Real Estate Lender's Exercise of "Loan Balancing" Rights May be Deemed to Have Created Mechanics' Liens

Paul G. Mackey*

In this article, the author uses the* BB Syndication Services v. First American Title Insurance Company *case to address issues of loan balancing and mechanics' liens filed by borrower's unpaid contractors.

One of the most common provisions in real estate building and construction loan agreements is the so called "balancing provision," which gives a lender the right to refuse to advance loan proceeds at any time that the amount of the loan remaining to be funded will not be sufficient to fund all of the costs remaining to complete the project which is the subject to of the loan (a situation referred to as the construction loan being "out of balance"). Balancing provisions typically contemplate that borrower may cure, or bring the loan back "in balance" by either funding the current and next due costs as needed and/or delivering cash collateral to lender to be used to fund improvement costs.

Many real estate professionals (certainly most bank loan officers) would never have thought that a court would consider the lender exercising its rights to withhold loan funds or deny a disbursement of the loan under a customary loan balancing provision to have "created" mechanics' liens filed by borrower's unpaid contractors. But that is precisely what the Seventh Circuit Court of Appeals held in *BB Syndication Services, Inc. v. First American Title Insurance Company*.

While the *BB Syndication Services* case involved a construction project in Missouri and was decided based on Wisconsin law, the provision of the loan title insurance policy at the heart of the issue has the same language found in nearly all commercial loan policy forms used throughout the United States, including the American Land Title Association ("ALTA") Loan Policy (6-17-06) (the "ALTA 06 Policy"), the exclusive form of commercial loan policy available in New York and other states. The focus of the *BB Syndication Services* case was the policy exclusion from coverage for acts of the insured, specifically as applied to mechanics' liens which would otherwise be covered by the loan title insurance policy issued to BB Syndication.[1] Among the matters expressly excluded from coverage under the ALTA 06

*Paul G. Mackey, a partner in the real estate practice of Schiff Hardin LLP, represents banks and other financial institutions in a broad range of commercial real estate transactions. He has experience handling debt and equity financings of office buildings, shopping centers, residential apartment buildings, hotels and industrial properties throughout the United States. He also represents clients in buying, selling and leasing substantial commercial properties. Mr. Mackey can be reached at pmackey@schiffhardin.com.

Policy is Exclusion 3(a), which excludes coverage for "[d]efects, liens, encumbrances, adverse claims, or other matters (a) created, suffered, assumed, or agreed to by the Insured Claimant."

The court in *BB Syndication Services* discussed several appellate cases addressing the question of whether a construction lender exercising a contractual right to cut off funding under the loan agreements "created" or "suffered" mechanics liens subsequently filed against the project for purposes of Exclusion 3(a) and found mixed outcomes. The Seventh Circuit noted that most courts that have addressed the question "imply a fault requirement"[2] or bar coverage only "where there has been misconduct or inequitable behavior on the part of the lender, where the lender assumes or agrees to liens, or where the lender stands to receive an inequitable windfall if the insurer settles lien claims in order to protect the mortgage priority."[3]

How Does a Lender "Create" or "Suffer" Mechanics' Liens?

Since the lender, BB Syndication Services, did not enter into agreements for work with any subcontractors or direct any work on the property, what was it that the lender did that was so egregious as to effectively void title insurance coverage for mechanics' liens? The court gave great weight to the fact that early in the construction process, the lender apparently became aware that the loan was out of balance because the general contractor working for borrower claimed, based on changes to the project plans, that the initial project budget of $118 million had increased by about $20 million to $30 million.

At that time, the lender had only disbursed a little over $5 million of an $86 million construction loan. The lender chose to continue funding to keep construction on the project going, and did not exercise its right to cease making advances until a year later after it had paid out over $61 million. Shortly after that point, the estimated cost overruns were around $37 million.[4]

While that might have been a difficult decision, it was not an irrational one (BB Syndication Services characterized its continuing to lend substantial sums as demonstrating its good faith-"a willingness to do everything possible to see the project through").[5] Nonetheless, the court's analysis in *BB Syndication Services* was that if the lender had insisted on cutting off funding immediately upon learning that the loan was out of balance unless and until the borrower put up sufficient equity to cover the shortfall, "the lender's losses would have been less than $5 million-and most likely zero-because the land alone was worth roughly $12 million.

Instead, BB Syndication chose to continue funding the project.[6] That was its prerogative, of course, but in the end this risky business decision resulted in $17 million in liens from unpaid work."[7] Few lenders would agree with the court's implication that the decision to foreclose on a partially built construction project is an easy decision with little risk. Earlier cases interpreting Exclusion 3(a) found that "poor judgment or even negligence by [construction lender] . . . is not enough to trigger clause 3(a),"[8] but the court in *BB Syndication Services*, in contrast, found that the lender's "poor business judgment precipitated the liens."

