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# Stockton Mortgage, Inc. v Tope

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- **For purposes of coverage under title insurance policy, a notice of abatement action is not a defect, lien, or encumbrance on title.**

*Stockton Mortgage, Inc. v Tope* (2014) 233 CA4th 437

In a cross-action against a title insurance company following a default on a real estate loan to purchase and rehabilitate a home, the court of appeal granted summary judgment in favor of the insurer, First American Title. The plaintiffs, investors in the loan, sued various parties (including First American) for damages arising from the alleged failure to follow up on the status of a release of notice of abatement action, which had been listed on the preliminary title report as an exception to coverage, with a statement that "Prior to close of Escrow Alliance Title Company [the escrow holder] will require a FULL RELEASE be obtained." The investors had been solicited by Stockton Mortgage Real Estate Loan Servicing Corporation (Stockton Mortgage) for money to be used to fund the loan. Stockton Mortgage was one of the cross-complainants that initiated the cross-action against First American, Alliance, and two of Alliance's employees.

Before close of escrow, Alliance had contacted the County Environmental Health Department to obtain a release of the notice of abatement, but the County would not issue the release because violations still existed. The lender's policy covered "a defect in or lien or encumbrance on the title" of the property and did not list a notice of abatement as an exception from coverage. The court concluded that the notice of abatement was *not* a defect, lien, or encumbrance on *title* to the property; instead, it was only a notice that the premises were substandard, which merely related to the physical condition of the property and raised the issue of future enforcement. Further, the accrual of enforcement costs did not transform the notice of abatement into a defect in or a lien or encumbrance on title. Although the County engaged in some limited abatement activity and sought to recoup its "enforcement costs" (totaling $2005 and paid by Alliance before close of escrow), the County had not recorded a lien against the property to recover its costs. Any accrual after the close of escrow, *as a post-policy event*, would not be covered under the policy.

In any event, the cross-complainants were not insured under the lender's policy. Stockton Mortgage never had an interest in the land or held an indebtedness secured by the deed of trust. Rather, *Stockton Management* was named as the beneficiary under the deed of trust. Furthermore, it had assigned its beneficial interest under the deed of trust to the investors.

Without an interest in the property or indebtedness under the deed of trust after the assignment to the investors, the cross-complainants were not insured under the policy.

The court also rejected the cross-complainants' argument that because they had potential liability for warranties and covenants made in connection with the assignment of the deed of trust, they were still covered under the policy. The cross-complainants failed to identify what warranties or covenants they gave to the investors as part of the assignment. They also failed to establish that they had standing as third party beneficiaries under the policy by way of a servicing agreement with the investors. According to the court (233 CA4th at 451), "This novel argument goes nowhere."

The cross-complainants argued that Alliance, acting as agent for First American, orally agreed to remove the abatement notice before the close of escrow. The only evidence for this purported oral agreement was the preliminary report; the court refused to infer an oral agreement based on the statement in the report. At most, the evidence showed that Alliance, not First American, entered into an oral agreement.

The court also found without merit the cross-complainants' negligence, negligent misrepresentation, and implied and equitable indemnity causes of action.

***THE EDITOR'S TAKE:*** Alliance Title Company was able to dodge liability for failing to inform its insured about the county's recorded and unreleased Notice of Abatement Action because the court of appeal deemed that notice was not a defect, lien, or encumbrance against the title that Alliance was insuring, such that the failure to mention it as an exception in the insurance policy did not make the insurer liable.

Everyone appreciates that title insurance policies insure titles to real property, not the property itself. There is a difference between a defect in the soil of property and a defect in the title to that soil, with only the latter being covered by a title insurance policy. But while the difference between the two may often be clear, their paths are often murky and convergent.

A faulty condition of property frequently must follow a long, winding course before it elevates itself to a condition of title that a title insurer must report to its customer. The property flaw may start life as a mere potential defect in property (*e.g.,* a loose screw in a piece of wood) that everyone except a fussy owner may ignore, both physically and from a title perspective. If the condition gets too bad (the screw gets too loose), someone (*e.g.,* a tenant or a neighbor) may complain about it, and someone else (such as a building inspector) may do something about it, *e.g.,* order its repair. A report may be filed and the condition will thereby be elevated into a formal grievance or command to the property owner to fix. See Health & S C §17980. But the existence of such a commanding document does not necessarily mean that the owner's title has as yet been impaired. According to this decision, a governmental order to abate a code violation is not yet a defect, nor a lien nor an encumbrance, on title as to make the owner's title unmarketable.

(Technically, the limitations of marketable title should inform interested purchasers of the property that they should provide for inspection contingencies in their offers rather than expect traditional marketable title to function as an exit device at close of escrow; she may be getting a marketable title even if there is a screw loose somewhere bothering an inspector.)

Only later—after a local official has made an authorized correction of the disrepair and the municipality has failed to recover those costs from the owner—might the owner's title be brought into the picture. If the repair bill isn't reimbursed, Health & S C §17980.2(b) allows a lien to be imposed and recorded. Once a recorded lien is on the property, not only does the house itself owe the repair cost (CC §1114; CCP §1180), but equally importantly, so does its next owner, whether or not she ever assented to its imposition. The repair cost has become a lien on the land—like a mortgage—intruding on the current owner's ability to transfer marketable title to the purchaser unless it is removed. Purchasers get the law much more on their side at close of escrow when and if a physical defect has elevated itself into a title defect.

The stakes also get considerably higher because a defect affecting title makes that title unmarketable whether or not it carries any demonstrable economic harm along with it. A purchaser can reject a title as unmarketable because it is subject to an easement or covenant or declaration of CCRs, even though the property itself may be a good deal more valuable with it than without it.

So transactors in real estate have to treat governmental complaints differently from liens and encumbrances and defects on title because the system treats them so differently. With or without superlien priority, an old physical complaint recently elevated into a title defect may have acquired a legal stature it previously lacked. That makes it unsurprising that title insurance companies need to report on defective conditions that may someday grow into liens on title differently from how they treat the conditions that are already liens. Conventional mortgages, easements, or restrictive covenants generally impacted titles long ago, when they were first recorded (regardless of how much they were paid down, used, or enforced), so purchasers and lenders had to be warned of them at the start, differently from those inchoate liens that spring up when a local government gets mad enough.—*Roger Bernhardt*