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The Limits Of Title Insurance

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Most real estate closings culminate in the issuance of title insurance. A title insurance policy confirms that the parties created whatever insured interests in real estate that they thought they created. The policy also tells the policyholder that no one has any claims to the insured real estate except as listed in the policy.

Like any other insurance policy, a title insurance policy has a long list of exclusions, qualifications, and restrictions – sometimes longer than the language that provides insurance. Those exclusions and their numbering have become quite standard across the country.

Of particular interest, exclusion 3(a) in any title insurance policy denies coverage for – or, in other words, the policy doesn't protect the policyholder against – anything that is "created, suffered, assumed, or agreed to" by the policyholder. That exception means, for example, that if the policyholder granted an easement to someone, the title policy won't protect the policyholder from that easement. It makes sense.

A recent Arkansas Court of Appeals case interpreted exclusion 3(a) more broadly, in a way that might give pause to anyone who participates in a real estate closing and expects to rely on a title insurance policy. The complex factual history of the case somewhat obscures the fundamental issue, which can be distilled as follows.

A bank made a loan. The borrower gave the bank a mortgage to secure the loan. The bank obtained a policy of title insurance covering the mortgage. The bank then handled the recording of the mortgage, but somehow screwed it up. No one noticed until six years later, when the bank tried to foreclose.

The errors in recording meant that the insured mortgage suffered from problems that it shouldn't have. The title insurance policy would ordinarily cover those problems. The bank made a claim on its policy.

The title insurance company denied coverage based on exclusion 3(a), stating that the bank's careless recording of the mortgage was a problem that the insured bank "suffered" or "created," so the policy didn't cover it. Needless to say, that proposition came as a surprise to the bank.

The Arkansas court agreed with the title insurance company, saying that the bank "had within it the power to prohibit" the particular mistake that actually occurred. That was enough for the court to conclude that the bank had "suffered" the problem, or in other words allowed it to happen.

Therefore, the title insurance company didn't have to pay for the loss that the bank experienced because of the sloppy recording.

Other courts have taken a less friendly position towards the title insurance industry, declaring that exception 3(a) prevents coverage only if the policyholder takes some affirmative action to create problems with the insured interest in real estate, such as creating and recording an easement before the insured document has been recorded.

In the Arkansas case at issue, the bank learned the hard way that it should have left the recording process to the title insurance company. Had the bank done that, the title insurance company couldn't have blamed the bank if the documents were recorded incorrectly. Perhaps the title insurance company should have insisted on controlling that process. Perhaps the title insurance company should be charged with having committed an error by allowing the bank to record the documents. It is easy enough for title insurance policyholders to insist that the title insurance company handle recordings. In fact, that is the normal procedure for most closings.

The logic of the Arkansas case might prompt some larger concerns. For example, suppose the bank's mistake had related not to the recording process, but instead to the preparation of the mortgage. Suppose, for example, that state law requires a particular "Julex" clause in every mortgage, without which the mortgage does not create a valid lien and cannot be foreclosed. Finally, suppose the bank forgot to include a "Julex" clause in the mortgage.

If the parties recorded that mortgage and the title insurance company insured the bank that its mortgage created a valid lien, could the title insurance company disclaim coverage because it was the policyholder that forgot to include the "Julex" clause? The logic of the Arkansas case would invite the title insurance company to blame the bank for the error and deny coverage under policy exception 3(a). In other words, the title

insurance policy might not really stand behind the effectiveness and validity of the closing documents if the policyholder can be blamed for whatever deficiencies afflict the documents.

Participants in real estate transactions shouldn't over-rely on their title insurance policies. They and their counsel still need to get it right and try to make it easy to deny responsibility and blame the title insurance company if something goes wrong. That's one reason the title insurance companies collect premiums.

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I help buyers, sellers, borrowers, lenders, tenants, property owners, and other commercial real estate market participants identify and achieve their business goals. To do that, I need to understand risk, security, numbers, value, financeability, flexibility, and exit strategy. Some legal issues matter a lot and many don't. It's important to know the difference. I write extensively on commercial real estate law and practice – over 300 articles and five books on leasing, lending, and other areas, with some emphasis on ground leases. I occasionally serve as an arbitrator or expert witness in complex real estate disputes. That lets me see how transactions go wrong. Often, the problems could have been avoided by keeping it simple and following the money, but everyone got sidetracked. As a Forbes contributor, I try to tell stories that teach worthwhile lessons for real estate deals. **Read Less**