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Title insurance and fraudulent loans:
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Roger Bernhardt

Victim of fraudulently made loans not protected by title insurance issued to purported originating lender.

First Am. Title Ins. Co. v XWarehouse Lending Corp. (2009) 177 CA4th 106, 98 CR3d 801

Access Lending Corporation (Access), which changed its name to XWarehouse Lending Corp. during this litigation, is in the business of “warehousing” real property loans during the time between origination and sale in the secondary mortgage market. In a 2004 Master Repurchase Agreement (MRA), CHL Mortgage Group (CHL) agreed to originate mortgage loans to individual borrowers to be resold to Access. The promissory note and deed of trust would be sold and assigned to Access, to be repurchased by CHL for sale and delivery in the secondary mortgage market. The MRA also provided that at CHL’s election, the purchase price could be funded by funds transferred directly from Access to the closing agent on behalf of CHL, provided that Access verified possession of the closing documents by the closing agent and that CHL delivered the mortgage document for the loan to Access within 3 business days of closing.

In two transactions in 2004, the funds were transferred directly from Access to the closing agent. At closing, the escrow agents released the funds as a payoff to CHL to refinance the named borrowers’ existing loans. First American issued title policies for the mortgage loans with CHL as named insured. However, CHL failed to repurchase the loans from Access and the borrowers never made any payments to Access. Access began separate foreclosure proceedings against the two borrowers. One borrower challenged Access’s right to the proceeds of the foreclosure sale. The other borrower forestalled foreclosure with an affidavit that the signatures on the note and deed of trust had been forged and began quiet title litigation. Access tendered its claim for defense costs to First American, which refused tender, and brought its own action for declaratory relief. The trial court granted summary judgment for First American, holding that Access was not an insured and thus was not entitled to coverage under the policies. The court of appeal affirmed.

In addition to naming CHL as the insured in the policies, the policies also defined the insured (and its successors) as the owner of the indebtedness secured by the mortgage. Access’s arguments for a broad definition of indebtedness so as to cover the transfers made by Access through escrow to CHL were unavailing. The term “indebtedness” reasonably can only refer to that reflected in the “insured mortgage” defined as the deed of trust from each named borrower to CHL to secure an indebtedness from the borrower to CHL. In addition, to meet the definition of an insured under the policy, there must be an existing indebtedness between borrower and lender. In other words, for Access to qualify for coverage as a successor to CHL, there must have been a valid underlying indebtedness for the title insurer to be liable. See *McClellan Realty v*

Institutional Investors Trust (MD Pa 1988) 714 F Supp 733, aff'd without opinion (3d Cir 1989) 879 F2d 858. Access did not meet the definition of an insured under the title policy because there was no transfer of funds between CHL and borrower; there was no valid underlying indebtedness. Moreover, Access's losses were not sustained or incurred by reason of the invalidity or unenforceability of the lien, but by the absence of an existing indebtedness between CHL and the borrowers. If the named borrowers had received the benefit of the loans, then the deeds of trust would have been enforceable. See *Pacific Am. Constr. v Security Union Title* (Utah 1999) 987 P2d 45, 47.

Under the MRA, Access obtained warranties and a first priority lien in specified collateral owned by CHL and status as an additional loss payee on CHL's errors and omissions insurance or mortgage impairment insurance and fidelity bond coverage. Access's losses and defense costs were not recoverable under First American's policies because they were not caused by any defect in the title or mortgage liens. Rather, the failure of the indebtedness between the named borrowers and CHL caused the losses. (The court of appeal also noted other litigation involving CHL and Access and CHL's Chapter 7 bankruptcy, as well as the federal imprisonment of CHL's president, who had pleaded guilty to fraud offenses.)

THE EDITOR'S TAKE: I have read this opinion a number of times and I confess to still not understanding what it means when it says that title insurance "insures against defects in the mortgage itself, but not against problems arising from or related to the underlying debt." The court says that "a mortgage lien and the mortgage debt are two entirely different legal concepts or species," but that is a distinction that is awfully subtle to grasp. I know that a mortgage can be bad even though the debt is good (*e.g.*, when the note was signed but the mortgage was not), but if a debt is bad, the mortgage purporting to secure it is also always bad, because a mortgage by definition needs a debt to support it. If the mortgage was insured, why is the loss not covered when an underlying bad debt has made it into a bad mortgage?

When I look at a title insurance policy that declares that it insures against losses incurred by reason of "the invalidity or unenforceability of the lien of the insured mortgage," I do not see where it says that this coverage excludes a mortgage that is invalid or unenforceable because there was no enforceable underlying obligation for it to secure. I wonder whether an ordinary insured party appreciates that limitation in coverage.

I understand the financial argument that a title insurer probably has not investigated the validity of the underlying loan transaction such as to be expected to underwrite that risk. But, on the other hand, all real estate professionals expect title insurance to cover the risk in an owner's policy that the estate in land ostensibly held by the insured was effectively conveyed to her through a chain of authentic and delivered deeds, even though the insurer has undoubtedly not actually investigated the validity of those underlying transactions. How

is the burden of taking on that risk different when the policy covers the mortgage on the title rather than the title itself?

It is easy to understand why the policy would not cover the mortgage broker itself, since CHL never made a loan at all, having rather simply stolen loan funds that its warehouse lender had advanced; it was also clearly disqualified from insurance protection on the grounds that it had itself caused any loss that occurred and it itself had suffered no loss. But the warehouse lender, Access Lending, was not guilty of any of that—it had suffered a real loss of funds, and it had not been the cause of that loss.

First American successfully argued that Access was not an insured under a policy that named CHL as a covered party. But the policy defined “insured” as including “each successor in ownership of the indebtedness.” Access certainly looks like a successor, and the nonexistence of the indebtedness looks remarkably similar to the nonexistence of a fee interest in an owner’s policy. (Any analogy to owners’ policies on this point is weak, since those generally do not insure their successors, like lender’s policies do, although even they usually continue coverage following intrafamily transfers. In the secondary market, if coverage of successors is really limited as was held here, then participants in that industry had better start reconsidering how they behave.)

In a footnote, the court refers to earlier California cases, holding them to be different because “moneys had been actually dispersed or credited to the named borrower by either the lender or its assignee.” However, one of those cases, *Coast Mut. Building-Loan Ass’n v Security Title Ins. & Guar. Co.* (1936) 14 CA2d 225, 57 P2d 1392, looks so similar to this case that I could not really tell it apart, except that the mortgage loss was held to be covered by the title insurance there. (So does another decision, *California Pac. Title & Trust Co. v MacArthur* (1934) 1 CA2d 323, 36 P2d 413, except that it assumed coverage rather than explicitly holding it to exist.) Those decisions dealt with earlier policies of title insurance, but I do not see significant differences in the wording of the crucial provisions as to matter.

In a related case, now pending in different district of the court of appeal, another lender of CHL is suing the escrow company for similar losses. Keep an eye out for round two of this extremely interesting saga.—*Roger Bernhardt*