

THE ALTA STANDARD LOAN POLICY – 1992

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I. INTRODUCTION

Like the Owner's Policy, the Loan Policy of title insurance is a contract of indemnity under which the title insurer agrees to protect the insured party against certain defined risks. *FN Hoyd v. Chicago Title Insurance Co.*, 354 N.W 154, 156 (Neb. 1964) Where the Owner's Policy generally insures a purchaser of property, the Loan Policy insures the lender against the same risks as the Owner's Policy but goes on to provide additional protection to the Lender. This chapter address Loan Policy by examining such additional protection as provided to the Lender and by examining the differences between the Owner's and Loan Policies in practice.

To begin, title insurance differs from most other insurance in several ways. First, it is issued for a single premium while its coverage lasts indefinitely. Second, its issuance involves a great deal of research and document review by the insurer to limit and contain the risk to the insurer and the insured. Unlike insurers under other insurance policies, like life and health insurance, the title insurer is unguided by actuarial tables, but instead relies on a careful review of the specific title to be insured. The insurer acts not only to identify problem areas but also acts to minimize the risk that a problem will occur. By working with the parties to the transaction, a good underwriter is able to reduce significantly risks to the benefit of all the parties, be they seller, buyer or lender.

Like the Owner's Policy, the Loan Policy provides the insured with two primary types of protection. The first is commonly known as the "duty to defend," and includes the promise to pay legal expenses if an adverse claim which might affect the lender's interest should arise.

The second, the so-called "duty to indemnify" includes the promise to reimburse or indemnify the lender for any damage to its interest secured by the mortgage insured if the condition of title is different than as it was insured under the policy.

There is no monetary limit on the insurer's duty to defend. The duty to indemnify is limited by the policy amount reflected on Schedule A of the policy (see _____ below_) and by provisions contained in the Conditions and Stipulations discussed below. Legal expenses incurred in defense of the policy do not reduce the policy amount. Under paragraph 6(a)(i) of the Conditions and Stipulations of the policy (see _____ below) the insurer may choose pay the stated policy amount, terminating policy coverage and its duty to defend under the policy.

A. DIFFERENCES BETWEEN THE OWNER'S AND LOAN POLICIES

The main difference between the Owner's Policy and the Loan Policy is, simply enough, that the policies insure different parties. As shown below, when the individual provisions of the Loan Policy are discussed, the Loan Policy insures against the same title risks as the Owner's Policy but additionally provides protection against risks that are related to the lien of the mortgage which secures the owner's indebtedness. (See below _____)

The owner is clearly not an insured party under the Loan Policy and does not benefit under third-party beneficiary theories. *First American Title Insurance Company of Texas v. Willard*, 1996 WLR 9426 (Tex App. 1996;); *McKenzie v. Columbian Title Insurance Company*, 931 SW 2nd 843 (Mo. App. 1996.) Occasionally, a title insurer may be asked to issue a letter of indemnification or "hold-harmless" letter to a subsequent insurer relative to a matter that was not included an exception to title under an prior policy. If the prior policy insured the owner, the current request is essentially a claim and will generally be honored barring defenses the insurer may have under the policy. If the prior policy is a Loan Policy, the request from the owner—who is not an insured—is unwarranted and will often be denied unless the insurer under the original policy also assumed other obligations to the owner under an escrow or other relationship.

Loan policies are typically issued at the request of the borrower to satisfy the requirements of a lender and typically paid for by the borrower. Usually when the borrower is also the purchaser of the property which will secure the loan, that is when the mortgage will be what is commonly called a "purchase money mortgage," the Loan

Policy will be issued at a reduced rate (or a simultaneous issue rate,) when the Owner's Policy is issued for a liability amount equal to or greater than liability requested for the Loan Policy. The simultaneous issue rate is possible, because the insurer is (for the most part) insuring two parties against a single risk..

Frequently, title insurer's are able to underwrite certain risks for a Loan Policy that cannot be underwritten for the Owner's Policy. It is often suggested that this done because lenders are able to exert more economic pressure on title insurers than the average consumer. While this is certainly the case in isolated instances, a more reasoned view results from looking carefully at the likelihood that a lender would suffer the loss or damage necessary to result in a claim under a Loan Policy. This matter is covered more fully in _____, but broadly speaking, there are several conditions that must precede a claim by an insured lender. Not only must a title defect exist (which would result in a claim under the Owner's Policy,) but additionally the lender must suffer a loss which would require at least two independent conditions to exist. First, the borrower must be in default on the insured mortgage. Second, after successfully foreclosing on the mortgage, the value of the property (as diminished by the title defect) must be less than the outstanding indebtedness of the loan. (See _____ below.) It is these two additional requirements which provides the title underwriter greater latitude when insuring a lender.

B. WHY A LOAN POLICY IS NEVER AN OWNER'S POLICY

Despite what is often said and written, a Loan Policy never becomes an Owner's Policy; a Loan Policy is always a Loan Policy. Clearly as discussed below in _____, coverage under the Loan Policy continues for the benefit of the insured lender if the lender acquires title through the land by foreclosure or deed in lieu of foreclosure or "other legal manner which discharges the lien of the insured mortgage," it is inaccurate and misleading to suggest that the lender now has an Owner's Policy or is provided the coverage of an Owner's Policy. *Paramount Properties Co. v.*

Transamerica Title Ins. Co., 1 Cal.3d 562, 83 Cal. Rptr. 394, 463 P.2d 746 (1970),
Laurel National Bank V. Mutual Benefit Insurance Co. 297 Pa. Super. 473, 444 A.2d 130
(1980); *Hawkins v. Oakland Title Ins. and Guar. Co.* 165 Cal. App.2d 116,, 331 P.2d 742
(1953)

In what ways, then, is a lender's coverage after foreclosure or acquisition of title different from that that afforded a third party purchaser at a foreclosure sale?

To begin with, Exclusion from coverage 3 (d) excludes from any matter attaching or created subsequent to the date of the policy. At the very least, the lender's coverage does not extend to the validity of the foreclosure . It clearly does not extend to the numerous matters which might arise after the recording of the mortgage.

Second, the liability under the Loan Policy (unlike an Owner's Policy) reduces as the loan is paid down. See _____ relative to Conditions and Stipulations no. 7. (a) (ii) and 9. (d). Mortgage payments that paid down the mortgage principal similarly reduced the amount of liability under the Loan Policy.

Because the liability under the Loan Policy is generally reduced from the original face amount (and because mortgage loans are seldom made for 100% of the value of the property,) the lender may have a difficult time demonstrating loss or damage, that is that the value of the land (even subject to the title defect) is less than the reduced liability under the policy. By way of comparison, an insured under an Owner's Policy would be able to tender a claim for any insured defect without considering these matters.

For these reasons, attorneys representing lenders are well advised to obtain a new owner's title insurance policy (or an open commitment rather than rely on continuation of the coverage under the mortgagee's policy. In fact, it is customary practice to obtain owner's coverage very early in the foreclosure process in a commitment for title insurance frequently called "minutes of foreclosure." The commitment not only provides information essential to any effective foreclosure but ultimately can become a real

Owner's Policy See Janice E. Carpi, "Title Insurance Following Foreclosure," Beyond the Workout: Risks for Lenders Taking Back and Owning Real Estate, Third Annual Spring CLE and Committee Meeting, Real Property Law Programs, Section of Real Property, Probate and Trust Law, American Bar Association, May 7-9, 1992, p. A-3.

C. TYPES OF LOAN POLICIES

Generally, most title insurers doing business in the State of Illinois use policy forms that closely correspond with the American Land Title Association Standard Loan Policy 1992. However, many other policy forms may also be used in order to provide lender's title protection. Therefore, the attorney for a lending institution should ascertain which form his institution will receive to insure the lien of a particular mortgage. In addition to the individual nomenclature that the company uses to describe its form, it will generally have a legend printed somewhere on the commitment that the policy is the same as or provides equivalent coverage to the 1992 ALTA Loan Policy.

Only two forms of Loan Policy are approved by ALTA: The 1992 ALTA Loan Policy and the 1987 Residential Loan Policy.. Occasionally a policy in the form formerly known as the ALTA 1970 Loan Policy is issued. There are many differences between the 1970 and the 1992 Loan Policies, but the primary differences are the Exclusion for Creditor's Rights matters (Exclusion 7) and the Arbitration paragraph contained in the Conditions and Stipulations at paragraph _____. Rather than issue the 1970 policy, these matters are generally addressed by endorsement. See _____ below for a discussion of the issues involved.

The Residential Loan Policy closing tracts the Residential Owner's Policy just as the 1992 ALTA Loan Policy tracts the 1992 Owner's Policy and does not warrant separate discussion.

Two other loan policies are available but have not been approved by ALTA and are not available from all title insurance company. Because they reflect creative reactions to the changing needs of lenders and are likely to be common place in the market place, they are discussed below.

Lender's Extended Liability Policy: ALTA has already approved the owner's version of this policy specifically designed for the residential market. By re-examining some underlying assumptions regarding title insurance and by seeking to add value to the product for consumers, title underwriters have been able to add value to the traditional title policy including coverages over matters that are traditionally "off limits" for title insurers, that is, post policy matters. Known under numerous names a copy of this innovative policy, "The Eagle Policy" is attached at exhibit _____.

International Policy: In response to the increasing globalization of investments, this policy accomplishes several goals:

1. It provides uniform insurance coverage irrespective of the country in which the insured parcel is located. Like the uniformity provided by the use of ALTA forms in the various United States, this policy requires the attorney involved in international transactions to be familiar with only one form of policy, whether the insured parcel be in Japan or France.
2. It provides investors or lenders who are not citizens of the country in which the insured parcel is located insurance coverage compatible with the expectations of those familiar with standard title insurance coverage afforded in the United States.

This uniform policy is not available for transactions in every country, but is currently available for many European, Caribbean and Latin American countries and some Asian countries. It is not intended to insure residents of the country in which the insured land is located. It is not available from every title insurer but is available from First American Title Insurance Company.

Because the **1992 ALTA Loan Policy** is the most widely used it will be the basis for discussion in this chapter. All further reference to the Loan Policy will specifically refer to the 1992 ALTA Loan Policy. The forms of the 1992 Loan Policy, the Residential Loan Policy, and the Extended Liability Loan Policy ("the Eagle Policy") are provided as Exhibits _____. Other title insurers doing business in the State of Illinois will generally be happy to provide an attorney with samples of their equivalent forms upon request.

The structure and format of the Loan Policy closely tracks that of the owner's Policy. The affirmative insuring provisions appear on the cover of the policy. The Exclusions from Coverage appear on the inside of the front cover. The Conditions and Stipulations comprise the remainder of the cover. Finally, Schedules A B will be inserted to complete the policy. Moreover, the substantive provisions of the Loan Policy are basically the same as the substantive provisions of the Owner's Policy except where changes are necessitated due to the fact that the Loan Policy insures both the quality and status of the title and the lien of the mortgage. As a result of the additional coverage, additional provisions are added and, in some instances, changes in the provisions appearing in the Owner's Policy are required.

It should be noted, however, that the standard Loan Policy provides additional coverage not afforded in the Owner's Policy. As will be seen shortly, the Loan Policy insures against unrecorded mechanics liens while the Owner's Policy does not so insure. In addition, the standard exceptions that appear in the Owner's Policy in Schedule B do not typically appear in the Loan Policy. Deletion of these general exceptions is generally referred to as affording "extended coverage" and is generally provided by endorsement.