Given the impreciseness of the "created, suffered, assumed or agreed to" language in loan title insurance policies it is not surprising that different courts have come to different conclusions as to when to lay the blame for mechanics' liens on the lender. The court in *BB Syndication Services* expressed a concern that construction lenders might "strategically delay" cutting off funding a loan based on the loan agreement balancing provision if lenders felt "that unpaid contractors' claims will be covered by title insurance once the loan proceeds run out."[9]

This concern ignores the fact that insuring provisions of the title insurance policy do not insure that contractors will be paid; rather the policy, in insuring paragraph 11, only insures the lender against loss incurred by reason of the "lack of priority of the lien of the Insured Mortgage upon the Title" over certain mechanics' liens.[10] Nonetheless, it is clear that courts wrestling with Exclusion 3(a) of the ALTA 2006 policy will take a careful look at the conduct of lenders for any indication that the decision to continue funding an out of balance loan (or to exercise a right to cut off funding) was made to somehow gain unfair advantage over the title insurer or with disregard for the consequences.

After concluding that, for purposes of the loan title insurance policy coverage, the lender's decision to continue funding the construction loan in *BB Syndication Services* was an act of the insured which effectively nullified mechanics' liens coverage, the court stated that the lender could have negotiated the terms of the policy to "explicitly contract for this protection" by "purchasing the so-called 'Seattle Endorsement' '' or otherwise.[11]

It should be noted that the recommended "Seattle Endorsement" is not among the dozens of endorsements recognized by ALTA. While construction lenders may seek to obtain such an endorsement, a number of States, including New York, Texas, Florida and Pennsylvania, prohibit title insurers from using any endorsement forms which have not been filed and approved, or promulgated, by the state insurance regulator.

Lender Found to Have Implied Duty to *Title Insurer* to Prevent Liens

One of the more surprising aspects of the *BB Syndication Services* decision was the court's finding that the lender had "the authority and responsibility to discover, monitor and prevent" the loss from mechanics' liens,[12] presumably by cutting off funding as soon as it discovered its loan was out of balance. Prior cases considering whether or not a construction lender had a duty to its title insurer limited the question to whether or not the lender had a duty to advance construction loan proceeds and sometimes found fault in the act of ceasing to fund the loan.[13]

In those decisions in which a lender was found to be at fault for failure to fund an advance, the duty of the lender to fund was typically found to be in an agreement between the lender and the title company.[14]

By contrast, in another appellate case in which there was no such agreement, the court stated that "in the absence of any indication from the title insurance policy that" lender was obligated to continue funding for the benefit of the title insurer, the lender "owed no duty to [title insurer] to disburse the entire amount of the loan commitment."[15]

Lenders may rightly question the appropriateness of finding *any* implied duty on the part of the beneficiary of a title insurance policy when, in other contexts the form of the policy expressly states, in detail, the duties of the insured (see Condition 3 (duty to promptly notify insurer of claims) and Condition 6 (duty to cooperate in defending or prosecuting claims)).

In *BB Syndication Services*, the court went much further than prior decisions to find causation by the lender in that the court found a duty not just to fund loan proceeds but a broad duty of the lender to the title insurer "to investigate and monitor the construction project's economic viability."[16] The court found that, since the construction lender had demanded from its borrower the express right to monitor the project and require lien waivers and other back up as conditions to advances (the customary things a lender wants for the purpose of protecting lender's interests and its loan collateral), the lender had the duty to exercise those rights in such a manner as to minimize risk to the company which was paid an insurance premium to insure against certain risks.

What Can a Lender Do to Avoid the *BB Syndication* Result?

The holding in *BB Syndication Services*, that a construction lender had created the mechanics' liens in question by virtue of conduct that many real estate practitioners would find understandable and unremarkable (*i.e.*, continuing to fund a loan even though it appeared to be "out of balance" and only cutting off funding when the problem worsened and the borrower misapplied funds), should give lenders cause for concern.

To the extent available in any jurisdiction, construction lenders will want to attempt to procure a title policy endorsement to clarify what lender conduct triggers Exclusion 3(a) of the ALTA 06 Policy. It may also be that the real estate lending industry will lobby the American Land Title Association, which promulgates the title insurance forms used throughout the United States, to revise policy language to eliminate implied duties of the policyholder and/or provide clear explanation of any new duties owed to the issuer of the policy. If so, this will test the court's proposition that the ALTA 2006 policy form is not a contract of adhesion since the "construction-lending industry has remained involved in" the process of revising the ALTA insurance forms.

