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Title Insurance Coverage for Mechanics Liens: A Lender's Guide

By Noel C. Paul and Andrea Yassemedis - October 31, 2012

Some experts have estimated that the value of commercial real estate has spiraled downward as much as 45 percent since the height of the market in 2007.[1] One consequence: Delinquency rates have risen steadily.[2] If the commercial real estate market does not stabilize, the United States economy could experience a significant uptick in commercial real estate defaults.[3] In this economic environment, it is vital that lenders fueling commercial development take care to obtain a key safety net in the event the project goes bad: a policy of title insurance that covers mechanics liens filed against the property.[4]

Mechanics liens often result when development projects fail, and they can entail years of expensive litigation and potentially several million dollars in settlement payments. Like most policies available to large commercial entities, the scope of coverage provided by title insurance to lenders can vary significantly, and lenders should work to negotiate the most favorable terms and expansive coverage, including coverage for mechanics liens. Should claims arise for mechanics liens, lenders also should be ready for a potential dispute with their title insurer. Court holdings with respect to the key exclusion for coverage for mechanics liens are confusing and contradictory. Moreover, as claims for mechanics lien coverage increase, insurers will almost surely push back by testing the outer limits of the exclusion.

This article provides some guidance to lenders in understanding some of the fundamental issues related to coverage for mechanics liens. It then discusses the basic coverage provided to lenders under a standard title insurance policy and how lenders can obtain coverage specifically protecting against mechanics liens that might arise during the course of a real estate development project. The article also discusses the key exclusion raised by title insurers with respect to mechanics lien coverage and case law analyzing that exclusion. Finally, the article explains the proper rule for analyzing the exclusion and concludes by offering some additional recommendations for policyholders and their counsel.

Commercial Real Estate: High Risk, High Reward

Significant risk is built into the commercial real estate industry. There are several reasons for this. Real estate markets are traditionally cyclical, and downturns in the market can upset even the best-conceived and soundly underwritten projects.[5] Downturns can prompt a credit crunch, which can cause funding for projects to dry up or become too expensive.[6] Commercial real estate projects—for example, office buildings, retail centers, and industrial facilities—traditionally are highly leveraged, which means that developers fund the projects through loans rather than their own equity.[7] Both developers and lenders can reap huge profits from this model, but they also carry significant risk as a result. Real estate construction projects typically have long gestation periods, which leave them more vulnerable to the downward turn of the real estate cycle.[8] The structure of commercial real estate loans entails more risk for lenders, because they often have less recourse against borrowers' assets other than the commercial property itself.[9] Finally, when projects fail and lenders foreclose on the property, they also increasingly face a spate of mechanics liens filed by unpaid contractors and subcontractors on the project.[10]

Title Insurance for Lenders

A policy of title insurance insures against defects in or liens or encumbrances on a party's title to certain property.[11] Most title insurance is retrospective, that is, it insures against a past failure by the title company to uncover in the public records defects in title, such as liens or encumbrances, or to clear title as promised.[12] Should a defect in title arise that interferes with a property owner's continued use or possession of the property, the title insurance policyholder would potentially have coverage for its financial loss resulting from such interference—or even loss of ownership of the property.[13] Obviously, most title insurance is different from most forms of liability insurance, as liability coverage insures against the future occurrence of a contingency. But there are some key similarities. Among them, as is true of almost all types of liability coverage, title insurers are obligated to defend, at their expense, the policyholder against any lawsuit that challenges the policyholder's title to the property, provided the challenge is based on a defect insured against by the policy.[14] Also, as is true of almost all types of liability coverage, a title insurer must indemnify a policyholder in the event the policyholder suffers a loss resulting from a defect in the title undetected by the insurer.[15]

Most title insurance policies are drafted by a title insurance industry group named the American Land Title Association (ALTA).[16] The main policies provided by ALTA include a policy for an owner/developer, a seller's policy, a construction loan policy, and a lender's policy.[17] This article is primarily focused on the last—the lender's policy. The reason for the ALTA lender's policy is obvious: If a lender forecloses on its security interest in a commercial real estate project—that is, the property—the lender requires many of the same protections that the owner/developer required with respect to its title to the property. Thus, the lender's policy insures that title belongs to the lender, that no unknown liens or encumbrances exist against title, that title is marketable, and that the lender has access to the property.[18] If the public records list liens or encumbrances against title prior to the issuance of the title policy, the policy will list these exceptions to coverage on Schedule B of the policy. Importantly, the basic lender's policy also ensures that the lender's mortgage lien is valid and enforceable, and that the lender's mortgage has priority over all matters not otherwise excluded.[19] This coverage is key because the mortgage is the vehicle through which the lender recovers its security interest in its loan.