II. INSURING PROVISIONS

A. SCOPE OF COVERAGE

SUBJECT TO THE EXCLUSIONS FROM COVERAGE, THE EXCEPTIONS FROM COVERAGE CONTAINED IN SCHEDULE B AND THE CONDITIONS AND STIPULATIONS, FIRST AMERICAN TITLE INSURANCE COMPANY, a California corporation, herein called the Company, insures, as of Date of Policy shown in Schedule A, against loss or damage, not exceeding the Amount of Insurance stated in Schedule A, sustained or incurred by the insured by reason of:

...

The initial paragraph on the face of the policy provides a broad general outline of the scope of coverage afforded and indicates that there are some items that are not covered by the policy. The initial clause of the policy carves out three particular items, specifically the Exclusions from Coverage; the exceptions contained in Schedule B; and the provisions of the Conditions and Stipulations. Each of those areas, the Exclusions from Coverage, the exceptions contained in Schedule B, and the provisions of the Conditions and Stipulations, will be discussed in further detail in this chapter. It is enough to say here that coverage affirmatively stated in or provided by the policy is subject to these three matters.

The insuring company is identified. Since the author is familiar with the forms used by First American Title Insurance Company, Inc., those forms are used to discuss the ALTA 1992 Loan Policy.

This initial paragraph of the standard Loan Policy is identical to the initial paragraph of the owner's form.

B. MATTERS ADDRESSED IN BOTH OWNER'S AND LOAN POLICIES

As discussed above at _____, the Loan Policy incorporates the coverages included in an Owner's Policy and extends them to the lender. It also provides additional coverages to the lender relating specifically to the lien of the mortgage. For matters addressed in both the owner's and loan policies, the attorney will be directed to refer to the corresponding discussion in the chapter addressing the Owner's Policy. As discussed above at _____, none of this correspondence should be interpreted to suggest that an owner is somehow afforded coverage under the Loan Policy (or vice versa.) For additional clarification in appropriate instances, the provisions of the policy as insuring the lender may result in nuances of coverage that have special relevance to a lender, and those will be addressed separately.

SUBJECT TO THE EXCLUSIONS FROM COVERAGE, THE EXCEPTIONS FROM COVERAGE CONTAINED IN SCHEDULE B AND THE CONDITIONS AND STIPULATIONS, FIRST AMERICAN TITLE INSURANCE COMPANY, a California corporation, herein called the Company, insures, as of Date of Policy shown in Schedule A, against loss or damage, not exceeding the Amount of Insurance stated in Schedule A, sustained or incurred by the insured by reason of:

- 1. Title to the estate or interest described in Schedule A being vested otherwise than as stated therein.**
- 2. Any defect in or lien or encumbrance on the title;**
- 3. Unmarketability of the title;**
- 4. Lack of a right of access to and from the land;**

The provisions in paragraphs 1, 2, 3, and 4 are identical to those appearing in the owner's policies and are discussed at _____ above. In other words, the title insurer is insuring for the benefit of the mortgagee, the status and quality of title vested in the mortgagor.

In this respect, the standard ALTA Loan Policy provides additional coverage not afforded under some earlier forms of title insurance policies provided to lenders. See e.g. *Bank of Miami Beach v. Lawyers' Title Guaranty Fund*. 213 So.2d 95 (Fla.App. 1968), Indeed, other limited coverage policies such as that referred to as the 1996 ALTA Short Form Residential Limited Coverage Junior Loan Policy (10-19-96) similarly do not address the mortgagor's status or quality of title to the same extent as the ALTA Loan Policy, but these policies are in rather limited use.

C. INVALIDITY OR ENFORCEABILITY OF THE LIEN

SUBJECT TO THE EXCLUSIONS FROM COVERAGE, THE EXCEPTIONS FROM COVERAGE CONTAINED IN SCHEDULE B AND THE CONDITIONS AND STIPULATIONS, FIRST AMERICAN TITLE INSURANCE COMPANY, a California corporation, herein called the Company, insures, as of Date of Policy shown in Schedule A, against loss or damage, not exceeding the Amount of Insurance stated in Schedule A, sustained or incurred by the insured by reason of:

...

- 5. The invalidity or unenforceability of the lien of the insured mortgage upon the title;**

This is the first of the insuring provisions appearing on the cover of the policy that does not correspond to the provisions appearing in the standard ALTA owner's policies. This fifth affirmative insuring provision, and those that follow, result from the fact that the Loan Policy insures the lien of a mortgage as well as the status and quality of title vested in the mortgagor.

It is often said that the Loan Policy insures the lien of the mortgage upon the land, but what does this actually mean?. This fifth affirmative insuring provision provides that the title insurance company insures that the lien of the insured mortgage is both valid and enforceable, subject, of course, to the other policy provisions, This insurance of validity and enforceability of a mortgage lien provides broad and important protection for the lender.

Of course, in order to have a valid and enforceable mortgage lien, several requirements must be met. First, the mortgage instrument must be properly executed.. In the event that the mortgage is improperly executed and a loss results, the title insurance company is liable for the amount of loss sustained by the mortgagee. *Ferrell v. Inter-County Title Guaranty & Mortgage Co.*, 213 So.2d 518 (Fla.App. 1968). Many risks that are insured against in this provision including fraud, duress, incompetency, lack of corporate authority, forgery, all of which are notably “non-record” matters. Insurance is, of course, subject to policy exclusions such as contained in Exclusion 3(b) non-record matters known to the insured and not disclosed in writing to the insurer, which will be discussed more fully at _____ below.

Second, the title insurer must ascertain that there is, in fact, a subsisting debt that will support the mortgage lien. That is, the title insurer must ascertain that the lender has, in fact, paid out the proceeds of the loan to the borrower or for his account (765 ILCS 5/39).

Third, the title insurer will want to be sure that the mortgage lien is valid as to third parties by ascertaining that the mortgage is recorded . The fact that the mortgage lien arises in the absence of recording is of little comfort to the insurer or the insured 765 ILCS 5/2 since that mortgage lien may not be enforceable against certain individuals, e.g., subsequent purchasers for value without notice of the existence of the lien (765 ILCS 5/30).

It is important to read this (and all) insuring clauses in context of the policy In every instance the insured must demonstrate an actual loss or damage not merely that the insured mortgage is not a valid lien. Consider *Sipes v. Kansas City Title Insurance Company* 372 S.W. 2d 478 (Mo. App, 1963) wherein an insured mortgage was clearly an invalid lien. No recovery was had against the insurer because a foreclosure of a prior mortgage cut off the insured mortgage and the insured mortgage would have been without opportunity of recovery against the property even had the lien be valid.

It is important to note that the Loan Policy insures the validity and enforceability of the mortgage, it does not insure the particular manner of enforcement or the validity of all of the terms of the mortgage.

D. PRIORITY OF THE LIEN

SUBJECT TO THE EXCLUSIONS FROM COVERAGE, THE EXCEPTIONS CONTAINED IN SCHEDULE B, AND THE PROVISIONS OF THE CONDITIONS AND STIPULATIONS HEREOF, FIRST AMERICAN TITLE INSURANCE COMPANY, INC., a California, herein called The Company insures as of the Effective Date of policy shown in Schedule A, against loss or damage, not exceeding the amount of insurance stated in Schedule A, and costs, attorneys' fees and expenses which The Fund may become obligated to pay hereunder, sustained or incurred by the insured by reason of...

(6) The priority of any lien or encumbrance over the lien of the insured mortgage;

The ALTA standard Loan Policy insures the status and quality of title in the mortgagor, the validity and enforceability of the lien of the insured mortgage and, by virtue of this sixth provision, its priority. In other words, unless the title insurer notes another interest that has priority over that of the insured mortgage by setting forth that interest in Schedule B, the policy affirmatively insures that the insured mortgage is a first and prior lien. This is important since many lenders operate under regulations, whether self-imposed or imposed by state or federal governments or agencies which limit the lender to making loans secured by first mortgages on real estate. In the event that the mortgage securing a particular obligation is not a first mortgage, the loan may be in violation of these regulations. Depending upon the source of the regulation, the adverse results of such a situation may be substantial. In any event, the policy insures that the mortgage lien which is covered thereby is a first mortgage lien, but for the exceptions noted on the policy.

Priority has become a more complicated issue in the last twenty years. No longer is it possible to determine priority solely by determining which lien was recorded first. Because of the proliferation of mortgage product available to consumers and commercial borrowers since the mid 1980's (such as variable rate mortgage, adjustable rate

mortgages, consumer equity mortgages, and so on,) careful lenders have requested additional coverages in the form of endorsement to protect their interest under these types of loan arrangements. Lenders need to be assured, for example, that if a form of mortgage calls for an increase in the rate of interest based upon some sort of index, that those increases will not prejudice the priority of the mortgage as to encumbrancers who record after the recording of the mortgage but prior to the increase in rate. The lender needs to know that if the interest on his mortgage increases from 7 percent to 8 percent, he will be secured with a first mortgage for the principal and all accrued interest, at whatever the applicable rate of interest is. When possible, the title industry has responded to this need by offering endorsement to cover these fact situations which, by their nature, are post-policy in nature and would not ordinarily be covered by the policy. Reliance upon applicable state law (consider 765 ILCS 5/39, 205 ILCS 5/5 (d) and 815 ILCS 205/4.1 *et seq.* and sound underwriting practices has allowed the title insurers to offer an assortment of endorsements, many of which are discussed in Chapter_____.

E. UNRECORDED MECHANICS LIENS

SUBJECT TO THE EXCLUSIONS FROM COVERAGE, THE EXCEPTIONS CONTAINED IN SCHEDULE B AND THE PROVISIONS OF THE CONDITIONS AND STIPULATIONS HEREOF, FIRST AMERICAN TITLE INSURANCE COMPANY, INC., an Illinois Corporation, herein called The Fund, insures as of the Effective Date of policy shown in Schedule A, against loss or damage, not exceeding the amount of insurance stated in Schedule A, and costs, attorneys' fees and expenses which The Fund may become obligated to pay hereunder, sustained or incurred by the insured by reason of...

- 7. Lack of priority of the lien of the insured mortgage over any statutory lien for services, labor or material:**
- (a) arising from an improvement or work related to the land which is contracted for or commenced prior to Date of Policy; or**
 - (b) arising from an improvement or work related to the land which is contracted for or commenced subsequent to Date of Policy and which is financed in whole or in part by proceeds of the indebtedness secured by the insured mortgage which at Date of Policy the insured has advanced or is obligated to advance;**

No other area of the law causes greater consternation or generates greater claims tendered to title insurers in Illinois than the area of mechanics liens. The reader is directed to 770 ILCS 60/0.01 *et seq.* for the complicated and often vexing provisions of the Illinois Mechanics Lien Act as well as for a similarly vexing solution to the proper spelling of “mechanics liens.” This chapter has adopted the spelling used in the short caption of the statute—that is a spelling without any apostrophe. The solution is simple, easy to remember and has the stamp of approval of the Illinois Legislature.

Because of the complicated nature of Illinois mechanics lien laws and because the complicated real world aspects of new construction, the insuring provisions contained in the seventh provision appearing on the face of the policy provides invaluable insurance to the lender. Insurance is provided against unrecorded mechanics liens in two specific instances.

In the first instance, outlined in (a), the policy insures against loss or damage suffered by reason of the existence of a mechanics lien which, at the effective date of the policy, has gained or may thereafter gain priority over the lien of the insured mortgage. Since, in Illinois, it is possible for a mechanics lien to be a secret lien for a period of four months (770 ILCS 60/7), this coverage afforded by the title insurer is an important and valuable. The lender need not worry about inchoate and “hidden” mechanics liens which might, at some subsequent date, gain priority over the lien of his mortgage. In this respect, the title insurer provides critical and invaluable service.

