

UNDERWRITING COMMERCIAL TRANSACTIONS

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Would you expect a title insurance company or lender to underwrite a transaction involving either of these two types of properties the same way?



Why not?

What could be different about these two transactions?

1. Policy Amount
2. Types of Security Instruments
3. Attorney Involvement
4. Potential Leasehold Estates
5. Endorsement Requests
6. Proforma Expectations
7. Authority Issues
8. Closing Instructions
9. CPL Requests
10. Etc.

Real Property vs. Personal Property

- Many commercial transactions involve the purchase of personal property in addition to real property.
- Examples:
 - Equipment
 - Purchase of a Business
- This means there will likely be UCC Fixture Filings
 - If you want them insured, you will need to utilize a UCC Policy.

Attorney Involvement

- Are they local?
 - Many commercial customers have counsel in another state, or they will employ both local counsel and their typical out of state or in house counsel.
 - If they are out of state, it may be necessary to provide them with relevant local law or local procedure that impacts the transaction.
- Typical Process/Timeline for Commercial Transactions
 - Order
 - Issuance of Commitment
 - Title Objection Letter
 - Proforma
 - Instructions
 - Closing

Closing Instructions

- If an attorney is involved, these are usually provided by the attorney, not the Proposed Insured.
- They should outline the type of coverage requested, the endorsements requested, and permitted exceptions.
- Review carefully; They may be drafted in an attempt to expand policy coverage through verbiage in the closing instructions.
- Buzz words/phrases for the title company:
 - Unconditionally obligated
 - Irrevocably commit
 - Indemnity/Indemnify



SECTIONS

A FEATURED BENEFIT OF THE STATE BAR OF
CALIFORNIA REAL PROPERTY LAW SECTION

Stop Notices and Mechanic's Liens: Construction Lenders' Nightmares

Buchalter Nemer

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I. Introduction

Historically low interest rates have led to the substantial growth in real estate lending, especially construction lending. Unfortunately, the lead article in the Business Section of the January 28, 2016, issue of the Los Angeles Time was "Fears of U.S. recession are growing." In addition, there has also been a noticeable increase in the numbers of complaints filed in the California Superior Court to enforce stop notices and to foreclose mechanics liens. Further, last year the title insurance industry achieved a very significant victory over a construction lender which had made a construction loan in the amount of \$86 million, but was subordinate to \$17 million in mechanic's liens. The title insurer avoided all liability to the construction lender for indemnity against the mechanic's liens on the basis that the construction lender had "created" or "suffered" the mechanic's liens because the construction lender had "... cutoff loan funds..." See, *B&B Syndication Services, Inc. v. First American Title Insurance Company* (7th Cir. 2015) 780 F.3d 825.

The purposes of this Lender Alert are to: (1) acquaint you with the increased risks construction lenders face with respect to stop notices and mechanic's liens; (2) familiarize you with the "gaps" in title insurance coverage created by Exclusions 3(a) and (b); and (3) provide you with some practical

V. The Lender's Escrow Instructions Are The Key To Avoiding Loss Of Lien Priority

The construction lender's written escrow instructions to the title company are the key to obtaining a first priority Deed of Trust on the borrower's property. Proper written escrow instructions not only expressly instruct the title company to record the construction Deed of Trust as a first lien on the borrower's property, they also expressly instruct the title company to issue a loan policy of title insurance to protect the construction lender against loss or damage in the event that the construction Deed of Trust is not recorded as a first lien on the borrower's property. If the construction lender's escrow instructions to the title company require that the construction Deed of Trust be recorded as a first lien on the borrower's property, and that is not done, the construction lender may have a claim against the title company for breach of the escrow instructions and may be entitled to recover from the escrow agent all of its unpaid loan balance (since the title company will have disbursed the loan proceeds in violation of the express escrow instructions). See, *Ruth v. Lytton Savings and Loan Association of Northern California* (1968) 266 Cal. App. 2d 831, 838; *Old West Annuity and Life Ins. Co. v. Progressive Closing & Escrows, Inc.*, (10th Cir. 2003) 74 F. Appx. 4, 5; and *Citicorp Savings of Illinois v. Stewart Title Guaranty Company* (7th Cir 1987) 840 F. 2d 526, 531. Accordingly, escrow claims may be more valuable to the construction lender than a claim on a loan policy of title insurance which contains terms and exclusions which are favorable to the insurer and unfavorable to the construction lender.



First Lien Language

- Article encourages clients to add “first lien” language to closing instructions.
- Article indicates you can get more coverage for mechanic’s lien issues out of escrow instructions than the actual title policy.
- Reference to “Seattle Endorsement” aka “Intervening Lien Endorsement”.
 - The ALTA Loan Policy is subject to the terms and conditions of the policy, specifically Exclusions 3(a) and 3(b).

