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Construction Loans and Title Policies in the Seventh Circuit

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Construction lenders almost always obtain title insurance policies to protect the property under construction from being encumbered by the mechanics' liens of unpaid contractors and materialmen. In some states, such as Missouri, mechanics' liens are given statutory priority over the previously recorded mortgages of construction lenders. Consequently, the title policies become important to ensure that the lender's loan is fully protected, especially during construction when the value of the project may be less, sometimes far less, than the loan funds advanced.

A standard title policy insures a construction lender against any losses incurred by reason of any statutory lien for services, labor or materials having priority over the lender's mortgage for improvement or work related to the land contracted for or commenced prior to the date of the policy. During the construction period, the title company frequently issues "date down endorsements," which update coverage through the date of the endorsement. A typical title policy will also have standard exclusions, including excluding coverage for liens that are "created, suffered, assumed or agreed to" by the insured lender.

When a project is plagued with unanticipated cost overruns or other problems which precipitate a default under the construction loan agreement, the construction lender is faced with a Hobson's choice: Does it stop advancing the construction loan at a time when the value of the project may be worth significantly less than the outstanding loan? This will likely cause the claims of contractors and materialmen for the work unpaid at the time of default to ripen into senior mechanics' liens and the lender to claim coverage under the title policy. Instead, does the lender engage in a work-out of the project and keep lending in the hopes that it can be successfully completed? In *BB Syndication Services, Inc. v. First American Title Insurance Co.*, No. 13-2785, 2015 WL 1064156 (7th Cir. March 12, 2015) the Seventh Circuit Court of Appeals addressed this dilemma, analyzing a lender's claim of coverage under the provisions of a typical title insurance policy in the context of a failed project.

The Project

Trilogy Development Company, a real estate developer ("Trilogy"), contracted with

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J.E.Dunn Construction Company ("Dunn") to build a mixed-use commercial building in Kansas City Missouri's fashionable West Edge. The initial estimated cost of the project was $118 million. The project was to be funded by a $32 million equity investment by Trilogy and an $86 million construction loan made by BB Syndication Services, Inc., a Wisconsin lender ("BB"). BB obtained a title insurance policy containing the standard provision regarding the scope of coverage and the exclusion described above from First American Title Insurance Company ("First American"), and contracted with First American to be the disbursing agent.

The project was begun before construction designs were finalized and there were early indications that the project costs would exceed the initial estimates. Dunn claimed that design changes would increase the project costs by $20 million to $30 million, making the construction loan out of balance and potentially in default. At this point, BB had disbursed only $5 million of its $86 million commitment. However, after negotiations with Trilogy, BB chose to continue to fund. Approximately one year later, Dunn stopped construction when Trilogy failed to pay it the proceeds of the loan disbursement. Trilogy hired a new contractor and commenced an arbitration proceeding against Dunn, which resulted in an award in excess of $11 million in Dunn's favor. As a result of the award and the inability of Trilogy to fund the shortfall, BB declared a default and stopped lending. By this point, approximately $61 million of the total $86 million commitment had been disbursed.

In response, Trilogy filed a petition under Chapter 11 of the Bankruptcy Code. 11 U.S.C. §§ 101-1532. During the bankruptcy case, Trilogy initiated an adversary proceeding to determine the priority of approximately $17 million of mechanics' liens arising after BB stopped funding. Asserting its rights under the title policy, BB demanded that First American defend it in the adversary proceeding and indemnify it for any losses which may arise. First American refused, claiming that BB had created the mechanics' liens by cutting off funding. The bankruptcy court ultimately determined that under Missouri law, the mechanics' liens, including $11 million asserted by Dunn, were senior in priority to BB's construction mortgage. The project, which sat idle for over a year, was eventually sold at auction during the bankruptcy for $10 million, ironically to the party who originally sold the land to Trilogy at a greater price.

The Suit Under the Title Policy

BB filed suit against First American in Wisconsin state court alleging a breach of the duty to defend and a bad faith breach of the coverage provisions under the

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title policy. First American removed the case to the United States District Court for the Western District of Wisconsin, which found that First American breached its duty to defend. However, because BB caused the mechanics' liens to arise by cutting off funding, the exclusion provision precluded coverage under the policy and therefore there was no bad faith. BB appealed the District Court's decision regarding the exclusion provision, and if that was successful, sought to revive its bad faith claim. First American did not cross appeal the duty to defend decision.

