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Crooked Originators and Cruel Insurers

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by Roger Bernhardt*

I first commented on the case of *First American Title Insurance Co. v Xwarehouse Lending Corp*., 177 Cal App 4th 1006 (2009), in one of my columns in the *California Real Property Law Reporter*. Later, I sent a copy of that column to *DIRT*, where Daniel Bogart, its co-editor reprinted it as a Daily Development, where it generated a buzz storm of hostility, mostly from title industry attorneys. Having their criticisms in mind, I am now writing up the case again for mortgage counsel.

CHL Mortgage Group, whose president is now in prison, originated residential mortgages for sale in the secondary market. Between the time of origination and sale to an investor, the mortgages were warehoused with Access Lending, who purchased and held them until CHL had lined up its ultimate buyers. Under its Master Repurchase Agreement with CHL, Access sent the funds into escrow where they were distributed to CHL when the escrow agent was ready to transmit back to Access the note, the deed of trust, an assignment of the deed of trust, and—most important—a title insurance commitment or title policy in CHL's name. Those policies (1992 standard form ALTA policies) named CHL as the insured, and defined "insured" as "the owner of the indebtedness secured by the insured mortgage *and each successor in ownership of the indebtedness*." The policies insured against losses sustained by the insured by reason of "invalidity or unenforceability of the lien of the insured mortgage upon the title."

When it was discovered that CHL was not actually making real loans to individuals but was instead forging phony notes and deeds of trust in the names of unrelated property owners, its title insurer, First American Title Insurance Co., brought this action for declaratory relief, contending that it had no duty to indemnify or even defend Access Lending for those transactions.

A California Court of Appeal agreed with First American's defenses. Access was not named as an insured under the policy—CHL was the only named insured. Nor could Access claim to be the successor in ownership of the indebtedness, since there was no indebtedness. CHL had never loaned money to the nominal borrowers at all, and the funds transferred into escrow by Access (for CHL to pay itself off for the loans it had pretended to make to fictitious borrowers) was not the indebtedness that was covered in the title insurance policy provision referring to successors.

The court ruled: "Any losses suffered by Access are not due to defects in the title or mortgage liens, but are entirely due to the failure of an existing indebtedness between the named borrowers and CHL." Title insurance "insures against defects in the mortgage itself, but not against problems arising from or related to the underlying debt." Now that is a distinction I have trouble accepting. The court's declaration that "a mortgage lien and the mortgage debt are two entirely different legal concepts or species," may be too subtle for most real estate attorneys and lenders 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, since a mortgage by definition needs a debt to support it. If a mortgage was insured, why is the mortgagee's loss not covered when an underlying bad debt has made it into a bad mortgage? 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," does not say that such coverage excludes mortgages that are invalid or unenforceable when there was no enforceable underlying obligation for them to secure, and while title insurers may believe that such a limitation in coverage is implicit, I doubt that an ordinary insured parties do. To conclude that a lender's policy insures only the validity of the mortgage and not the validity of the debt that the mortgage purportedly secures is hardly to take its present language at face value. (In California, our Insurance Code permits title insurers to insure: "(a) The identity, due execution, and validity of any *note* or bond secured by mortgage" as well as "(b) The identity,

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due execution, validity and recording of any such *mortgage*."§12390)

It is easy to understand that the policy should not protect the crooked mortgage broker, since it never made a loan at all and had suffered no loss (as well as being itself the cause of any loss that did occur). But its successor warehouse lender, Access, 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. I understand the financial argument that a title insurer probably has not investigated the validity of the underlying loan transaction and should therefore not be expected to underwrite that risk. Yet, on the other hand, all real estate professionals do expect owner's title insurance policies to cover the risk that the estate ostensibly held by the insured was not actually conveyed to her (because of forgery, incompetence or nondelivery), even though the insurer has undoubtedly not actually examined the validity of the underlying transactions. Rational actors often undertake to cover risks they have not personally investigated and to collect from others for doing so.

In a footnote, the court referred to earlier California cases, which it asserted were 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, looked 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 did another decision, *California Pac. Title & Trust Co. v MacArthur* (1934) 1 CA2d 323, except that it assumed there was 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 decided by a different district of the California Court Of Appeal, (*Gateway Bank v Ticor Title Company*, 2009 WL 4190455), another lender of CHL lost its damage claim against the escrow company for similar losses. That result seems easier to accept, since escrow instructions and escrow duties are not expected to run to successors in the way that we thought lenders' title insurance policies did.

The California Bankers Association appeared as *amicus* in both cases pointing out that protection should be even clearer under 2006 ALTA policies, which refer to unenforceability of the lien "due to forgery…", and asserting that the lending industry had always taken it for granted that it was protected against such risks and, without it "secondary market confidence in mortgages could quickly erode." With or without the erosion, mortgage purchasers should appreciate the exposure these decisions reveal. ◆

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