Coverage for Mechanics Liens

When large real estate development projects go bad, it often will be the case that contractors and subcontractors will have gone unpaid for several months or years or will bring frivolous claims for payment. Thus, when a lender forecloses on its lien and takes possession of the property, mechanics liens can seem to come out of the woodwork. Mechanics liens are creatures of state statute.[20] They generally are liens that secure payment for labor or materials supplied in improving, repairing, or maintaining real or person property, such as a building.[21] Because most title insurance looks backward, mechanics liens that arise by reason of work done on the property after the issuance of the title policy generally are not covered.[22] For lenders, this presents a clear problem because the same conditions that prompt foreclosure often lead to the filing of dozens of mechanics liens that, together, can total several million dollars. As a result, it has become common for lenders to negotiate for extended coverage that provides coverage for mechanics liens for the duration of the construction of the property.[23] With respect to mechanics liens, this extended coverage incorporates into the lender's policy coverage for the following:

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 commences 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.
[24]

Subsection (a) of the extended coverage provides lenders with coverage for liens for work that might have preexisted the issuance of the policy.[25] This coverage is important because some state statutes allow prospective lienholders to wait many months before filing a mechanics lien claim, and such inchoate claims would not be evident in the public records at the time the policy becomes effective.[26] Subsection (b) is even more vital. It secures coverage for mechanics liens that result from work done on the property that is paid for by the lender.[27] If the liens result from work that was not contemplated by the original loan, however, then coverage may be in doubt.[28] Other than that limitation, subsection (b) provides significant protection for lenders involved with a real estate development project.

To guard against mechanics liens, lenders and title insurers often will negotiate the addition of a pending disbursement clause to the title policy.[29] These clauses often are negotiated when the lender intends to make a series of disbursements to the borrower over the course of the project, rather than one lump payment.[30] The process often works as follows: As the project moves forward, the borrower submits disbursement requests to the lender for work performed; the lender reviews the requests and, upon approval, sends the disbursement to the title insurer to hold in escrow; the title insurer obtains lien waivers from the relevant contractors requesting payment and disburses the lender's funds.[31] The title insurer then adds an endorsement to the title policy extending coverage for mechanics liens through the date of the disbursement, but no further.[32] The pending disbursement clause clarifies that coverage for mechanics liens is available only through the date provided by these endorsements.[33]

A Key Exclusion to Coverage for Mechanics Liens

Observers report that, at least in Illinois, no area of the law generates more claims tendered to title insurers than that of mechanics liens.[34] Indeed, other observers suggest that, in light of the uptick in foreclosures in the commercial real estate sector and the significant number of claims for mechanics liens brought by policyholders, title insurers have narrowed the scope of coverage for mechanics liens that they are willing to underwrite.[35] Even assuming broad "extended coverage," however, the ALTA lender's policy includes a broad exclusion aimed at limiting policyholders' coverage for mechanics liens. Specifically, the 2006 ALTA lender's policy excludes "[d]efaults, liens, encumbrances, adverse claims or other matters: created, suffered, assumed, or agreed to by the Insured Claimant." [36] The exclusion frequently is raised by title insurers against lenders. Among the most common circumstances are when the insured lender does not fully fund construction; when the insured lender does not fully fund construction for improvements done before default; when the insured lender intentionally funds only a part of the construction costs and requires the borrower to fund the remaining costs; [37] and even when the insured lender fully funds its loan.[38] Courts apply the exclusion differently depending on the facts of each case. The scope of the relationship between the lender and title insurer, including whether the lender engaged the title insurer as an escrow/disbursement agent, often is a significant factor.