The second instance, provides protections against certain *post-policy matters* which could decrease the value of the lender’s collateral. Subparagraph (b) provides insurance against lack of priority arising from mechanics liens for work financed in whole or in part by the lender’s funds advanced at or prior to the closing or funds which the lender is obligated to advance (under its loan agreement, mortgage or other such agreement.)

The post-policy mechanics lien coverage is clearly limited and does not include all mechanics liens which could attempt to deny the lender’s priority. For example, a post-policy lien which attaches to the property for work which is *not* at least in part financed by the lender’s funds are *not* covered under this insuring provision. Such a lien might claim priority based upon an “enhancement” theory (770 ILCS_60/16) and would not be covered under the policy. If such situations were not eliminated from coverage, the title insurer would be faced with a situation where he might be called upon to perfect the

priority of the insured lien at a point as many as 20 or 30 years subsequent to the effective date of the policy. Earlier editions of the ALTA Loan Policy did not eliminate this situation from coverage, and the title insurance industry suffered a number of serious claims in the 1950's. .

Note, however, that if proceeds of the insured mortgage which have been disbursed at the effective date of the policy or which the lender is required to disburse later are used to pay for improvements commenced and contracted for subsequent to the effective date of the policy, a lien arising as a result of such improvements is *not* eliminated from coverage under the policy. For this reason, the ALTA Loan and Extended Coverage Policy Statement commonly used in Illinois contains a lender's disbursement statement section wherein the lender states that it has no knowledge nor does it require that any part of the loan proceeds be used to finance construction of improvements to be commenced in the future. [See exhibit_____]. If the proceeds from the loan are being used for construction purposes, (and therefor subjecting the lien of the mortgage to mechanics liens which would be insured against under the policy), a title exception will be raised for "possible mechanics liens." If the full proceeds of the loan are not being disbursed when the policy is to be issued, it is common practice to tie the coverage amounts to the loan funds actually disbursed. This requires a modification of insuring provision 7 by what is frequently referred to as a "pending disbursement" modification. This change may be accomplished by endorsement or a special exception to Schedule B of the policy.

In the event that a lender wants mechanics lien coverage in such a situation, there are several options open to him and to the title insurer. A portion of the loan proceeds may be escrowed with the title insurer to be disbursed only upon completion of appropriate owner's and contractor's affidavits and lien waivers sufficient to provide protection under the Illinois Mechanics Lien Act. Or the whole loan disbursement process may take place in connection with a construction escrow in which the title insurer issues periodic endorsements to the Loan Policy .

For a discussion of construction loan issues please see Chapter _____ .

F. ASSIGNMENT OF THE MORTGAGE

SUBJECT TO THE EXCLUSIONS FROM COVERAGE, THE EXCEPTIONS FROM COVERAGE CONTAINED IN SCHEDULE B AND THE CONDITIONS AND STIPULATIONS, FIRST AMERICAN TITLE INSURANCE COMPANY, a California corporation, herein called the Company, insures, as of Date of Policy shown in Schedule A, against loss or damage, not exceeding the Amount of Insurance stated in Schedule A, sustained or incurred by the insured by reason of:...

8. The invalidity or unenforceability of any assignment of the insured mortgage, provided the assignment is shown in Schedule A, or the failure of the assignment shown in Schedule A to vest title to the insured mortgage in the named insured assignee free and clear of all liens.

This insuring provision provides coverage when the insured mortgage is acquired by assignment of the mortgage from a prior holder. Schedule A of the policy should reflect the assignment (of record) and the assignee as an insured.

In many ways the development and the ALTA policy paralleled and was prompted by the development of the secondary residential mortgage market created by large institutional investors. These investors who purchased mortgages from across the company required a uniform insurance policy rather than the many differing forms in existence before the standard ALTA forms. A similar homogenization in commercial transactions is occurring in the late 1990's with the securitization of commercial transactions and the development of so-called "conduit" lending. These forces not only require uniform title insurance coverages, but they require that the title policies anticipate the free transfer and assignment of mortgages to investors. This final insuring provision along with the definition of "insured" in the Conditions and Stipulations (See _____ below) is the title industry's response.

The Company will also pay the costs, attorneys' fees and expenses incurred in defense of the title or the lien of the insured mortgage, as insured, but only to the extent provided in the Conditions and Stipulations.

This final language states the insurer's duty to defend.

III. EXCLUSIONS FROM COVERAGE

A. SCOPE OF THE EXCLUSIONS

The cover of the ALTA Loan Policy lists eight areas of affirmative protection afforded under the policy, subject to the Exclusions from Coverage, the exceptions contained in Schedule B, and the provisions of the Conditions and Stipulations.

On the inside of the front cover appear seven Exclusions from Coverage. These Exclusions from Coverage apply generally to all titles or mortgage liens that are insured by the title insurance company. . These Exclusions from cover pertain to general matters about which the title insurer has either no or limited means of acquiring information and, therefore declines to provide insurance coverage. Most of them relate to governmental regulations of one sort or another, one deals with the mechanics liens not financed with funds from the insured transaction, one deals with the complicated ramifications of bankruptcy and related laws and one (no. 3) deals with a collection of matters of which are likely to be outside of the insurer's knowledge. Thus, while the Exclusions from Coverage are general, this should not lead the attorney to conclude that they are unimportant or irrelevant. They should be carefully read and analyzed with regards to each transaction.

As with the Insuring Provision, when the Exclusions form Coverage are reviewed, there is great similarity when the Owner's Policy is compared to the Loan Policy The reader will be referred to the Chapter ____ dealing with the Owner's Policy except in certain instances where there are significant differences in the Exclusions as they relate to the Loan Policy.

B. EXCLUSIONS FROM COVERAGE IN BOTH OWNER'S AND LOAN POLICIES

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

- 1. (a) Any law, ordinance or governmental regulation (including but not limited to building and zoning laws, ordinances, or regulations) restricting, regulating, prohibiting or relating to (i) the occupancy, use, or enjoyment of the land; (ii) the character, dimensions or location of any improvement now or hereafter erected on the land; (iii) a separation in ownership or a change in the dimensions or area of the land or any parcel of which the land is or was a part; or (iv) environmental protection, or the effect of any violation of these laws, ordinances or governmental regulations, except to the extent that a notice of the enforcement thereof or a notice of a defect, lien or encumbrance resulting from a violation or alleged violation affecting the land has been recorded in the public records at Date of Policy.**
- 2. Any governmental police power not excluded by (a) above, except to the extent that a notice of the exercise thereof or a notice of a defect, lien or encumbrance resulting from a violation or alleged violation affecting the land has been recorded in the public b**

The first and second Exclusions from Coverage is identical to the first exclusion from coverage appearing in the ALTA owner's policies and, therefore, the attorney is referred to _____ above.

C. LOSS OR DAMAGE BY REASON OF OTHER DEFECTS

The following matters are expressly excluded from the coverage of this policy and the Company will not pay loss or damage, costs, attorneys' fees or expenses which 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;**
 - (c) resulting in no loss or damage to the insured claimant;**
 - (d) attaching or created subsequent to Date of Policy (except to the extent that this policy insures the priority of the lien of the insured mortgage over any statutory lien for services, labor or material); or**
 - (e) resulting in loss or damage which would not have been sustained if the insured claimant had paid value for the insured mortgage.**

For the most part, this third exclusion from coverage is the same as the third exclusion from coverage appearing in the owner's policies and, therefore, the attorney is referred to _____ above.

The only changes are necessitated by the differences between the owner's and loan policies are reflected in subparagraphs (d) and (e) Paragraph (d) in the Loan Policy makes clear that certain matters which would otherwise be excluded from coverage are included in the coverage for the Loan Policy, specifically the mechanics lien matter as outlined in the insuring provisions of the policy (see _____ above).

There are some particular paragraphs which require special attention as the relate to lenders and the Loan Policy and they will be addressed in order.

D. CREATED, SUFFERED OR ASSUMED

- 3. Defects, liens, encumbrances, adverse claims or other matters:**
- (a) created, suffered, assumed or agreed to by the insured claimant;**

Because the relationship between borrower and lender is often complex and continues after the date of the policy, this exclusion is meant to reaffirm basic insurance tenets and public policy theories, that a party should not be insured against his own acts.

What may be clear in theory is often not clear in the real world and the courts have dealt with this issue in several cases. For example, the court in *Feldman v. Urban Commercial, Inc.*, 87 N.J. Super, 391, 209 A.2d 640 (1964) found that the defect which caused loss to an insured mortgagee arose because of the insured's "deliberate, affirmative action in pursuing his unconscionable [business] scheme." In a frequently cited case, *First National Bank & Trust Company of Port Chester v. New York Title Insurance Co.*, 171 Misc. 854, 12 N.Y.S. 2d 703 (1939) discusses the terms of the exclusion in reference to a mortgaged deemed a preference in bankruptcy. See also *McLaughlin v. Attorney's Title Guaranty Fund*, 61 Ill App 3rd 911, 378 N.E.2d 355, 18 Ill.Dec. 891 (1978).

For example, in the instance shared appreciation, contingent interest mortgages, lenders should be concerned that such transactions may be re-characterized as partnerships or joint ventures. Similar concerns consider Sher, Leopold Z., and Kerry J. Miller, "Interpreting the term: "created" in Policy exclusion 3(a)" Title Insurance 1998, Mastering Critical Issues Facing the Buyer, Seller and Lender, PLI, NY

One special areas particular to the borrower-lender relationship merits special attention in regard to this exclusion. It involves both this exclusion 3 (a) and 3(d.) (post-policy matters.) It relates to the risk that the mortgage or the entire financing transaction will be recharacterized by a co are also raised relative to loan or financing which permits interest-on-interest, negative amortization, and capitalization of additional interest. See John C. Murray, Participating Mortgages and Equity Kickers - Legal Issues, Real Property Law Section of Michigan State Bar Association, Annual Spring Meeting, Orlando, Florida, March 1990.

The risks of recharacterization also occur in sale-leaseback transactions. See Thomas C. Homburger and Brian P. Gallagher, "To Pay or Not to Pay: Claiming Damages for Recharacterization of Sale Leaseback Transactions Under Owner's Title Insurance Policies," Real Property Probate and Trust Journal, (American Bar Association), Fall 1995, p. 443. They appear explicitly in transactions utilizing synthetic leases. A "recharacterization endorsement" may be sought by lenders in certain situations in connection with both shared appreciation/contingent interest, sale-leaseback transactions and synthetic leases. These endorsements may or may not be available depending on the particular facts of each transaction and applicable law.

E. NOT KNOWN TO THE INSURER

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

...

- (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;**

This second subparagraph of the third exclusion from coverage is essentially the same as that in the Owner's Policy. The basis of this exclusion is a practical one and based upon the protections given under the law to bona fide purchasers for value. Defense of an insured who has not acted in good faith (that is, one who as proceeded despite known title defects) is clearly not an easy task and one which title insurers reasonably decline to do.

Note that a careful reading of this subparagraph indicates that the insured must only disclose his knowledge of defects, liens, encumbrances, adverse claims, or other matters that are not known to the title company and not shown by the public records. The insured need not disclose knowledge of defects if the defect is known also to the title insurer. *Foremost Construction Co. v. Killam*, 399 S.W.2d 593 (Mo. 1966); *Enterprise Timber, Inc. v. Washington Title Insurance Co.*, 457 P.2d 600 (Wash. 1969).