There are other things construction lenders can do to reduce the risk of being found to have "created" mechanics liens to the detriment of potential title insurance claims.

First, lenders should ensure that their form of building or construction loan agreement contains an express, prominent disclaimer of any third party beneficiaries of lender's obligation to lend. Although such provisions are found in most well drafted building or construction loan agreements, there is no indication in the *BB Syndication Services* decision as to whether such a provision was present in the loan documents in that case. Construction lenders and their counsel should:

(i) ensure that their building or construction loan agreements contain a provision that confirms that the agreement is for the sole benefit of borrower and lenders, expressly excluding any and all third party beneficiaries;

(ii) have such a provision expressly note that all conditions to advances are expressly for the benefit of the lender and can be freely waived by lender; and

(iii) consider expressly referring to any issuer of a title insurance policy as being excluded from third party rights.

Second, construction lenders may consider, prior to loan closing and issuance of the loan title insurance policy, specifically giving the title insurer notice of both:

(i) the fact that the loan agreement contains a balancing clause and other preconditions to each loan advance; and

(ii) the fact that the loan agreement expressly excludes third party beneficiaries and states that conditions to advance set forth therein are solely for the benefit of lender and may be waived by lender in its sole and absolute discretion.[17]

Third, at the time when a lender learns of a construction loan being out of balance, it should consider taking a harder line with the borrower (*i.e.*, refusing to fund until borrower has brought the loan back in balance) when the lender might have otherwise been more flexible had it not been for the prospect of potentially losing the benefit of title insurance when a court, perhaps years later, determines the lender should have cut its losses and foreclosed, as in the *BB Syndication Services* case.

Lastly, when making a conscious decision to continue funding a loan which is "out of balance" or to exercise its right to cut off funding until the loan is back in balance, a lender should create a record of the reasons for the decision, by either setting it forth in any letter to borrower advising borrower of the default (or reserving rights if the decision is to keep funding for some period) and providing a copy to the title insurance company. Litigants may later try to paint such letter as self-serving, but particularly if the borrower or the title insurer do not at the time complain that the lender is acting wrongfully, such a record will help fight any later allegations that lender's decision to fund or not fund was not made in good faith or was otherwise wrongful.

Perhaps the most important lesson for construction lenders is one that relates not to the forms of the title insurance policy or loan documents, but to the underlying structure of the business deal: recognizing that "fast track" projects in which the loan is committed prior to final plans and specifications and/or prior to there being a guaranteed maximum price construction contract in place (or a substantial percentage of major subcontracts already signed) involve a greater risk of cost overruns, funding shortfalls and ensuing mechanics' lien issues.

When considering financing fast track projects, construction lenders should take steps to mitigate the additional risks by more carefully considering the qualifications, ability and financial strength of the borrower, requiring a completion guaranty from a credit worthy principal, declining to advance funds until the plans and budget are final or nearly so and/or requiring that the borrower enter into a general contract with a guaranteed maximum price.

Conclusion

The competing interests of construction lenders, title insurers and mechanics' lienors have been always been fertile ground for dispute. Since judicial decisions interpreting the title insurance provisions regarding mechanics' liens have often come to inconsistent and sometimes surprising conclusions and the lien laws of each state vary considerably, it behooves construction lenders to try to make explicit that they are not undertaking duties to title insurers beyond those set forth in the title insurance policies and, if applicable, in any express written agreements with the title insurer.

NOTES:

[1]Policy forms vary and in some states, such as Illinois, where mechanics' liens can have priority over the lien of the lender's mortgage even if the claims related to work commenced after the date of the policy (or the recording of the mortgage), mechanics' lien coverage is often adjusted by policy endorsement to reflect state lien laws. As was the case in *BB Syndication Services*, the title insurance company typically issues so-called "date down" endorsements with each loan disbursement insuring the priority of the lien of the mortgage over the total amount of all advances made as of the date of the date down endorsement. *BB Syndication Services, Inc. v. First American Title Ins. Co.*, 780 F.3d 825, 827–28 (7th Cir. 2015).

[2]*BB Syndication Services, Inc. v. First American Title Ins. Co.*, 780 F.3d 825, 827–28 at 831 (7th Cir. 2015), citing *Home Federal Sav. Bank v. Ticor Title Ins. Co.*, 695 F.3d 725, 732–33 (7th Cir. 2012) ("[T]he clear majority view . . . is that [Exclusion 3(a)] applies only to intentional misconduct, breach of duty, or otherwise inequitable dealings by the insured."). The Eighth and Tenth Circuits, according to the Seventh Circuit in this opinion, "have squarely held that when a construction lender cuts off funding in this situation [referring to a situation in which the lender ceases funding the loan due to cost overruns], it 'creates' or 'suffers' any liens that arise from insufficient funds, triggering the application of Exclusion 3(a)." *BB Syndication Services, Inc. v. First American Title Ins. Co.*, 780 F.3d 825, 833 (7th Cir. 2015).