Case Law Analyzing the Key Exclusion

Although courts have published opinions with respect to the "created, suffered, assumed,

or agreed to" exclusion for more than 40 years, there are surprisingly few cases addressing its meaning and scope. The courts that have analyzed the exclusion have issued mixed opinions.

Brown

In *Brown v. St. Paul Title Insurance Corp.*, a lender, Citizens Mortgage Investment Trust (CMIT), agreed to loan of up to \$27 million to develop a real estate venture.^[39] CMIT entered into an agreement with the title insurer, St. Paul, whereby St. Paul agreed to hold CMIT's series of disbursement funds in escrow and make payment to the borrower only upon reception of proper lien waivers.^[40] After a series of disbursements, the borrower defaulted and CMIT foreclosed.^[41] CMIT made no further disbursements, and subcontractors later filed mechanics lien claims against title to the property, now owned by CMIT.^[42] The liens resulted from work that took place between the time the borrower submitted its final draw request and the time CMIT authorized payment by St. Paul.^[43] Because CMIT could have paid the lienholders by disbursing the remainder of its overall loan but chose not to, St. Paul urged that the liens had been "created or suffered" by CMIT.^[44] The court agreed: "While CMIT admittedly was under no obligation to continue funding the project after the default," the court held, "it seems clear that the parties contemplated that CMIT would provide adequate funds to pay for work completed prior to the default."^[45] Thus, the *Brown* court held that the liens were "created or suffered" by CMIT and that CMIT's coverage claim for the liens was excluded.^[46]

Bankers Trust

The *Brown* court relied on the prior holding of the Court of Appeals for the Tenth Circuit with respect to a factually similar case.^[47] In *Bankers Trust Co. v. Transamerica Title Insurance Co.*, lender Bankers Trust agreed to lend as much as \$2.75 million toward the construction of an apartment complex in Colorado.^[48] The title insurer Transamerica issued a policy of title insurance to Bankers Trust with respect to its mortgage on the property.^[49] Transamerica and Bankers Trust also entered into a separate disbursement agreement, whereby Transamerica agreed to serve as escrow and disbursement agent for the project, similar to the services provided by the insurer in *Brown*.^[50] After 13 advances of loan proceeds, the borrower defaulted, Bankers Trust foreclosed, and mechanics liens totaling more than \$325,000 were filed against the property.^[51] As in *Brown*, the lender had funds available to pay the liens but did not pay them because the loan was in default and it had no obligation to further advance funds.^[52] According to the court, Transamerica's promise to secure lien waivers after funds were disbursed by Bankers Trust "clearly contemplated that adequate funds were to be made available to Transamerica in order to satisfy claims."^[53] Like the lender in *Brown*, Bankers Trust "created or suffered" the liens to exist, the court held, by refusing to make adequate funds available.^[54]

American Savings

Notwithstanding *Brown* and *Bankers Trust*, several courts have rejected the application of the exclusion. In *American Savings & Loan Ass'n v. Lawyers Title Insurance Corp.*, the Court of Appeals for the Sixth Circuit refused to follow the argument by title insurer Lawyers Title that the lender American Savings had "created, suffered, assumed, or agreed to" mechanics liens against the relevant property.^[55] American Savings committed to lend \$1 million for construction of a housing complex but understood that the borrower might need to secure additional funding from another source.^[56] After the project collapsed and mechanics liens emerged, Lawyers Title argued that American Savings had "created, suffered, assumed, or agreed to" the liens because it knew that the borrower might need to find another lender.^[57] (Unlike the lenders in *Brown* and *Bankers Trust*, American Savings had disbursed its entire loan.^[58]) The court disagreed.^[59] The court construed the terms "created, suffered, assumed, or agreed to" to generally require a conscious, deliberate act or at least some kind of inequitable conduct.^[60] Unlike the lenders in *Brown* and *Bankers Trust*, according to the court, American Savings avoided such charges by funding its full loan.^[61] Overall, Lawyers Title assumed the risk that the project developer would not secure additional financing, not American Savings.^[62]