F. RESULTING IN NO LOSS OR DAMAGE

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

...

(c) **resulting in no loss or damage to the insured claimant;**

The third subparagraph of this third exclusion from coverage is identical to that appearing in the owner's policies and, therefore, the attorney is referred to _____ above.

An additional comment is necessary, however, since the Loan Policy relates to the mortgage lien. Generally speaking, in most instances a title defect, lien or encumbrance that is not excepted from coverage in an Owner's Policy will be the source of some loss sooner or later. While the mere existence of a judgment lien might not cause loss or damage at the present time, such loss or damage will result in the future if the insured attempts to sell the premises or if the judgment creditor seeks to enforce the lien.

Therefore, as a practical matter, the title insurer is likely to attempt to resolve the matter at an early date, often even prior to the insured's actually having suffered a loss.

However, the factual circumstances are somewhat different when a mortgagee policy is involved, for the title insurer only agrees to indemnify or reimburse the insured for loss suffered by reason of the invalidity, unenforceability or lack of priority of the mortgage lien. Prior to the insured's suffering any loss, it may be necessary that the mortgagor default and foreclosure proceedings be instituted. In such a situation, if the loss suffered by the insured is as a result of diminished value of the security as opposed to the title defect, there is no loss damage under the policy.

G. SUBSEQUENT TO THE DATE OF POLICY

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

under this policy;

...

(d) **attaching or created subsequent to Date of Policy (except to the extent that this policy insures the priority of the lien of the insured mortgage over any statutory lien for services, labor or material); or**

The fourth subparagraph of the third exclusion from coverage is similar to the fourth subparagraph of the third exclusion contained in the owner's policies and, therefore, the attorney is referred to _____ above. However, because the seventh paragraph of the affirmative insuring provisions appearing on the face of the policy provides protection against unrecorded mechanics liens in situations where such lien may arise after the effective date of the policy but may take priority over the mortgage, the policy language is amended to indicate that a mechanics lien which arises after the effective date but takes priority over the mortgage will not be excluded from coverage by this provision.

H. PAYMENT OF VALUE

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

...

resulting in loss or damage which would not have been sustained if the insured claimant had paid value for the insured mortgage.

This final subparagraph of exclusion 3 was added to the Loan Policy in 1987. The often unacknowledged bedrock of title insurance is the protection given under the recording laws to bona fide purchasers for value. In order to recover, the insured claimant must have acted in good faith (without knowledge of title defects. See _____ above) and must be a purchaser for value. If the insured claimant is an assignee of the insured mortgage and did not pay value for the assignment, the validity and priority of the assignment is subject to challenges by certain creditors.

I. DOING BUSINESS LAWS

EXCLUSIONS FROM COVERAGE

The following matters are expressly excluded from the coverage of this policy:

4. Unenforceability of the lien of the insured mortgage because of the inability or failure of the insured at Date of Policy, or the inability or failure of any subsequent owner of the indebtedness, to comply with applicable doing business laws of the state in which the land is situated.

As is the case with the other Exclusions from Coverage, this fourth exclusion embodies matters as to which the company has no or limited means of information or matters that lie almost exclusively within the control of the insured and that, therefore, are excluded under the policy.

In many states, it is possible for a foreign corporation to make loans and receive as security therefor mortgages on real estate that are perfectly valid. However, in many states a foreign corporation that has not complied with the “doing business” laws of the state may not bring an action in its own name in the state courts which means that the mortgage cannot be judicially enforced. The laws of all states provide some restriction on doing business in the state by an entity that is not licensed or registered in the state.

Under some circumstances, an endorsement known as a Doing Business Endorsement is available to give the lender protection over this matter.

J. USURY AND CONSUMER CREDIT

5. Invalidity or unenforceability of the lien of the insured mortgage, or claim thereof, which arises out of the transaction evidenced by the insured mortgage and is based upon usury or any consumer credit protection or truth in lending law.

The title insurer does not insure the validity and enforceability of the lien if any invalidity or unenforceability, or claim thereof, is the result of a violation of the usury laws or consumer credit protection or truth in lending laws. It is the legal responsibility of the lender to avoid violations of usury laws and consumer credit protection or truth in lending laws. These laws were passed, generally speaking, in an effort to regulate lenders and most lending institutions spend a considerable amount of time and money in order to

verify that their lending practices and procedures do not violate such laws. Since information with respect to violation of these laws and, in fact, the ability to control violations, is vested in the insured lender, the title insurance company excepts such matters from coverage.

In some instances, however, the title insurance industry has undertaken to provide coverage in this area. Although the Illinois usury laws taken together with consumer protection laws are something less than a model of clarity, in many instances, title insurers will insure the enforceability of commercial real estate loans with respect to usury based upon a review of the relevant loan documents. . Typically, this is accomplished by using a usury endorsement discussed in _____.

While it is possible to obtain “usury coverage” in certain instances, the title insurance industry has generally not been willing to provide lenders with coverage for violations of consumer credit protection or truth in lending laws. Simply put, the issues are different. The consumer protection laws generally relate primarily to disclosure of interest rates, payment schedules, and other terms of the loan transaction to the borrower. Most lenders have on their staffs one or more compliance officers whose primary function is to assure the institution that it does not violate these laws. Compliance includes behavior uniquely under the control of the lender and outside of the review of the title insurer.

K. MECHANICS LIENS NOT FINANCED BY THE MORTGAGE

6 Any statutory lien for services, labor or materials (or the claim of priority of any statutory lien for services, labor or materials over the lien of the insured mortgage) arising from an improvement or work related to the land which is contracted for and commenced subsequent to Date of Policy and is not financed in whole or in part by proceeds of the indebtedness secured by the insured mortgage which at Date of Policy the insured has advanced or is obligated to advance.

This exclusion refers to mechanic lien matters which are specifically excluded in the insuring provisions, that is post-policy matters which result from work not funded from the insured mortgage. These matters may, in fact, affect any recovery the lender may have under a theory of “enhancement.” See _____ for a discussion of this issue and insuring provision 7.

L. CREDITORS’ RIGHTS

7. Any claim, which arises out of the transaction creating the interest of the mortgagee insured by this policy, by reason of the operation of federal bankruptcy, state insolvency, or similar creditors' rights laws, that is based on:

- (a) the transaction creating the interest of the insured mortgagee being deemed a fraudulent conveyance or fraudulent transfer; or**
- (b) the subordination of the interest of the insured mortgagee as a result of the application of the doctrine of equitable subordination; or**
- (c) the transaction creating the interest of the insured mortgagee being deemed a preferential transfer except where the preferential transfer results from the failure:**
 - (i) to timely record the instrument of transfer; or**
 - (ii) of such recordation to impart notice to a purchaser for value or a judgment or lien creditor.**

In 1990, ALTA added exclusions in both the owner’s and lender’s policies which excluded the effect of bankruptcy and “creditors’ rights” issues arising out of the transaction being insured. The current 1992 ALTA owner’s and loan policies exclude coverage for fraudulent transfers and also for preferential transfers that are not the result of failure to timely record the instrument of

transfer. The loan policy, but not the owner's policy, also specifically excludes (in the second subparagraph of Exclusion 7) any claim or loss based on the subordination of the interest of the insured mortgagee as the result of equitable subordination.

Prior to 1990, the ALTA owner's and lender's policies did not provide coverage for creditors' rights issues for most transactions, unless specific affirmative coverage was negotiated with the title insurer and such additional coverage was permitted under the state statutes and regulations governing title insurers. Coverage for creditors' right issues was not (at least in the opinion of title companies) provided under the older policies because of the standard exclusions for matters created, suffered, assumed or agreed to by the insured claimant, the exclusion for matters known only to the insured and not disclosed to the title insurer, and the exclusion for post-policy matters.

Notwithstanding the reliance by title insurers on the standard exclusions in the older forms of ALTA policies described above, a serious question in title insurance underwriting in recent years has been whether the title insurer accepts the risk for losses with respect to a policy that does not contain the creditors' rights exclusion. Lenders in particular have argued that coverage for creditors' right exist when a policy is issued with no creditors' rights exclusion. They base this contention on the fact that the ALTA 1990 and 1992 title policies contain a preprinted creditors' rights exclusion, and that prior to the 1990 policies, title

companies added special exclusions or exceptions for creditors' rights to certain title policies. Thus, they argued, it necessarily followed that a policy issued without a specific exclusion or exception for creditor's rights meant that the title company agreed to assume the liability for such risks.

Fortunately for title insurers, this issue was specifically addressed in *Chicago Title Insurance Co. v. Citizens and Southern Nat'l Bank*, 821 F. Supp. 1492 (N.D. Ga. 1993), which held that a title company's inclusion of a creditors' rights exclusion in other title policies does not create an implication that creditor's rights issues are covered in policies that contain no such specific exclusion. This, of course, is what title companies have contended all along.

Lenders are usually very concerned about the removal of the creditors' rights exclusion in connection with foreclosures, deeds in lieu of foreclosure, modifications and other loan workouts, as well as in connection with new lending, refinancing, and sales and acquisitions of commercial properties and loan portfolios. Title insurers, on the other hand, are very concerned about possible claims based on fraudulent conveyances and preferential transfers by the borrower, and the risk of equitable subordination of all or a portion of the lender's claim against the borrower in the event of a subsequent bankruptcy filing by or against the borrower. A title company's area of expertise is in reviewing land title records, not in reviewing a borrower's financial records for evidence of its potential insolvency or in reviewing the actions of a lender for evidence of misconduct, overreaching, or unconscionable behavior that may lead to subordination of all or a portion of the mortgagee's claim against the borrower.

The first subparagraph of the seventh exclusion from coverage deals with fraudulent transfers or conveyances. Under Section 548 of the Bankruptcy Code (“Code”), a fraudulent transfer occurs if the transfer is made, either voluntarily or involuntarily, “with actual intent to hinder, delay or defraud” creditors. A transfer is also deemed to be constructively fraudulent under Section 548 and may be set aside if, within one year prior to the filing of the bankruptcy petition, the creditor receives “less than reasonably equivalent value” in a transaction *and* the transaction does not meet any one of the following requirements: (i) the transferor was insolvent at the time of the transfer or was rendered insolvent as the result of the transfer, (ii) the transferor was undercapitalized at the time of the transfer or became undercapitalized as the result of the transfer, or (iii) the transferor was unable or rendered unable by the transfer to pay its debts as they became due. (These tests are sometimes referred to as the “insolvency test,” the “capitalization test,” and the “cash flow test”). The Code (as well as most state law) generally applies a “balance sheet” test of insolvency, i.e., whether the debtor’s liabilities exceed the value of its assets. 11 U.S.C.A. Secs. 548(a)(2)(A)-(B)(i), 101(32)(A); *In re Roco*, 701 F.2d 978, 983 (1st Cir. 1983). The Code’s insolvency definition is not controlling where the trustee or debtor in possession proceeds under Section 544(b)(i) of the Code, in which case the applicable state law definition applies. The concept of unreasonably small capitalization has been left for judicial determination, but important factors considered by the courts include whether the

debtor's assets are sufficient to obtain operating credit on an ongoing basis, and a review of the totality of the debtor's financial and managerial problems (regardless of insolvency) at the time of the alleged fraudulent conveyance. *See Moody v. Security Pac. Bus. Credit, Inc.*, 971 F.2d 1056, 1071-73 (3rd Cir. 1992).