The Seventh Circuit's Opinion

The Seventh Circuit first determined that Wisconsin law applied and then focused on the exclusion provisions of the title policy, citing, among other things, its prior decision of *Home Federal Savings Bank v. Ticor Title Insurance Co.*, 695 F. 3d 725, 732-33 (7th Cir. 2012), wherein it held that "The clear majority view ... is that the exclusion [provision] applies only to intentional misconduct, breach of duty, or otherwise inequitable dealings by the insured [lender]."

BB argued that it had a contractual right to stop funding the loan when the loan became out of balance. The court found that this provision was based upon an agreement between BB and Trilogy, not one between BB and First American. Moreover, if BB's action caused the cost overruns, or if BB had control over when the project was aborted, BB could be deemed at fault for the resulting mechanics' liens. *BB Syndication, Inc. v. First American Title Company*, 2015 WL 1064156 at *6. The central issue in the case, said the court, was whether the lender or the title company bore the risk of liens arising from the cessation of loan funds due to cost overruns. *Id.*

Prior Circuit Court Decisions

The court noted that four Circuit Courts of Appeals, including the Seventh Circuit, had previously addressed this question in five reported decisions. The Tenth and Eighth Circuits squarely held that when a lender cuts off funding, it "creates" or "suffers" any liens that arise, triggering the application of the exclusion. *See Bankers Trust Co. v. Transamerica Title Ins. Co., 594 F.2d 231* (10th Cir. 1979); *Brown v. St. Paul Title Ins. Co.*, 634 F.2d 1103 (8th Cir. 1980). Both courts reasoned that insufficient construction funding is not the type of risk that title insurance is built to bear. *BB Syndication Services, Inc. v. First American Title Co.*, 2015 WL 1064156 at *7.

The Seventh Circuit noted, however, that three subsequent cases distinguished

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Bankers Trust and Brown, and reached an opposite conclusion. The Sixth Circuit in *American Savings & Loan Ass'n v. Lawyers Title Insurance Corp.*, 793 F.2d 780 (6th Cir. 1986) and the Eighth Circuit in *Chicago Title Insurance Co. v. Resolution Trust Corp.*, 53 F.3d 899 (8th Cir. 1995) addressed situations in which the construction lenders had fully disbursed their initial loan commitments. The Seventh Circuit observed that the courts in both *American Savings* and *Chicago Title* found that where a lender has released all loan funds initially committed, it cannot be said to have "created" or "suffered" liens arising from insufficient project funds. *BB Syndication*, 2015 WL 1064156, at *7.

Relying on these decisions, BB argued that under its loan agreement, it was only obligated to lend the lesser of $86 million or 80% of the appraised value of the property, or 75% of the total cost of the project. Because the disbursed loan proceeds were $61 million, the 80% of appraised value threshold was met. The Seventh Circuit agreed with the District Court that this argument lacked factual foundation as no appraisal had been done. *Id.*

BB also argued that its case was factually distinguishable from *Brown* and *Bankers Trust*, where the lenders cut off funding shortly after it became clear that the project costs would exceed the budgets. Instead, BB's case was closest to *American Savings* and *Chicago Trust* where the courts found that the lenders continued to fund even though they knew that the projects were underfunded and experiencing cost overruns. BB argued that its willingness to continue to fund and attempt to see the project through demonstrated its good faith and therefore the fault for the mechanics' liens should not be laid at its feet. *Id.* at *7-8.

The court disagreed, saying instead of good faith, continuing to lend may evidence poor business judgment. *Id.* at*8. Under the loan agreement, BB had the right to monitor the project to ensure that it continued to be viable. When it first became evident that the project was out of balance, it could have compelled the developer to supply more equity or stopped funding. At that point, the loan obligation was only $5 million, which would have been covered by the value of the land. *Id.* at *8. Instead, it kept the loan spigot open. BB's decision to continue to lend resulted in $17 million of liens for unpaid work, a liability it argued should be shifted to the title company. *Id.*

The court found that this stretched title insurance too far, especially in light of the fact that in most cases, continuing construction lending and thereby construction is in the lender's sole discretion, and likely increases the value of the lender's collateral. If the lender can also shift the business risk of unpaid mechanics' liens

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to the title company, it obtains an additional windfall. *Id.* The court found that only the lender has the ability, and thus the duty, to investigate and monitor the viability of a construction project. When liens arise from insufficient funds, the lender has "created" them by failing to discover and prevent cost overruns, whether at the beginning of construction or during the project's life. *Id.* at *9.