[3]*Chicago Title Ins. Co. v. Resolution Trust Corp.*, 53 F.3d 899 (8th Cir. 1995).

[4]*BB Syndication Services, Inc. v. First American Title Ins. Co.*, 780 F.3d 825 (7th Cir. 2015). Some of the added costs at this time were due, in part, to the original contractor stopping work. The borrower briefly hired a new contractor, but did not make up the shortfall needed to bring the loan into balance. Then, when the lender called the loan, the borrower declared bankruptcy. In the bankruptcy proceeding $17 million in mechanics' liens were held to have priority over the lien of the lender's mortgage and the uncompleted project was sold for $10 million. The lender received only $150,000 on its $61 million loan. *Id.* at 828–29.

[5]*BB Syndication Services, Inc. v. First American Title Ins. Co.*, 780 F.3d 825, 835 (7th Cir. 2015).

[6]Quite apart from the legal issues involved in the *BB Syndication Services* case, construction lenders should note well that the construction project involved was being done on a so-called fast track basis, "meaning that the contracts were signed and work started before the design was finalized." *BB Syndication Services, Inc. v. First American Title Ins. Co.*, 780 F.3d 825, 828 (7th Cir. 2015). A fair inference is that if the project budget and loan transaction were structured based on final design plans, dramatic budget increases soon after loan closing would have been much less likely.

[7]*Id.* at 835.

[8]*Brown v. St. Paul Title Ins. Corp.*, 634 F.2d 1103, 1108 n.8 (8th Cir. 1980).

[9]*BB Syndication Services, Inc. v. First American Title Ins. Co.*, 780 F.3d 825, 836 (7th Cir. 2015).

[10]ALTA Loan title insurance policies also include a duty to defend the insured lender in litigation in which any third party asserts a claim covered by the policy adverse to the insured lender at the title insurance company's cost, but the title insurance company is afforded the option to pay the lender the amount of the insurance, to purchase the indebtedness or to settle the claims with the third party claimants or the insured. (See ALTA 06 Policy, Conditions 5(a) and 7).

[11]*BB Syndication Services, Inc. v. First American Title Ins. Co.*, 780 F.3d 825, 836 (7th Cir. 2015). The treatise that the court cites with respect to an endorsement readily available to provide coverage at additional cost, Michael T. Madison et al., Law of Real Estate Financing § 6:19 (2001), cites a 1985 periodical for reference to the "Seattle Endorsement," 5 ABA Real Prop. Financing Newsletter 19 (1985). The text of this Seattle Endorsement is "In construing Exclusions from Coverage 3(a), the insured will not be deemed to have created, suffered, assumed or agreed to a defect, lien, encumbrance, adverse claim or other matter because of insured's failure, which failure is permitted under the loan documents and/or applicable law, to disburse the full amount of its loan proceeds or because the loan proceeds are insufficient to complete construction of the improvement and/or pay all construction costs."

[12]*BB Syndication Services, Inc. v. First American Title Ins. Co.*, 780 F.3d 825, 839 (7th Cir. 2015).

[13]*See, e.g., Home Federal Sav. Bank v. Ticor Title Ins. Co.*, 695 F.3d 725 (7th Cir. 2012) (no duty to continue funding found); *Brown v. St. Paul Title Ins. Corp.*, 634 F.2d 1103 (8th Cir. 1980) (lender has duty to title insurer to fund), and *Bankers Trust Co. v. Transamerica Title Ins. Co.*, 594 F.2d 231 (10th Cir. 1979) (lender has duty to title insurer to fund).

[14]*Brown v. St. Paul Title Ins. Corp.*, 634 F.2d 1103, 1110 (8th Cir. 1980), and *Bankers Trust Co. v. Transamerica Title Ins. Co.*, 594 F.2d 233 (10th Cir. 1979).

[15]*Home Federal Sav. Bank v. Ticor Title Ins. Co.*, 695 F.3d 734 (7th Cir. 2012).

[16]*BB Syndication Services, Inc. v. First American Title Ins. Co.*, 780 F.3d 825, 836 (7th Cir. 2015).

[17]In jurisdictions such as Illinois and Missouri where title insurers customarily require, as a condition to any mechanics' lien coverage, that construction loan proceeds be disbursed through the title company pursuant to a disbursement agreement, the respective duties of lender to the title company, and vice versa, with respect to funding (particularly in out of balance situations and other default scenarios) should be expressly delineated in the disbursement agreement to avoid having to rely on the courts' to try to determine the intent of the parties.