The Uniform Fraudulent Conveyance Act ("UFCA") and the Uniform Fraudulent Transfer Act ("UFTA"), one or the other of which is effective in each of the states, similarly contain constructive fraud provisions that require that the transfer be made for "fair consideration" (UFCA) or "reasonably equivalent value" (UFTA). Each of these statutes also requires that an additional element be present: either under capitalization of the transferor or the incurrence of debts by the transferor beyond its ability to pay. The UFCA and UFTA are available to the trustee or debtor in possession under the "strong arm" language of Section 544(b) of the Code, which enables the trustee or debtor in possession to avoid any transfer of an interest of the debtor in property that is avoidable under applicable state law. Under the UFTA, the limitations period for bringing a fraudulent-conveyance action is four years after the transfer was made or the obligation incurred, unless the fraud was intentional and was not discovered until a later time, in which event the limitations period is extended for one year after discovery (the limitations period for recovery under Section 548 of the Code is one year). The usual remedy for a fraudulent conveyance is to void the transfer and recover the property, although a good-faith purchaser for value is protected

under Section 548(c) of the Code (and under the UFTA) to the extent of value given for the transfer, and in such case the remedy would be for money damages for the lesser of the value of the asset transferred or the amount necessary to satisfy the claim of the creditor.

“Reasonably equivalent value” and “fair consideration” are considered to have essentially the same meaning. “Reasonably equivalent value” is not defined or explained by the Bankruptcy Code, and has been determined by both federal and state courts on a case-by-case basis. Factors considered by the courts include the good faith of the parties, the difference between the amount paid and the fair market value, the percentage of the fair market value paid, and whether the transaction was arm’s length. *See Washington v. County of King William (In re Washington)*, 232 B.R. 340, 342 (Bankr. E.D. Va. 1999); *In re Morris Communications NC, Inc.*, 914 F.2d 458, 467 (4th Cir. 1990).

However, in the case of forced sales (such as foreclosures) such factors may not be appropriate or determinative. The U.S. Supreme Court specifically addressed the issue of reasonably equivalent value in the context of a mortgage foreclosure sale *in BFP v. Resolution Trust Corp.*, 511 U.S. 531, 114 S.Ct. 1757 (1994), which held that reasonably equivalent value, in the case of a mortgage foreclosure, is the price received at a regularly conducted, non-collusive foreclosure sale of the property as long as all the requirements of the State’s foreclosure laws have been complied with. However, the Court was careful to note that its opinion applied only to real-estate mortgage foreclosures. Thus, the Court’s holding in BFP would not necessarily apply to other real-estate

transactions such as deeds in lieu of foreclosure (where reasonably equivalent value for conveyance of the property must be established), or to tax foreclosure sales unless certain due-process and procedural safeguards were present. A number of recent court opinions have applied the *BFP* holding, *supra*, to other forced-sale situations, such as judicial tax sales, and have upheld such sales upon a finding that the procedural and substantive rights of the debtor had been protected. See, e.g., *In re Washington*, *supra*; *In re Samaniego*, 224 B.R. 154 (Bankr. E.D. Wash. 1998); *Russell-Polk v. Bradley (In re Russell-Polk)*, 200 B.R. 218 (Bankr. E.D. Mo. 1996). However, at least one court has ruled that a tax foreclosure sale, although conducted in accordance with State law, was invalid and constituted a fraudulent transfer. *Sherman v. Rose (In re Sherman)*, 223 B.R. 555, 559 (10th Cir. B.A.P. 1998).

Constructively fraudulent transfers may be deemed to have occurred as the result of “upstream” or “sidestream” transactions such as the following: leveraged buyouts; asset purchases where the seller’s debts are assumed; mortgage loans to finance partner buyouts; transfers of all or a portion of the mortgage proceeds to a parent or sister entity without adequate consideration; guarantees of the mortgage indebtedness of a parent or sister entity (often securitized by a second mortgage on the property); cross-collateralization of existing mortgages with mortgage obligations owed by others; mortgages to secure debt proceeds distributed as dividends; transfers of assets to general partners; and the issuance of partnership or other equity interests in exchange for the contribution of real property(ies). Any of these transactions, depending on the facts, could result in a transfer for less than adequate consideration (i.e. “reasonably equivalent value”) or cause the person or entity making the transfer to become insolvent.

The second subparagraph of the seventh exclusion from coverage in the ALTA standard form policy excludes the subordination of the interest of the insured mortgagee as a result of the application of the doctrine of equitable subordination. This specific exclusion is not found in the owner's policy, and relates solely to Section 510(c) of the Bankruptcy Code, which permits the bankruptcy court to subordinate, on equitable grounds, all or part of a lender's allowed claim or interest, to transfer any lien securing a subordinated claim to the bankruptcy estate, or to disallow the claim entirely, even if no preferential transfer (under Section 547 of the Code) or fraudulent conveyance (under Section 548 of the Code) has occurred.

The principles of equitable subordination are not set out in the Code, and are defined by case law. Equitable subordination is an extraordinary remedy and courts have generally held that the following conditions must be satisfied before the sanctions of Section 510(c) will be imposed: the claimant must have engaged in some kind of inequitable conduct; the misconduct must have resulted in injury to the creditors of the bankrupt or conferred an unfair advantage on the claimant; and equitable subordination of the claim must not be inconsistent with the provisions of the Code. Because equitable subordination is remedial, not penal, the claim will generally be subordinated only to the extent necessary to offset the specific harm that the debtor and its other creditors suffered on account of the alleged inequitable misconduct. *See, e.g., In re Mobil Steel Co.*, 563 F.2d. 692 (5th Cir. 1977).

The third subparagraph of the seventh exclusion from coverage in the ALTA standard loan policy excludes from coverage any claim that is based on the transaction creating the interest of the insured mortgagee being deemed a preferential transfer unless the transfer results from failure to timely record the instrument of transfer, or such recordation fails to impart notice to a purchaser for value or a judgment or lien creditor. The concept of a preferential transfer is a creation of federal bankruptcy law. Under Section 547 of the Code, the trustee in possession or the debtor may avoid a transfer if an interest in the debtor's property is transferred to or for the benefit of the creditor and is on account of an antecedent debt. In addition, the transfer must have been made while the debtor was insolvent, must have been made within 90 days before the date that the bankruptcy petition was filed (unless the creditor to whom such preferential transfer was made was an "insider," in which event the preference period is extended to one year after the transfer), and must allow the creditor to receive more than the creditor would have received by liquidation of the property under Chapter 7 of the Code.

Under Section 547(d)(4) of the Code, the trustee or debtor in possession cannot avoid the transfer to the extent that contemporaneous "new value" was given by the otherwise preferred creditor. Certain transactions such as the granting of, or substitution of, new or additional security (including a mortgage) to a particular pre-existing creditor (with no additional funds or other consideration flowing from the creditor) in order to delay or avoid foreclosure or the exercise of other creditor remedies by the creditor, raise preference issues.

Also, cross collateralizing and cross defaulting existing independent mortgages from a single borrower who is insolvent (or rendered insolvent by such action) could also result in a preferential transfer if the value of all of the properties secured exceeds the amount previously secured by the independent mortgage.

A recent bankruptcy court decision, *In re FIBSA Forwarding, Inc.*, 230 B.R. 334 (Bankr. S.D. Tex. 1999), held that the ruling of the Supreme Court in *In re BFP v. Resolution Trust Corp.*, *supra* (finding that a regularly conducted, non-collusive foreclosure sale was not a fraudulent transfer under Section 548 of the Code), should be applied to nullify a challenge to a real estate foreclosure sale on the basis that it constituted a preferential transfer. The court reached this conclusion even though it acknowledged that the secured creditor had resold the property within a matter of weeks after the foreclosure sale for a substantially greater sum than it had bid at the foreclosure sale to obtain the property.

Section 547(e)(1) of the Code provides that, with respect to real property, a transfer is perfected when it is valid against a bona fide purchaser, i.e., when it has been properly recorded. Section 547(e)(2) specifies that a transfer is made when it takes effect between the transferor and the transferee (i.e., upon execution and delivery of the mortgage) *if* it is perfected at or within 10 days after that time. Otherwise, it is made when the transfer is perfected (i.e., recorded), and the 90-day preference period would commence from that date. This section of the Code prevents the assertion of the argument that any mortgage recorded after the date of execution of the note evidencing the indebtedness constitutes additional

security for an antecedent debt and, therefore, is a preferential transfer. The problem of delayed mortgage recording is specifically addressed in subsections (i) and (ii) of subparagraph (c) of Exclusion 7 of the ALTA lender's policy. These provisions provide coverage against a preferential transfer claim in the event that loss or damage is incurred by the insured as the result of the failure to timely record the mortgage or the failure of the mortgage to impart notice to a purchaser for value or a judgment or lien creditor.

III. CONDITIONS AND STIPULATIONS

A. INTRODUCTION

The Conditions and Stipulations cover some two and one-half pages in the ALTA standard Loan Policy. Included within these provisions are individually numbered paragraphs further delineating the rights, duties and obligations of both the insurer and the insured. In addition to knowing and understanding the affirmative insuring provisions appearing on the face of the policy and the Exclusions from Coverage, the attorney for the insured must have a functional knowledge of the provisions of the Conditions and Stipulations if he is to adequately represent his client. In some instances, these provisions require action on the part of the insured within certain time limitations, and a failure to comply with these terms may result in an insured's being denied coverage under the policy. In other situations, these provisions impose burdens upon the title insurance company. The attorney must be able to explain to his client the obligations that the policy imposes upon him and the duties that the title insurer assumes under the policy.

B. DEFINITION OF TERMS

The following terms when used in this policy mean:

- (a) "insured": the insured named in Schedule A. The term "insured" also includes**
 - (i) the owner of the indebtedness secured by the insured mortgage and each successor in ownership of the indebtedness except a successor who is an obligor under the provisions of Section 12(c) of these Conditions and Stipulations (reserving, however, all rights and defenses as to any successor that the Company would have had against any predecessor insured, unless the successor acquired the indebtedness as a purchaser for value without knowledge of the asserted defect, lien, encumbrance, adverse claim or other matter insured against by this policy as affecting title to the estate or interest in the land);**

- (ii) any governmental agency or governmental instrumentality which is an insurer or guarantor under an insurance contract or guaranty insuring or guaranteeing the indebtedness secured by the insured mortgage, or any part thereof, whether named as an insured herein or not;**
- (iii) the parties designated in Section 2(a) of these Conditions and Stipulations..**

This paragraph differs significantly from the definition of “insured” which is contained in the ALTA owner’s policies primarily because it is intended to protect a (perhaps) continuous series of parties throughout the life of the loan and, in the event of a foreclosure or deed in lieu of foreclosure, a limited number of successors to the “owner” of the indebtedness. Because the Loan Policy is intended to protect so many different parties in different circumstances, this definition is somewhat long.

Clearly the named insured appearing in Schedule A is an insured just as in the Owner’s Policy.

Also included in this definition is nearly each successor in ownership of the indebtedness secured by the insured mortgage. Excluded specifically from this coverage is any obligor (such as a guarantor of the indebtedness) against whom the insurer has subrogation rights under Section 12 (c) of the Conditions and Stipulations (see _____ below) who has obtained an interest in the mortgage insured. The insurer specifically reserves any defenses it may have *any* previous insured under the policy unless the successor acquired title for value and without knowledge of the defect which has resulted in the claim. This protection for bona fide purchasers for value is not afforded successors in title under the Owner’s Policy.