Resolution Trust

The court in *Mid-South Title Insurance Corp. v. Resolution Trust Corp.* also rejected an insurer's effort to apply the "created, suffered, assumed, or agreed to" exclusion, this time on the basis of the absence of any ancillary disbursement agreement between the lender and the title insurer.^[63] In *Resolution Trust*, the lender issued four disbursements to the borrower totaling more than \$8 million.^[64] Prior to the final disbursement, the title insurer Mid-South Title informed the lender that certain mechanics liens had been filed against the property.^[65] As a result, the lender refused to approve the final disbursement, the borrower defaulted, and the lender foreclosed.^[66] As in *Brown* and *Bankers Trust*, the lender had sufficient funds to pay the lienholders.^[67] The court distinguished these cases, however, because they included the presence of an additional disbursement agreement between the lender and title insurer that, according to the *Resolution Trust* court, created an "implied duty" to provide adequate funds to satisfy liens.^[68] The absence of such an agreement in the instant case (the title insurer merely was obligated to report the presence of liens), according to the court, did not compel the lender to disburse funds sufficient to pay the liens.^[69] "[A]bsent a contractual relationship ancillary to the insurance contract at issue," the court reasoned, "there was no implied duty between these parties that all committed loan funds must have been expended."^[70] Furthermore, the court adopted the reasoning of *American Savings* in holding that the terms "created, suffered, assumed, or agreed to" did not encompass the lender's conduct, because the liens were created prior to the lender's refusal to disburse additional funds.^[71]

Home Federal

In a significant victory to policyholders, a recent decision by the Court of Appeals for the Seventh Circuit adopted the reasoning of *Resolution Trust* in holding that the policyholder did not intentionally create a mechanics lien by refusing to fund the remainder of loan funds or pay a certain lienholder.^[72] In *Home Federal Savings Bank v. Ticor Title Insurance Co.*, the Seventh Circuit reasoned that the majority rule is that the "created or suffered" exclusion is intended to protect the insurer from liability for matters caused by the policyholder's "intentional misconduct, breach of duty, or otherwise inequitable dealing."^[73] Because there was no evidence the lender Home Federal acted as such, the court held that the exclusion did not apply.^[74] In this case, unlike *Brown* and *Bankers Trust*, the court held, there was no disbursement agreement between Home Federal and

the insurer Ticor Title indicating that Home Federal was bound to disburse the entirety of the loan.^[75] Moreover, because Home Federal had paid an additional premium for its mechanics lien endorsement, the court held that Home Federal would not receive an unfair windfall.^[76]

Proper Application of the Exclusion

The *American Savings, Resolution Trust*, and *Home Federal* courts reach the right result. They recognize that exclusions to coverage should be read narrowly and that the exclusion of coverage for liens "created, suffered, assumed, or agreed to" by the policyholder should be limited in application to willful and intentional conduct by the policyholder.^[77] They also recognize that title insurers that receive additional premium for providing forward-looking mechanics lien coverage should not be allowed to rewrite the contract in the event the deal goes sour because mechanics liens actually arise.^[78]

Moreover, when title insurers issue a policy to a lender, they have access to and are held to have knowledge of the terms and provisions of the lender's loan with the borrower. They understand that such loans contain many grounds for default and that a lender may demand full payment of the loan upon an event of default or discontinue disbursements altogether. Title insurers cannot possibly be surprised when mechanics liens result from a lender's decision to exercise its right not to disburse funds. Nor should they be permitted to deny coverage when a lender exercises this right. Going forward, courts should reject a title insurer's argument based on the "created, suffered, assumed, or agreed to" exclusion if an event of default has prompted the lender's decision not to make payment. Such conduct, which is permitted under the loan, cannot reasonably be described as creating, suffering, assuming, or agreeing to liens, nor can it be deemed inequitable.

Moreover, the rule in *Brown and Bankers Trust* essentially renders forward-looking coverage for mechanics liens illusory, as there are few circumstances other than those relating to an event of default that would cause a significant number of mechanics liens to be filed against title to the property. As long as title insurers continue to accept additional premium in consideration for forward-looking extended coverage for mechanics liens, they should be required to actually provide the coverage.