Exclusions 3(a) and 3(b)

Exclusions From Coverage

The following matters are expressly excluded from the coverage of this policy, and the Company will not pay loss or damage, costs, attorney's fees or expenses that arise by reason of:

3. Defects, liens, encumbrances, adverse claims or other matters:

- (a) created, suffered, assumed or agreed to by the Insured Claimant;
- (b) not Known to the Company, not recorded in the Public Records at Date of Policy, but Known to the Insured Claimant and not disclosed in writing to the Company by the Insured Claimant prior to the date the Insured Claimant became an Insured under this policy;

Closing Instructions cont.

- It is okay for the instructions to state that the title company agrees to issue the policy subject to specific permitted exceptions.
- Using language such as “first lien position” may be inappropriate.
- Do not issue a “side letter” saying you will record the Deed of Trust in first lien position.
 - This is a violation of the monoline statute.

Closing Instructions: Claim Sample

- Developer purchased 200 acres of land and used it to secure a Deed of Trust. FATICO insured the loan for \$7 million.
- Loan goes into default, lender discovers borrower actually owns only 160 acres of land.
 - Examiner misinterpreted several corrective deeds in the back chain and missed that there was a sale out of 40 acres (note: acreage was not referenced in the legal description).
- Claim is filed, appraisal of missing land is conducted. Missing land is appraised at \$500K.
- Lender agrees missing land is worth \$500K, but ultimately refuses to accept our check.

Closing Instructions: Claim Sample

This firm represents ██████████ Enterprises, LLC (the “Lender”), in connection with the above-captioned loan transaction, and this letter constitutes the instructions of the Lender with respect thereto.

1. You are authorized to record the Deed of Trust, Assignment of Rents, Security Agreement and Fixture Filing (#10) followed by the Water Rights Deed of Trust (#2) (collectively, the “Recording Documents”) in the Official Records of Nye County, Nevada and file the UCC-1 (#4) with the Nevada Secretary of State upon (i) oral or written authorization to proceed from the undersigned, as Lender’s counsel, and (ii) satisfaction of the following conditions precedent:

a. Fee title to the property described in the Deed of Trust, Assignment of Rents, Security Agreement and Fixture Filing is vested solely in Borrower.

Closing Instructions: Claim Sample

- Lender files breach of contract claim under escrow instructions.
- Lender asserted that we had contracted with them, outside the terms of the policy, that the borrower owned all of the land described in the Deed of Trust.
- They claim they never would have made the loan if they knew that the developer didn't own the full 200 acres, and because of the language in their escrow instructions we should be obligated for the full amount.
- The loss under the terms of the title policy would have been \$500K.
- Total loss for escrow claim including legal fees: Over \$4 million.

Lessons

- Escrow claims are not limited by the terms of the policy. We have exposure for contract and negligence claims under escrow instructions.
- Escrow staff is encouraged to read the closing instructions carefully when they are prepared by a third party (which is often the case in commercial transactions).
- Don't be surprised if the Underwriter wants to see a copy of the closing instructions on a commercial deal before they extend approval.

Leasehold Estates

- Are we insuring the leasehold interest or the fee interest?
- Will there be new construction for tenant improvements?
- Do we need a SNDAs?
 - SNDA = Subordination, Non-Disturbance and Attornment Agreement
 - Is subordination language within an existing lease sufficient?

Schedule B, Part II – Loan Policy

In addition to the matters set forth in Part I of this Schedule, the Title is subject to the following matters, and the Company insures against loss or damage sustained in the event that they are not subordinate to the lien of the Insured Mortgage.

This is the section where we affirmatively insure that an encumbrance on title is subordinate to the lien of the Deed of Trust or Mortgage.

Note that it says “subordinate” not “subsequent”.

- Should only include encumbrances that create an interest in real property (fee, leasehold, easement).

Inspections

What are we looking for when it's commercial property?

- Evidence of new construction
- Evidence of leasehold interests
- Evidence of unrecorded use (i.e. shared parking)
- Evidence of encroachments

Endorsements

- One of the biggest differences between residential and commercial transactions, especially for lenders.
- Endorsements should be attached to Proforma.
- Endorsements should be issued based on instructions; You should not select endorsements for lender in reliance on vague language such as “if applicable”.
- Endorsements must be priced appropriately (elevated risk for commercial transactions often means elevated pricing).
- Endorsements must be underwritten.

Underwriting Commercial Endorsements

Examples – What do we need?