The term also includes any governmental agency or instrumentality that is an insurer or guarantor of the loan, as in the case of loans guaranteed by the Veteran’s Administration or Farmers Home Administration. This is true even if they are not specifically named in the policy.

Finally, the term includes parties designated in paragraph 2 (a) of the Conditions and Stipulations which relates to continuation of coverage after a foreclosure, deed in lieu, etc. and is discussed below at _____..

While the definition of the term “insured” includes succeeding owners of the indebtedness secured by the insured mortgage and would seem to indicate that policy amendment or endorsement would not be required in the case of an assignment, it is customary for the policy to be endorsed or amended to include the recording information on the assignment in order to amend Schedule A activating the affirmative insuring provisions provided by paragraph 8 appearing on the face of the policy.

(c) "knowledge" or "known": actual knowledge, not constructive knowledge or notice which may be imputed to an insured by reason of the public records as defined in this policy or any other records which impart constructive notice of matters affecting the land.

(d) "land": the land described or referred to in Schedule [A][C], and improvements affixed thereto which by law constitute real property. The term "land" does not include any property beyond the lines of the area described or referred to in Schedule [A][C], nor any right, title, interest, estate or easement in abutting streets, roads, avenues, alleys, lanes, ways or waterways, but nothing herein shall modify or limit the extent to which a right of access to and from the land is insured by this policy.

(e) "mortgage": mortgage, deed of trust, trust deed, or other security instrument.

(f) "public records": records established under state statutes at Date of Policy for the purpose of imparting constructive notice of matters relating to real property to purchasers for value and without knowledge. With respect to Section 1(a)(iv) of the Exclusions From Coverage, "public records" shall also include environmental protection liens filed in the records of the clerk of the United States district court for the district in which the land is located.

- (f) **"unmarketability of the title": an alleged or apparent matter affecting the title to the land, not excluded or excepted from coverage, which would entitle a purchaser of the estate or interest described in Schedule A or the insured mortgage to be released from the obligation to purchase by virtue of a contractual condition requiring the delivery of marketable title.**

The remaining terms defined in paragraph 1 of the Conditions and Stipulations are identical (or nearly identical) with the definitions contained in the owner's policies. and, therefore, the attorney is referred to _____ above.

C. CONTINUATION OF INSURANCE AFTER ACQUISITION OF TITLE

3. CONTINUATION OF INSURANCE.

- (a) **After Acquisition of Title. The coverage of this policy shall continue in force as of Date of Policy in favor of (i) an insured who acquires all or any part of the estate or interest in the land by foreclosure, trustee's sale, conveyance in lieu of foreclosure, or other legal manner which discharges the lien of the insured mortgage; (ii) a transferee of the estate or interest so acquired from an insured corporation, provided the transferee is the parent or wholly-owned subsidiary of the insured corporation, and their corporate successors by operation of law and not by purchase, subject to any rights or defenses the Company may have against any predecessor insureds; and (iii) any governmental agency or governmental instrumentality which acquires all or any part of the estate or interest pursuant to a contract of insurance or guaranty insuring or guaranteeing the indebtedness secured by the insured mortgage.**

This Condition and Stipulation clarifies that coverage to the lender continues after foreclosure, or conveyance in lieu of foreclosure or other legal means which discharges the mortgage lien. (Although one of the means of acquisition that is listed in the policy is a trustee's sale, it should be clear that such provision will not alter state law which, in Illinois, provides that no property may be sold under a power of sale contained in a mortgage or trust deed but all mortgages and trust deeds must be

foreclosed. _735_ILCS 5/15-1405) Continued protection is afforded successors who are subsidiaries of lending institutions (usually specifically created to own “REO” properties.) Because these transferees are not purchasers for value they are not shielded from knowledge of their predecessor in title, and the insurer specifically reserves defenses and rights which it may have against that predecessor. Note also that a parent or subsidiary corporation (which is not a transferee,) which acquires at a foreclosure sale would not be covered under the policy. Any governmental agency or governmental instrumentality which acquires all or any part of the estate or interest in most cases would be insured, in harmony with the language defining “insured” contained in Conditions and Stipulations Section 1.

(b) After Conveyance of Title. The coverage of this policy shall continue in force as of Date of Policy in favor of an insured only so long as the insured retains an estate or interest in the land, or holds an indebtedness secured by a purchase money mortgage given by a purchaser from the insured, or only so long as the insured shall have liability by reason of covenants of warranty made by the insured in any transfer or conveyance of the estate or interest. This policy shall not continue in force in favor of any purchaser from the insured of either (i) an estate or interest in the land, or (ii) an indebtedness secured by a purchase money mortgage given to the insured.

This provision is identical to that appearing in the ALTA owner’s policies and therefore, the attorney is referred to _____ above. It makes sense relative to a Loan Policy in the event the lender acquires an interest in the property as anticipated by Section 2(a) of the Conditions and Stipulations.

(c) Amount of Insurance. The amount of insurance after the acquisition or after the conveyance shall in neither event exceed the least of:

- (i) the Amount of Insurance stated in Schedule A;**
- (ii) the amount of the principal of the indebtedness secured by the insured mortgage as of Date of Policy, interest thereon, expenses of foreclosure, amounts advanced pursuant to the insured mortgage to assure compliance with laws or to protect the lien of the insured mortgage prior to the time of acquisition of the estate**

or interest in the land and secured thereby and reasonable amounts expended to prevent deterioration of improvements, but reduced by the amount of all payments made; or

(iii) the amount paid by any governmental agency or governmental instrumentality, if the agency or instrumentality is the insured claimant, in the acquisition of the estate or interest in satisfaction of its insurance contract or guaranty.

There is no equivalent to this provision appearing in the standard Owner's Policy because the liability amount is somewhat more clear cut.

Subparagraphs (i), (ii) and (iii) specify the limitation of liability of the title insurer which is defined least of the three subparagraphs. That is it is not to exceed the least of the amount of insurance as stated in Schedule A, or the amount of the unpaid principal of the indebtedness, together with interest and expenses of foreclosures or any amounts advanced to protect the lien of the mortgage and secured by the mortgage at the time the insured acquires the estate or interest in the land, or if the insured is a governmental agency or instrumentality, the amount paid by that agency or instrumentality pursuant to the terms of its contract of insurance or guaranty. The attorney should note that several options are available to the title insurer if a loss occurs when the loan remains a lien on the land (prior to acquisition by the Lender) and these are determined under Section 6 of the Conditions and Stipulations. This is discussed below at _____.

If the value of the land with the defect alleged exceeds the amount of the lender's debt, then there is no compensable loss under the Loan Policy. *See Green v. Evesham Corp*, 179 N.J. Super 105, 430 A.2d 944 (1981) for a clear discussion of loss payable under the Loan Policy.

D. NOTICE OF CLAIM

3. NOTICE OF CLAIM TO BE GIVEN BY INSURED CLAIMANT.

The insured shall notify the Company promptly in writing (i) in case of any litigation as set forth in Section 4(a) below, (ii) in case knowledge shall come to an insured hereunder of any claim of title or interest which is adverse to the title to the

estate or interest or the lien of the insured mortgage, as insured, and which might cause loss or damage for which the Company may be liable by virtue of this policy, or (iii) if title to the estate or interest or the lien of the insured mortgage, as insured, is rejected as unmarketable. If prompt notice shall not be given to the Company, then as to the insured all liability of the Company shall terminate with regard to the matter or matters for which prompt notice is required; provided, however, that failure to notify the Company shall in no case prejudice the rights of any insured under this policy unless the Company shall be prejudiced by the failure and then only to the extent of the prejudice.

This third paragraph of the Conditions and Stipulations is substantially identical to that contained in the Owner's Policy except for changes necessary to reflect the inherent differences which exist between and owner's and Loan Policy. The attorney is referred to _____ above.

For an example of prejudice experience by the insurer which resulted in a denial of claim see *Moe v. Transamerica Title Insurance Co.*, 21 Cal.App.3d 289, 98 Cal Rptr. 547 (1971)

E. DEFENSE; DUTY OF THE INSURED

4. DEFENSE AND PROSECUTION OF ACTIONS; DUTY OF INSURED CLAIMANT TO COOPERATE.

(a) Upon written request by the insured and subject to the options contained in Section 6 of these Conditions and Stipulations, the Company, at its own cost and without unreasonable delay, shall provide for the defense of an insured in litigation in which any third party asserts a claim adverse to the title or interest as insured, but only as to those stated causes of action alleging a defect, lien or encumbrance or other matter insured against by this policy. The Company shall have the right to select counsel of its choice (subject to the right of the insured to object for reasonable cause) to represent the insured as to those stated causes of action and shall not be liable for and will not pay the fees of any other counsel. The Company

will not pay any fees, costs or expenses incurred by the insured in the defense of those causes of action which allege matters not insured against by this policy.

(b) The Company shall have the right, at its own cost, to institute and prosecute any action or proceeding or to do any other act which in its opinion may be necessary or desirable to establish the title to the estate or interest or the lien of the insured mortgage, as insured, or to prevent or reduce loss or damage to the insured. The Company may take any appropriate action under the terms of this policy, whether or not it shall be liable hereunder, and shall not thereby concede liability or waive any provision of this policy. If the Company shall exercise its rights under this paragraph, it shall do so diligently.

(c) Whenever the Company shall have brought an action or interposed a defense as required or permitted by the provisions of this policy, the Company may pursue any litigation to final determination by a court of competent jurisdiction and expressly reserves the right, in its sole discretion, to appeal from any adverse judgment or order.

(d) In all cases where this policy permits or requires the Company to prosecute or provide for the defense of any action or proceeding, the insured shall secure to the Company the right to so prosecute or provide defense in the action or proceeding, and all appeals therein, and permit the Company to use, at its option, the name of the insured for this purpose. Whenever requested by the Company, the insured, at the Company's expense, shall give the Company all reasonable aid (i) in any action or proceeding, securing evidence, obtaining witnesses, prosecuting or defending the action or proceeding, or effecting settlement, and (ii) in any other lawful act which in the opinion of the Company may be necessary or desirable to establish the title to the estate or interest or the lien of the insured mortgage, as insured. If the Company is prejudiced by the failure of the insured to furnish the required cooperation, the Company's obligations to the insured under the policy shall terminate, including any liability or obligation to defend, prosecute, or continue any litigation, with regard to the matter or matters requiring such cooperation.

This provision is substantially the equivalent to that contained in the Owner's Policy and, therefore, the attorney is referred to _____ above.

F. PROOF OF LOSS

5. PROOF OF LOSS OR DAMAGE.

In addition to and after the notices required under Section 3 of these Conditions and Stipulations have been provided the Company, a proof of loss or damage signed and sworn to by the insured claimant shall be furnished to the Company within 90 days after the insured claimant shall ascertain the facts giving rise to the loss or damage. The proof of loss or damage shall describe the defect in, or lien or encumbrance on the title, or other matter insured against by this policy which constitutes the basis of loss or damage and shall state, to the extent possible, the basis of calculating the amount of the loss or damage. If the Company is prejudiced by the failure of the insured claimant to provide the required proof of loss or damage, the Company's obligations to the insured under the policy shall terminate, including any liability or obligation to defend, prosecute, or continue any litigation, with regard to the matter or matters requiring such proof of loss or damage.

