owned by the borrower. If this were to be the situation, the lender would not want to accept a deed in lieu of foreclosure (without appropriate title insurance coverage which would probably not be available) because the lender would acquire title to the property subject to the liens. In this situation, consideration should be given by the lender to having the borrower convey the property to a special purpose entity designated by the lender to eliminate the borrower's ownership of the property, and then continue with the non-judicial foreclosure sale so that the lender can acquire title to the property and eliminate the junior liens.

XXIV.

THE LENDER'S USE OF ITS TITLE INSURER AS THE FORECLOSURE TRUSTEE

While there are a number of businesses which specialize in conducting foreclosure sales,

the lender must recognize that if a foreclosure sale is conducted by a person other than the title insurer that involvement of an additional party will provide the title insurer with an opportunity to seek to avoid liability and to claim that the loss or damage was caused by the foreclosure trustee. Therefore, the lender should give due consideration to having its title insurer serve as the foreclosure trustee.

XXV.

THE CLAIM AND/OR LITIGATION PHASE OF THE LOAN

A. Introduction

While the vast majority of policies of title insurance do not have claims made upon them, there is always a risk to the insured lender that there will be a basis for making a claim on the policy. All standard forms of policies of title insurance contain a provision which obligates the insured to promptly notify the insurer in writing of any claim or litigation which is known to the insured and provides that in the event that the insured fails to provide such notice, that the insurers liability will terminate with regard to matters where prompt notice was required. Most policies and case law holds that the insured's failure to give prompt notice to the insurer will only terminate the insured's coverage where the insurer has been prejudiced by the failure to provide prompt notice and then only to the extent of the prejudice. However, the insured has nothing to gain in delaying providing written notice to the insurer in the event that any issues which arise which may impact title insurance coverage.

B. Tender Of Claims By The Insured Lender To The Title Insurer

In the event that the lender determines that there may be a colorable basis for making a claim to the title insurer (or the settlement agent if the settlement agent is different than the title insurer) then prompt written notice should be sent to the title insurer. It is the author's recommendation that the written notice be sent by Federal Express and by regular mail, both to the title insurer at the address shown on the policy of title insurance and to the settlement agent and/or the title insurer at the office where the loan was closed.

The California Fair Claims Settlement Practices Regulations sets forth the time periods within which the California Department of Insurance wants the title insurer to respond to claims by its insureds. The author recommends that the day after a claim has been submitted by Federal

Express to a title insurer that a representative of the lender telephone the title insurer to confirm the title insurer's receipt of the claim and to ascertain the name of the person who will handle the claim. Depending upon the nature of the claim (i.e. a lawsuit by an adjacent property owner who claims an easement over the subject property) the claim may require very prompt attention by the insurer. If this is the situation, the letter tendering the claim to the title insurer should provide the relevant dates (i.e. a response is due to the complaint on or before a certain date).

C. The Title Insurer's Response To The Claim

1. Introduction

Depending upon the nature of the claim, the title insurer has a variety of options. First, the title insurer may deny the claim. Second, the title insurer may accept the claim with a reservation of rights. Third, the title insurer may accept the claim without a reservation of rights. Depending upon the nature of the claim and the response of the title insurer to the claim, additional action may be required by the insured.

If the insurer rejects the claim, the insured may file suit (or start an arbitration) against the insurer. In the alternative, the insured may obtain a tolling agreement from the insurer while it seeks to deal with the claim without the insurer's participation. However, if the insured feels that the insurer has inappropriately rejected the claim, but does not intend to file suit (or start an arbitration) against the insurer at that time, a tolling agreement should be obtained from the title insurer and the settlement agent and copies of correspondence, pleadings and other relevant documents should be to the title insurer and the settlement agent as the insured seeks to deal with the claim.

If the insurer accepts the claim without a reservation of rights, the insured should anticipate that the insurer will select counsel to address the claim. Most policies of title insurance provide that the insurer has the right to select counsel of its choice (subject to the right of the insured to object for reasonable cause) to represent the insured with respect to a claim. It is not uncommon for title insurers to have a group of lawyers to whom they routinely refer their claims. Accordingly, the lender should determine whether the lawyer selected by the title insurer is a person who is routinely retained by the title insurer and who may have an economic bias in favor of the title insurer.

2. **The Selection Of Counsel To Represent The Insured Can Be A Very Significant Factor In A Claim**

Merely because the title insurer accepts the insured's claim (whether with or without a reservation of rights) the insured lender should remain vigilant to make certain that the claim is being properly handled and that the insured's rights are not being lost or compromised.

The lender may have claims against persons other than the title insurer (i.e. the settlement agent, a loan broker, an appraiser, a surveyor, etc.). Merely because the title insurer has accepted the insured's claim does not conclude the claim process, because since the lender will wish to pursue its rights against all potential sources of recovery. Frequently, the lawyer selected by the title insurer will not pursue claims against third parties. Accordingly, the insured lender may need to retain its own counsel to pursue those claims against third parties.

D. The Insurer's Right Under the Policy To Make Title As Insured

Frequently, the title insurer elects to attempt to make title as insured when it has accepted the tender of a claim (whether with or without a reservation of rights). While the insurer's right, under the policy of title insurance, to make title as insured is highly beneficial to the insurer, it is very detrimental to the insured since it forces the insured to engage in litigation and delays the payment of the insured's claim. If the insurer has elected to seek to make title as insured, the insured should remember that more than 90% of all cases filed in the Superior Court never go to trial and there is a high probability that the case will be settled at some point. Accordingly, the insured should request that the title insurer, among other things, engage in an early mediation to see if the claim can be resolved.

XXVI.

CONCLUSION

Title insurance is an invaluable aspect of any secured loan transaction which is properly closed. While title insurance claims do not occur on a frequent basis, they can result in the insured's loss of the whole of its security for the loan. Therefore, it is highly recommended that a policy of title insurance be obtained to insure each secured loan transaction. Thereafter, during the modification/workout and the foreclosure phases of the loan, title insurance and the title insurer continue to perform valuable roles in the preservation of the lender's security for its loan.

Similarly, well drafted escrow instructions can materially enhance the secured lender's ability to recover from a financially responsible party in the event of a claim. Taken together, well crafted title insurance coverage and well drafted escrow instructions will materially enhance a lender's loan security.