

How Construction Lenders Can Avoid Title Insurance Coverage Denial for Mechanics Liens

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A title insurance company can deny a construction lender's coverage against mechanics liens that were asserted after the lender stopped funding the construction escrow, even though the lender was entitled to do so under the loan documents, the U.S. 7th Circuit Court of Appeals ruled in *BB Syndication Services, Inc. v. First American Title Insurance Company*. In this case, the lender stopped funding a project after the loan became out of balance ("when revised cost estimates exceed the committed loan amount plus the cash the developer has invested"). However, the insurer denied coverage for resulting mechanics lien claims under Exclusion 3(a) to the lender's loan title insurance policy, claiming the liens were "created, suffered, assumed or agreed to" by the lender.

In *BB Syndication Services*, the lender issued a construction loan to a developer to build a mixed-use project. The project was constructed on a "fast track" construction delivery method through which the project's design was completed after the construction contracts were executed. At the beginning of the construction, developer-initiated design changes resulted in a significant increase (\$20 to \$30 million) in the project budget. Although all parties, including the lender, were aware of this budget increase, construction progressed and the lender continued to fund subsequent construction draws. The title company issued "future advances" or "date down" endorsement coverage for each loan disbursement through a customary title company construction escrow.

When the construction loan became out of balance by more than \$37 million, the lender stopped funding the construction escrow, and \$17 million in mechanics liens were asserted. The lender made a claim on its lender's policy and the title company denied coverage based on Exclusion 3(a). Litigation ensued that eventually landed in front of the 7th Circuit, which ruled in favor of the insurer.

In its opinion, the court analyzed various factual scenarios from prior cases where Exclusion 3(a) was invoked when a lender stopped funding, including cases fully funded construction loans, construction loans where the lender did not discover the funding shortfall until completion and instances in which the title insurer was not also the construction escrowee.

In synthesizing these cases, the court held that Exclusion 3(a) excludes coverage for liens that arise as a result of insufficient funds. Exclusion 3(a) does not completely nullify mechanics lien coverage, but protects lenders against the possibility of lenders paying twice for the same work. Interestingly, the court mentions a "Seattle Endorsement" to the lender's policy that precludes the title insurer from invoking Exclusion 3(a). According to many industry sources, however, the Seattle Endorsement has gone the way of the Creditor's Rights Endorsement and the dinosaur and is not issued by most national underwriters.

Given the *BB Syndication Services* decision and no apparent endorsement to address Exclusion 3(a), lenders need to be aware of the risks in terminating construction funding and the need to be proactive from the onset of the project to avert the need to stop funding, including:

- If most of the construction drawings are not complete, ensure that there is ample contingency in the construction budget to address design changes or inaccurate estimates of the cost of the work before bidding is complete.

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- If construction budget issues are discovered and the loan is out of balance or there is a certainty that the loan will be out of balance, address the shortfall with the borrower promptly upon discovery of the budget shortfall. This could require an increase in the borrower's equity, or a revision of the project's scope to reduce the remaining budget, in either case bringing the loan back in balance.
- Ensure that the general contract and all subcontracts contain liberal work stoppage provisions. Ideally, an owner should be able to stop work at a project for a period of at least thirty days, with little or no penalty, so that the lender and borrower can address the budget issues.

If the lender abruptly stops funding, unpaid work and potential mechanics liens are a near certainty. If a lender does decide to stop funding, it should order the owner to stop work and the lender should issue a "final" draw to pay for work performed through the stoppage. In most construction projects, payment follows the work by 21 to 45 days. If the lender stops funding and performs a subsequent "final" construction draw, the lender should instruct the construction escrowee to only accept final or unconditional lien waivers from the contractors as if the project had been completed.

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