In addition, the insured claimant may reasonably be required to submit to examination under oath by any authorized representative of the Company and shall produce for examination, inspection and copying, at such reasonable times and places as may be designated by any authorized representative of the Company, all records, books, ledgers, checks, correspondence and memoranda, whether bearing a date before or after Date of Policy, which reasonably pertain to the loss or damage. Further, if requested by any authorized representative of the Company, the insured claimant shall grant its permission, in writing, for any authorized representative of the Company to examine, inspect and copy all records, books, ledgers, checks, correspondence and memoranda in the custody or control of a third party, which reasonably pertain to the loss or damage. All information designated as confidential by the insured claimant provided to the Company pursuant to this Section shall not be disclosed to others unless, in the reasonable judgment of the Company, it is necessary in the administration of the claim. Failure of the insured claimant to submit for examination under oath, produce other reasonably requested

information or grant permission to secure reasonably necessary information from third parties as required in this paragraph, unless prohibited by law or governmental regulation, shall terminate any liability of the Company under this policy as to that claim.

With one exception (contained in the final sentence) this language mirrors the language contained in the Owner's Policy and the attorney is directed to the provisions discussed at _____ above.

The final sentence adds the words "unless prohibited by law or governmental regulation" to the language of the Owner's Policy in order to protect confidentiality as to information provided by the borrower which has been so designated.

G. OPTIONS TO PAY OR SETTLE CLAIMS

6. OPTIONS TO PAY OR OTHERWISE SETTLE CLAIMS; TERMINATION OF LIABILITY.

In case of a claim under this policy, the Company shall have the following additional options:

- (a) To Pay or Tender Payment of the Amount of Insurance or to Purchase the Indebtedness.**
 - (i) to pay or tender payment of the amount of insurance under this policy together with any costs, attorneys' fees and expenses incurred by the insured claimant, which were authorized by the Company, up to the time of payment or tender of payment and which the Company is obligated to pay; or**
 - (ii) to purchase the indebtedness secured by the insured mortgage for the amount owing thereon together with any costs, attorneys' fees and expenses incurred by the insured claimant which were authorized by the Company up to the time of purchase and which the Company is obligated to pay.**

If the Company offers to purchase the indebtedness as herein provided, the owner of the indebtedness shall transfer, assign, and convey the indebtedness and the insured mortgage, together with any collateral security, to the Company upon payment therefor.

Upon the exercise by the Company of either of the options provided for in paragraphs a(i) or (ii), all liability and obligations to the insured under this policy, other than to make the payment required in those paragraphs, shall terminate, including any liability or obligation to defend, prosecute, or continue any litigation, and the policy shall be surrendered to the Company for cancellation.

Subsections 6 (a) (ii) and (ii) address the insurer's rights when the insurer determines that the claim is such that payment of the full liability under the policy is advisable. Payment of that amount, of course, relieves the insurer of any further liability or obligation under the policy.

Under 6 (a) (ii) of the Loan Policy, the insurer has the right, in the event of a claim, to purchase the debt in satisfaction of all of its obligations under the policy. No similar right exists in the Owner's Policy. There is support for the theory that this right continues even after acquisition of the title to the land by the lender by means of foreclosure. *See Rancher's Life Insurance Company v. Bankers's Fire and Marine Ins. Co of Birmingham, Ala.*, 190 So. 2d 897 (1966.)

(b) To Pay or Otherwise Settle With Parties Other than the Insured or With the Insured Claimant.

(i) to pay or otherwise settle with other parties for or in the name of an insured claimant any claim insured against under this policy, together with any costs, attorneys' fees and expenses incurred by the insured claimant which were authorized by the Company up to the time of payment and which the Company is obligated to pay; or

(ii) to pay or otherwise settle with the insured claimant the loss or damage provided for under this policy, together with any costs, attorneys' fees and expenses incurred by the insured claimant which were authorized by the Company up to the time of payment and which the Company is obligated to pay.

Upon the exercise by the Company of either of the options provided for in paragraphs b(i) or (ii), the Company's obligations to the insured under this policy for the claimed loss or damage, other than the payments required to be made, shall terminate, including any liability or obligation to defend, prosecute or continue any litigation.

Section 6 (b) allows the insurer to settle smaller claims with the insured or with third parties. Upon settlement of specific issues, the insurer obligation for the claim terminates, of course. In all other ways, the Loan Policy remains in effect; amounts made in settlement do not reduce the liability if the settlement is made before the lender acquires title. See the final sentence of Conditions and Stipulations 9 (a.)

H. DETERMINATION AND EXTENT OF LIABILITY

7. DETERMINATION AND EXTENT OF LIABILITY.

This policy is a contract of indemnity against actual monetary loss or damage sustained or incurred by the insured claimant who has suffered loss or damage by reason of matters insured against by this policy and only to the extent herein described.

- (a) The liability of the Company under this policy shall not exceed the least of:**
- (i) the Amount of Insurance stated in Schedule A, or, if applicable, the amount of insurance as defined in Section 2 (c) of these Conditions and Stipulations;**

This language is the same as that in the Owner's Policy except that it also refers to Section 2 (c) of the Conditions and Stipulations which is discussed above at _____ . This establishes one limit on recovery under the Loan Policy,

- (ii) the amount of the unpaid principal indebtedness secured by the insured mortgage as limited or provided under Section 8 of these Conditions and Stipulations or as reduced under Section 9 of these Conditions and Stipulations, at the time the loss or damage insured against by this policy occurs, together with interest thereon; or**

The subsection establishes a second limit under the Loan Policy.

The liability under the Loan Policy does not generally extend to any debt created subsequent to the date of the policy unless coverage is extended by endorsement, although some advances to protect the lien or the collateral are authorized under Section 9(b) of the Conditions and Stipulations. Also see Section 2 (c.) (ii). Limitation under Section 8 are discussed below at _____. Reductions pursuant to Section 9 are discussed below at _____ and relate to payments in settlement of prior claims.

- (iii) the difference between the value of the insured estate or interest as insured and the value of the insured estate or interest subject to the defect, lien or encumbrance insured against by this policy.**

This establishes a third limit under the Loan Policy . It is one which intends to measure accurately the extent of the loss the lender has suffered.

- (b) In the event the insured has acquired the estate or interest in the manner described in Section 2(a) of these Conditions and Stipulations or has conveyed the title, then the liability of the Company shall continue as set forth in Section 7(a) of these Conditions and Stipulations.**
- (c) The Company will pay only those costs, attorneys' fees and expenses incurred in accordance with Section 4 of these Conditions and Stipulations.**

The Loan Policy is not subject to a coinsurance clause as is the Owner's Policy and subsection (b) makes clear that, all things being equal, the liability under the Loan Policy is determined in the same manner before or after acquisition of title.

The provisions of (c) are the same as those contained in the Owner's Policy and clarifies that the insurer will only pay defense costs as to insured matters.

I. LIMITATION OF LIABILITY

8. LIMITATION OF LIABILITY.

(a) If the Company establishes the title, or removes the alleged defect, lien or encumbrance, or cures the lack of a right of access to or from the land, or cures the claim of unmarketability of title, or otherwise establishes the lien of the insured mortgage, all as insured, in a reasonably diligent manner by any method, including litigation and the completion of any appeals therefrom, it shall have fully performed its obligations with respect to that matter and shall not be liable for any loss or damage caused thereby.

(b) In the event of any litigation, including litigation by the Company or with the Company's consent, the Company shall have no liability for loss or damage until there has been a final determination by a court of competent jurisdiction, and disposition of all appeals therefrom, adverse to the title or to the lien of the insured mortgage, as insured.

(c) The Company 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 Company.

(d) The Company shall not be liable for: (i) any indebtedness created subsequent to Date of Policy except for advances made to protect the lien of the insured mortgage and secured thereby and reasonable amounts expended to prevent deterioration of improvements; or (ii) construction loan advances made subsequent to Date of Policy, except construction loan advances made subsequent to Date of Policy for the purpose of financing in whole or in part the construction of an improvement to the land which at Date of Policy were secured by the insured mortgage and which the insured was and continued to be obligated to advance at and after Date of Policy.

Subparagraph (d) is unique to the Loan Policy. Otherwise, except for the addition of language with reference to the lien of the insured mortgage, Section 8 is the same as appearing in Section 9 of the Conditions and Stipulations of the ALTA owner's policies, and, therefore, the attorney is referred to _____ above.

Subparagraph (d) makes clear that post-policy-date advances by the lender are not covered by the policy—with certain exceptions. The lender is permitted to recover advances made to protect the lien of the mortgage (e.g. payment of real estate taxes,) and reasonable amounts to prevent deterioration of the improvements. Obligatory advances under a construction loan can also be recovered. Obviously endorsements to the policy, such as an endorsement relative to revolving credit, can change this section considerably.

J. REDUCTION OF INSURANCE AND LIABILITY

9. REDUCTION OF INSURANCE; REDUCTION OR TERMINATION OF LIABILITY.

(a) All payments under this policy, except payments made for costs, attorneys' fees and expenses, shall reduce the amount of the insurance pro tanto. However, any payments made prior to the acquisition of title to the estate or interest as provided in Section 2(a) of these Conditions and Stipulations shall not reduce pro tanto the amount of the insurance afforded under this policy except to the extent that the payments reduce the amount of the indebtedness secured by the insured mortgage.

(b) Payment in part by any person of the principal of the indebtedness, or any other obligation secured by the insured mortgage, or any voluntary partial satisfaction or release of the insured mortgage, to the extent of the payment, satisfaction or release, shall reduce the amount of insurance pro tanto. The amount of insurance may thereafter be increased by accruing interest and advances made to protect the lien of the insured mortgage and secured thereby, with interest thereon, provided in no event shall the amount of insurance be greater than the Amount of Insurance stated in Schedule A.

(c) Payment in full by any person or the voluntary satisfaction or release of the insured mortgage shall terminate all liability of the Company except as provided in Section 2(a) of these Conditions and Stipulations.

What is a simple sentence in Section 10 of the Owner's Policy continues on and on in the Loan Policy.

All payments under this policy, except payments made for costs, attorneys' fees and expenses, shall reduce the amount of the insurance pro tanto

That first sentence is discussed above at _____. It states the general rule that any payment made in satisfaction of claim reduces the liability dollar for dollar. It is subject to several exceptions. Some noted in this sentence are attorneys' fees and expenses. Other exceptions follow.

However, any payments made prior to the acquisition of title to the estate or interest as provided in Section 2(a) of these Conditions and Stipulations shall not reduce pro tanto the amount of the insurance afforded under this policy except to the extent that the payments reduce the amount of the indebtedness secured by the insured mortgage.

Clearly, any payment which reduces the indebtedness secured by the mortgage reduces the lender's recovery. But all other payments would not if they are made before the lender acquires title. Typically, there would be no loss prior to acquisition of title by the lender, but it is possible.

(b) Payment in part by any person of the principal of the indebtedness, or any other obligation secured by the insured mortgage, or any voluntary partial satisfaction or release of the insured mortgage, to the extent of the payment, satisfaction or release, shall reduce the amount of insurance pro tanto. The amount of insurance may thereafter be increased by accruing interest and advances made to protect the lien of the insured mortgage and secured thereby, with interest thereon, provided in no event shall the amount of insurance be greater than the Amount of Insurance stated in Schedule A.

Payment in part of the indebtedness reduces the liability under the policy to the extent of the payment. Partial releases also reduce the amount of the liability to the extent of payment. When lenders secure an indebtedness with collateral other than real estate (and when the loan amount far exceeds the liability on the Loan Policy,) this presents a problems for the lender. Payment of a small fraction of the loan may be sufficient to reduce liability under the policy (and by virtue of this subparagraph) to \$0. For this

reason lenders frequently request what is know as a Last Dollar endorsement which amends the language here. Similar paydowns under a revolving credit facility would run afoul of this language without a revolving credit endorsement.

c) Payment in full by any person or the voluntary satisfaction or release of the insured mortgage shall terminate all liability of the Company except as provided in Section 2(a) of these Conditions and Stipulations.