Conclusion

Few courts have grappled with the issue of coverage for mechanics liens that arise when a development project fails. Given the popularity (or necessity) of extended coverage for mechanics liens and the inevitable ebbs and tides of commercial real estate markets, state and federal courts across the country will almost certainly be weighing in on these issues with greater frequency. Although real estate attorneys traditionally have counseled clients on issues relating to the basic coverage provided under a title policy, insurance coverage attorneys are well suited to advise clients on complex coverage issues implicating the title insurer's duties to defend and indemnify. For many coverage attorneys, title insurance may seem like a different animal altogether. Although the basic structure of the policy is similar to other forms of coverage, counsel should closely scrutinize the precise policy language to understand the many nuances of title policy coverage. Moreover, in defending policyholders seeking coverage for mechanics liens, counsel should take care to familiarize themselves with the details of the applicable mechanics lien statute. Each statute varies, and differences in when and how mechanics liens must be filed and perfected, among other issues, can significantly affect the application of key policy provisions. As courts increasingly take on the issue of coverage for mechanics liens, these policy- and statutory-based details could mean the difference between full coverage and a total loss.

Keywords: American Land Title Association, ALTA, Illinois Mechanics Lien Act, lenders, commercial real estate

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[1] E.g., Tanya D. Marsh, "Understanding the Commercial Real Estate Debt Crisis," 1 *Harv. Bus. L. Rev. Online* 33 (2011).

[2] Marsh, *supra* note 1, at 33.

[3] Cong. Oversight Panel, *February Oversight Report: Commercial Real Estate Losses and the Risk to Financial Stability* 6 (2010); see also Mark Bergen, "That Other Foreclosure Crisis: Commercial Real Estate Teeters," *Forbes.com*, Apr. 10, 2012.

[4] With respect to the proper usage of the term "mechanics lien," this article follows the style adopted by the Illinois legislature in the state's Mechanics Lien Act, 770 Ill. Comp. Stat. 60/0.01.

[5] Federal Deposit Insurance Corp., Division of Research & Statistics, "Commercial Real Estate and the Banking Crises of the 1980s and Early 1990s," in *An Examination of the Banking Crisis of the 1980s and Early 1990s* 138, 139 (Dec. 1997).

[6] Federal Deposit Insurance Corp., *supra* note 5, at 138, 139.

[7] Federal Deposit Insurance Corp., *supra* note 5, at 138, 139.

[8] Federal Deposit Insurance Corp., *supra* note 5, at 138, 139.

[9] Federal Deposit Insurance Corp., *supra* note 5, at 138, 139.

[10] S.H. Spencer Compton & Steven G. Rogers, "Underwriting Mechanics' Lien Coverage in the New Economy," *N.Y. L.J.*, Nov. 22, 2011.

[11] James L. Gosdin, *Title Insurance: A Comprehensive Overview* 82 (ABA Section of Real Property, Probate and Trust Law 3d ed. 2007).

[12] Gosdin, *supra* note 11, at 82-83.

[13] Tiffany D. Booker, "An Overview of Title Insurance and the Title Insurance Industry," in *The Attorney's Guide to Title Insurance* 1-1, 1-5 (Ill. Inst. of Continuing Legal Education 2005).

[14] Booker, *supra* note 13, at 1-1, 1-9.

[15] John C. Murray & James F. Karela, "The ALTA Standard Loan Policy," in *The Attorney's Guide To Title Insurance* 4-1, 4-4 (Ill. Inst. of Continuing Legal Education 2005).

[16] Gosdin, *supra* note 11, at 82.

[17] Booker, *supra* note 13, at 1-11, 1-12.

[18] Booker, *supra* note 13, at 1-11.

[19] Booker, *supra* note 13, at 1-11.

[20] *Black's Law Dictionary* 935 (7th ed. 1999).