- ALTA 15 Series: Non-Imputation
 - Non-Imp Affidavit, evidence of signing authority, possible indemnity, organizational chart
- Future Development Endorsements (ALTA 3.2-06, ALTA 9.7-06, ALTA 28.3-06)
 - Plans outlining what type of improvements they are building and where they will be located on the property
- ALTA 12-06 Series: Aggregation (aka Tie-In)
 - Identify all sites and associated policies; Underwriters can not tie in to each others policies
- ALTA 28 Series: Encroachments
 - Survey may be necessary, physical inspection, aerial photographs, legals must be run out

Proformas

- A Proforma is a mock up of what the final policy will look like.
- Typically requested in all commercial transactions.
- Very helpful tool in understanding what the final policy will look like, especially if we are insuring an interest that has not yet been created (i.e. leasehold interest).
- Should contain disclaimer language that this is not the final policy.
 - This includes Proforma endorsements.

Survey Expectations

- New Survey Standards Effective February 23, 2016.
- Title changed from “ALTA/ACSM” to “ALTA/NSPS” in order to acknowledge the merger of the American Congress on Surveying and Mapping into the National Society of Professional Surveyors.
- An ALTA/NSPS should always be certified to your underwriter if they are relying on the representations made in that survey for insuring purposes.
- Does it always have to be a brand new survey?

Survey Coverage

- When asking for “survey coverage” we may seek clarification. Are you asking for removal of the general exception for boundary line issues, etc.?
- Many people mistakenly assume that “survey coverage” is a request for a ALTA 25-06 Survey Endorsement, which only insures that the land described in the survey is the same land described in the policy.

Commercial Owner's Affidavit

- If you are providing extended coverage, you may want to obtain a commercial owner's affidavit from the seller for a sale, or a borrower for a refinance.

Representations:

1. Owner of the property is in possession.
2. There are no bankruptcy or receivership proceedings ongoing.
3. No state or federal tax liens outstanding.
4. No pending dispute or litigation regarding property lines.
5. No unpaid taxes.
6. No work, services or labor in the last 90 days that would give rise to mechanic's lien risk.
7. No unrecorded mortgages or contracts.
8. No leasehold estates, except those identified in the affidavit.

Authority

- Establishing proper signing authority is vitally important in any transaction, but in commercial transactions it is especially so because the policy liability amounts can be much higher.
- Authority for Lessees.
 - If there is a Lessee entity executing an SNDA, we need to see authority docs for the Lessee too before we can rely on the SNDA.
- Several layers of entities
 - i.e. There is an LLC in title. There are 3 Members of the LLC, as follows:
 - Member 1: **Individual**, Member 2: **LLC**, Member 3: **Trust**

Authority

- You should not rely on the Secretary of State business search printout as your sole method of determining proper signing authority.
- If you recently closed a transaction with the same entity where signing authority was established, you still need to inquire as to whether or not there have been any amendments to the authority docs.
- Try to ask for authority docs early – you may need a lot of time to review them.
 - Example

Example

COMPANY:

[REDACTED] a Delaware limited liability company

By: [REDACTED] a Delaware limited liability company, its sole member

By: [REDACTED], a Washington limited liability company, its Manager

By: [REDACTED] a Washington limited liability company, its Manager

By: [REDACTED] a Washington limited liability company, its Manager

By: [REDACTED], a Washington limited liability company, its Manager

By: [REDACTED] a Washington limited liability company, its Manager

By: [REDACTED] a Washington limited liability company, its Manager

By: [REDACTED] a Washington limited liability company, its Manager

By: [REDACTED] its Manager

By: [REDACTED] a Washington limited liability company, its Manager

By: [REDACTED] its Manager

This transaction required review of organizational docs for 10 different layered entities before we could establish who could sign on behalf of the borrower.

Closing Protection Letters

- A lender who wants a title insurer to be responsible for some of the agent's actions in connection with the closing may request a Closing Protection Letter (aka "Insured Closing Letter") from the title insurer.
- General purpose of a CPL is to provide coverage against:
 1. Intentional redirection or fraudulent handling of lender's funds (defalcation).
 2. Failure to follow the lender's closing instructions, to the extent they relate to the validity, priority or enforceability of mortgage on the land, including obtaining documents and disbursement of funds in connection therewith.

Closing Protection Letters

- In a commercial transaction it is very common for the lender to request a CPL with the same liability amount as their loan. This may require modification of the CPL form.
- The demand for CPLs has increased significantly due to cybersecurity issues.
- Title insurers need to consider how sophisticated the agent's escrow security is. There should be established safeguards in place that help prevent intruders from gaining access to the agent's system for the purpose of re-directing funds.

Questions?