This provision acknowledges that any payment by any person (a guarantor is a good example) makes the lender whole and terminates liability under the policy. If the lender releases the lien of the mortgage, liability under the policy is likewise terminated.

K. LIABILITY NONCUMULATIVE

10. LIABILITY NONCUMULATIVE.

If the insured acquires title to the estate or interest in satisfaction of the indebtedness secured by the insured mortgage, or any part thereof, it is expressly understood that the amount of insurance under this policy shall be reduced by any amount the Company may pay under any policy insuring a mortgage to which exception is taken in Schedule B or to which the insured has agreed, assumed, or taken subject, or which is hereafter executed by an insured and which is a charge or lien on the estate or interest described or referred to in Schedule A, and the amount so paid shall be deemed a payment under this policy.

The Attorney is referred to _____ for comments on the Owner's Policy. The Section has limited use in a lender's situation. Two occurrences are required to make this applicable to a Loan Policy. First the lender must have acquired title by foreclosure or conveyance in lieu of foreclosure. Second, a senior mortgage (to which the insured mortgage took subject to in its policy or executed or subordinated its position to) must have been insured by the same insurer and received payment in satisfaction of a claim tendered by it. Any payment made to the lender in the senior position reduces the

liability under the policy for the junior mortgage. Clearly, any payment to the senior lender benefits the junior lender by increasing the value of the collateral securing the second mortgage.

L. PAYMENT OF LOSS

11. PAYMENT OF LOSS.

(a) No payment shall be made without producing this policy for endorsement of the payment unless the policy has been lost or destroyed, in which case proof of loss or destruction shall be furnished to the satisfaction of the Company.

(b) When liability and the extent of loss or damage has been definitely fixed in accordance with these Conditions and Stipulations, the loss or damage shall be payable within 30 days thereafter.

This section is identical to Section 12 of the Conditions and Stipulations in the Owner's Policy and the attorney is referred to _____.

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M. SUBROGATION

12. SUBROGATION UPON PAYMENT OR SETTLEMENT.

(a) The Company's Right of Subrogation.

Whenever the Company shall have settled and paid a claim under this policy, all right of subrogation shall vest in the Company unaffected by any act of the insured claimant.

The Company shall be subrogated to and be entitled to all rights and remedies which the insured claimant would have had against any person or property in respect to the claim had this policy not been issued. If requested by the Company, the insured claimant shall transfer to the Company all rights and remedies against any person or property necessary in order to perfect this right of subrogation. The insured claimant shall permit the Company to sue, compromise or settle in the name

of the insured claimant and to use the name of the insured claimant in any transaction or litigation involving these rights or remedies.

If a payment on account of a claim does not fully cover the loss of the insured claimant, the Company shall be subrogated to all rights and remedies of the insured claimant after the insured claimant shall have recovered its principal, interest, and costs of collection.

(b) The Insured's Rights and Limitations.

Notwithstanding the foregoing, the owner of the indebtedness secured by the insured mortgage, provided the priority of the lien of the insured mortgage or its enforceability is not affected, may release or substitute the personal liability of any debtor or guarantor, or extend or otherwise modify the terms of payment, or release a portion of the estate or interest from the lien of the insured mortgage, or release any collateral security for the indebtedness.

When the permitted acts of the insured claimant occur and the insured has knowledge of any claim of title or interest adverse to the title to the estate or interest or the priority or enforceability of the lien of the insured mortgage, as insured, the Company shall be required to pay only that part of any losses insured against by this policy which shall exceed the amount, if any, lost to the Company by reason of the impairment by the insured claimant of the Company's right of subrogation.

(c) The Company's Rights Against Non-insured Obligor.

The Company's right of subrogation against non-insured obligors shall exist and shall include, without limitation, the rights of the insured to indemnities, guaranties, other policies of insurance or bonds, notwithstanding any terms or conditions contained in those instruments which provide for subrogation rights by reason of this policy.

The Company's right of subrogation shall not be avoided by acquisition of the insured mortgage by an obligor (except an obligor described in Section 1(a)(ii) of these Conditions and Stipulations) who acquires the insured mortgage as a result of an indemnity, guarantee, other policy of insurance, or bond and the obligor will not be an insured under this policy, notwithstanding Section 1(a)(i) of these Conditions and Stipulations.

This paragraph on subrogation is in many ways similar as that appearing in the ALTA Owner's policies and, therefore, the attorney is referred to _____ above for a full discussion.

However, additional language appears in the subrogation paragraph of the Loan Policy. Broadly speaking, this paragraph provides that upon the settlement of a claim under the policy, the title insurance company is entitled to exercise all the rights and remedies available to the insured against any person or property with respect to the claim. The rights of subrogation are well settled under insurance law.

Although, the right of subrogation vests in the title insurance company unaffected by any act of the insured claimant, the language of this provision provides that the insured shall cooperate and transfer such rights as necessary to perfect the right. The policy recognizes that if the insured is not made whole by payment under the policy, the subrogation rights to the insurer will take effect only after the insured recovers its principal, interest and cost of collection. In short the lender will have the first opportunity to be made whole before subrogation to the insurer shall take place..

Later portions of the paragraph provide that in the event an action taken by an insured claimant impairs the right of subrogation, the title insurer's liability is limited to paying only any amount in excess of the amount of recovery loss to the title insurance by reason of the impairment of the right of subrogation.

The subrogation paragraph of the Loan Policy permits the insured to take certain actions without having such actions deemed to be an impairment of the right of subrogation. The language specifically permits the mortgagor to release or substitute personal liability of the debtor or guarantor, extend or modify the terms of payment or release a portion of the estate or interest from the lien of the mortgage or release other collateral—all actions which might be typical for a lender on an ordinary loan. However, if the insured has knowledge of any potential claim or adverse interest, the insured exercises these options at its peril. The insurer's liability will be reduced commensurate with the impairment of its subrogation rights. One may argue that the insured is not permitted to impair the right of subrogation at all.

M.ARBITRATION

13. ARBITRATION.

Unless prohibited by applicable law, either the Company or the insured may demand arbitration pursuant to the Title Insurance Arbitration Rules of the American Arbitration Association. Arbitrable matters may include, but are not limited to, any controversy or claim between the Company and the insured arising out of or relating to this policy, any service of the Company in connection with its issuance or the breach of a policy provision or other obligation. All arbitrable matters when the Amount of Insurance is \$1,000,000 or less shall be arbitrated at the option of either the Company or the insured. All arbitrable matters when the Amount of Insurance is in excess of \$1,000,000 shall be arbitrated only when agreed to by both the Company and the insured. Arbitration pursuant to this policy and under the Rules in effect on the date the demand for arbitration is made or, at the option of the insured, the Rules in effect at Date of Policy shall be binding upon the parties. The award may include attorneys' fees only if the laws of the state in which the land is located permit a court to award attorneys' fees to a prevailing party. Judgment upon the award rendered by the Arbitrator(s) may be entered in any court having jurisdiction thereof.

The law of the situs of the land shall apply to an arbitration under the Title Insurance Arbitration Rules.

A copy of the Rules may be obtained from the Company upon request.

The language is identical to that in the Owner's Policy and the attorney's attention is directed to _____ above.

This language can be amended by endorsement, but it should be noted that the salient features of this section only come into play the insured amount is \$1,000,000.00 or less.

O. LIABILITY LIMITED TO THE POLICY

14. LIABILITY LIMITED TO THIS POLICY; POLICY ENTIRE CONTRACT.

(a) This policy together with all endorsements, if any, attached hereto by the Company is the entire policy and contract between the insured and the Company.

In interpreting any provision of this policy, this policy shall be construed as a whole.

(b) Any claim of loss or damage, whether or not based on negligence, and which arises out of the status of the lien of the insured mortgage or of the title to the estate or interest covered hereby or by any action asserting such claim, shall be restricted to this policy.

(c) No amendment of or endorsement to this policy can be made except by a writing endorsed hereon or attached hereto signed by either the President, a Vice President, the Secretary, an Assistant Secretary, or validating officer or authorized signatory of the Company.

This provision is substantially the same as the counterpart provision appearing in the ALTA Owner's Policy and, therefore, the attorney is referred to _____ above.

P. SEVERABILITY

15. SEVERABILITY.

In the event any provision of this policy is held invalid or unenforceable under applicable law, the policy shall be deemed not to include that provision and all other provisions shall remain in full force and effect.

This provision is substantially the same as the counterpart provision appearing in the ALTA Owner's Policy and, therefore, the attorney is referred to _____ above

Q. NOTICES

16. NOTICES, WHERE SENT.

All notices required to be given the Company and any statement in writing required to be furnished the Company shall include the number of this policy and shall be addressed to the Company at 114 East Fifth Street, Santa Ana, California 92701, or to the office which issued this policy..

This provision is identical to the counterpart appearing in the ALTA Owner's Policy and, therefore, the attorney is referred to _____ above.

IV. SCHEDULE A

As is the case with the owner's policies, the Loan Policy states the estate or interest that is encumbered by the mortgage and specifies in whom the title to that estate or interest is vested. This is necessary, of course, since the Loan Policy relates to the status and quality of the title as well as relating to the lien of the insured mortgage. Schedule A of the Loan Policy also contains a description of the insured mortgage. In the event any assignments have been recorded and are to be covered by the policy, they will be described as well. If the policy is to run to the assignee, the assignment must be described in Schedule A.

V. SCHEDULE B: STANDARD EXCEPTIONS

The five general or standard exceptions contained on Schedule B are discussed in reference to the Owner's Policy above at _____. In the metropolitan Chicago area the coverage over standard exceptions 1, 2, 3, 4, and 5 is routinely sought and routinely given for the Loan Policy by deleting the exceptions by endorsement. This is occasionally known as lender's extended coverage. It should be noted that different states and jurisdictions have different general or standard exceptions based upon the local law and custom.

VI. SCHEDULE B: SPECIAL EXCEPTIONS

In addition to the preprinted exceptions (the standard or general exceptions) Schedule B: Special Exceptions will contain specific matters affecting the property in question. For example, subdivision covenants and restrictions will be shown here. In the event there are defects, liens or encumbrances having priority over the lien of the insured mortgage, they will also be shown here.

VII. SCHEDULE B: SUBORDINATE MATTERS

SCHEDULE B - PART II

In addition to the matters set forth in Part I of this Schedule, the title to the estate or interest in the land described or referred to in Schedule [A][C] is subject to the following matters, if any be shown, but the Company insures that these matters are subordinate to the lien or charge of the insured mortgage upon the estate or interest:

Schedule B-Part II is only occasionally used in Illinois.

Shown here are matters which affect title and are appropriate exceptions to a corresponding owner's policy, but which are also specifically insured to be subordinate to the mortgage insured in the loan policy. It contains the only insuring language that appears on Schedule B.

A classic example of an item which might appear on Part II of Schedule B is second mortgage which is subordinate by its terms. Another example would be a lease which has subordinated by a recorded subordination, attornment and non-disturbance agreement. Note, however, that the recorded subordination, attornment and non-disturbance agreement which has provisions which are binding on the mortgagor is not appropriately shown on Part II of Schedule B, but rather should appear in Part I.