- [21] *Black's Law Dictionary* 935.
- [22] Gosdin, *supra* note 11, at 176.
- [23] Gosdin, *supra* note 11, at 177.
- [24] Murray & Karela, *supra* note 15, at 4-11.
- [25] Murray & Karela, *supra* note 15, at 4-12.
- [26] Murray & Karela, *supra* note 15, at 4-12.
- [27] Murray & Karela, *supra* note 15, at 4-12.
- [28] Murray & Karela, *supra* note 15, at 4-12.
- [29] Gosdin, *supra* note 11, at 177.
- [30] Murray & Karela, *supra* note 15, at 4-12, 4-13.
- [31] See *Brown v. St. Paul Title Ins. Corp.*, 634 F.2d 1103, 1105 (8th Cir. 1980) (providing explanation of process).
- [32] See *Brown*, 634 F.2d at 1105 (8th Cir. 1980).
- [33] Murray & Karela, *supra* note 15, at 4-12.
- [34] Murray & Karela, *supra* note 15, at 4-11.
- [35] S.H. Spencer Compton & Steven G. Rogers, "Underwriting Mechanics Lien' Coverage in the New Economy," *N.Y. L.J.*, Nov. 22, 2011.
- [36] Gosdin, *supra* note 11, at 179.
- [37] Gosdin, *supra* note 11, at 179.
- [38] *Am. Savings & Loan Ass'n v. Lawyers Title Ins. Corp.*, 793 F.2d 780 (6th Cir. 1986).
- [39] *Brown v. St. Paul Title Ins. Corp.*, 634 F.2d 1103, 1104 (8th Cir. 1980).
- [40] *Brown*, 634 F.2d at 1104-5.
- [41] *Brown*, 634 F.2d at 1106.
- [42] *Brown*, 634 F.2d at 1106.
- [43] *Brown*, 634 F.2d at 1106.
- [44] *Brown*, 634 F.2d at 1107-8.
- [45] *Brown*, 634 F.2d at 1110.
- [46] *Brown*, 634 F.2d at 1110.
- [47] *Brown*, 634 F.2d at 1108-9.
- [48] *Bankers Trust Co. v. Transamerica Title Ins. Co.*, 594 F.2d 231, 232 (10th Cir. 1979).
- [49] *Bankers Trust*, 594 F.2d at 232.
- [50] *Bankers Trust*, 594 F.2d at 232.
- [51] *Bankers Trust*, 594 F.2d at 234.
- [52] *Bankers Trust*, 594 F.2d at 234.
- [53] *Bankers Trust*, 594 F.2d at 233.
- [54] *Bankers Trust*, 594 F.2d at 234-35.
- [55] *Am. Sav. & Loan Ass'n v. Lawyers Title Ins. Corp.*, 793 F.2d 780, 785 (6th Cir. 1986).
- [56] *American Savings*, 793 F.2d 780.
- [57] *American Savings*, 793 F.2d at 783.
- [58] *American Savings*, 793 F.2d at 785.
- [59] *American Savings*, 793 F.2d at 785.
- [60] *American Savings*, 793 F.2d at 784-85.
- [61] *American Savings*, 793 F.2d at 786.
- [62] *American Savings*, 793 F.2d at 786.
- [63] *Mid-South Title Ins. Corp. v. Resolution Trust Corp.*, 840 F. Supp. 522, 529 (W.D. Tenn. 1993).
- [64] *Resolution Trust*, 840 F. Supp. at 525.
- [65] *Resolution Trust*, 840 F. Supp. at 525.
- [66] *Resolution Trust*, 840 F. Supp. at 525.
- [67] *Resolution Trust*, 840 F. Supp. 522, 525 (W.D. Tenn. 1993).
- [68] *Resolution Trust*, 840 F. Supp. at 527.
- [69] *Resolution Trust*, 840 F. Supp. at 528.
- [70] *Resolution Trust*, 840 F. Supp. at 528.
- [71] *Resolution Trust*, 840 F. Supp. at 530.
- [72] *Home Fed. Sav. Bank v. Ticor Title Ins. Co.*, 2012 WL 3871521 (7th Cir. Sept. 6, 2012).
- [73] *Home Federal*, 2012 WL 3871521, at *5.
- [74] *Home Federal*, 2012 WL 3871521, at *6.
- [75] *Home Federal*, 2012 WL 3871521, at *7.
- [76] *Home Federal*, 2012 WL 3871521, at *7.
- [77] *Am. Sav. & Loan Ass'n v. Lawyers Title Ins. Corp.*, 793 F.2d 780, 783 (6th Cir. 1986); *Mid-South Title Ins. Corp. v. Resolution Trust Corp.*, 840 F. Supp. 522, 531 (W.D. Tenn. 1993); *Home Federal*, 2012 WL 3871521, at *5.
- [78] *American Savings*, 793 F.2d at 784; *Resolution Trust*, 840 F. Supp. at 530; *Home Federal*, 2012 WL 3871521, at *7.