This interpretation, said the court, does not nullify the benefits of mechanics' lien coverage, as the court in suggested. The title policy is to insure against the failures of the payment process, such as the developer absconding with loan proceeds, not the business risks associated with the project's failure. *Id.* Moreover, this interpretation creates a clear rule that parties can bargain around. If the parties want to expand the coverage, they can contract for a so-called "Seattle Endorsement"—basically a promise by the insurer not to invoke the exclusion for liens arising from insufficient funds. *Id.*

Reconciling Its Prior Home Federal Decision

Finally, the court turned to its prior decision in *Home Federal*. In that case, a lender to a project in Indiana cut off funding after the developer defaulted, leaving a $6 million lien for unpaid work by the general contractor. The lender brought a foreclosure action and the contractor counterclaimed, alleging its lien was senior. The lender tendered the defense to the insurance company. The title company refused coverage because under Indiana law, mechanics' liens are junior in priority to the lien created by a previously recorded mortgage making the lienor's claim frivolous, and because of the exclusion for liens "created" or "suffered" by the insured lender cutting off funding.

In *Home Federal*, the court determined that the duty to defend was broader than the duty to indemnify and therefore defense was required even if the claim was frivolous. However, the court also held that if there was an applicable exclusion to coverage, even in the face of a valid claim, there was no duty to defend. *Home Fed. Sav. Bank*, 695 F.3d at 732-33. In both *Brown* and *Bankers Trust*, there existed a disbursement agreement between the insurance company and the lender, a fact which the *Brown* and *Bankers Trust* courts noted and which the Bankers Trust court found "critical." In *Home Federal*, however, the title company was not the disbursing agent. Because there was no disbursement agreement, the Home Federal court found that there was no obligation on the part of the lender to lend good money after bad. *Id.* at 734-35.

The court in *BB Syndication* indicated that its prior *Home Federal* decision may

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have relied too heavily on the existence of a disbursement agreement. *BB Syndication*, 2015 WL 1064156, at *10. While the *Brown* and *Bankers Trust* courts discussed the presence of a disbursement agreement, the court found that those decisions were really based upon the fact that title insurance is not designed to insure the risks of a broken transaction. *Id.* The court highlighted its view that *Home Federal* was not wrongly decided. Given that the law in Indiana clearly gave the mortgagee priority over subsequently filed mechanics' liens, the *Home Federal* court was correct in holding that the lender was under no duty to fund a subordinate lien and that the defense of such a weak claim would have cost little trouble or expense. *Home Fed. Sav. Bank*, 695 F.3d at 734.

In conclusion, the *BB Syndication* court held that the lender, not the title company, has the authority and responsibility to discover, monitor and prevent losses due to termination of a loan commitment upon default. Failure to do so compelled a finding that the lender "created" or "suffered" the resulting liens triggering the application of the standard exclusion of coverage.

Conclusion

The *BB Syndication* decision brings into stark focus a construction lender's acute dilemma. The Seventh Circuit seems to ignore its prior decision in *Home Federal* that the exclusion provision is triggered only by "intentional misconduct, breach of duty, or otherwise inequitable dealings by the insured," especially when the loan is in default and the lender's obligation to lend has terminated. Instead, the court has clearly imposed upon the lender the duty to monitor a project and declare a default at the first indication of trouble, or continue funding in an attempt to save the project and risk the consequences of any resulting mechanics' liens. In states like Missouri, where the mechanics' liens are given priority over the mortgage lender, this is likely a multimillion dollar choice. However, even in states like Wisconsin, where mechanics' liens are subordinate to the prior recorded mortgage lien, the *BB Syndication* decision could be read to provide that where there exists an applicable exclusion, a title company may be excused from the contractual duty to defend because the mortgagee would have "created" or "suffered" the lien by ceasing to advance funds to a defaulting borrower.

If you have any questions on the topics discussed in this e-alert, please contact your Reinhart attorney or any member of Reinhart's Business Reorganization team.

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