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Underwriter successful in limiting liability to lender after borrower default

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Court Report
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 Exclusive

After a borrower in California defaulted on a \$37 million construction loan, the lender sued the underwritten title company and the title insurer for allegedly breaching the lenders closing instructions and the title policy and also for alleged fraud, breach of fiduciary duties and bad faith. After almost 2 months of trial, a jury found otherwise, finding no fault on the part of the title company or the title insurer.

“There was a lot at stake in this case,” said **Eric Early**, partner at the Los Angeles-based firm of Early Sullivan Wright Gizer & McRae LLP, the lead trial counsel for the title companies. “We are very grateful that the jury saw it 100 percent the right way.”

While he couldn't speak generally for the title insurance community, Early noted that he has seen a number of similar lawsuits.

“We see a lot of lenders trying to overcome their failed underwriting decisions by going after title insurance companies and underwritten title companies,” he said. “The loan in question in our lawsuit was made shortly before the market crashed, when lenders were throwing around money left and right. There was a lot of money at stake here, and one of our main themes at trial was that behind the bank's theories of purported liability, this was really a case of a bank trying to recoup from my clients, who had done nothing wrong, a loss caused by the bank's failed underwriting and lending practices, and by the market crash.”

The case, heard in the Superior Court of the State of California for the County of Riverside, is *Central Pacific Bank v. Fidelity National Title Insurance Company and Fidelity National Title Company (No. RIC 525131)*.

The facts

The lawsuit arose out of a \$37 million construction loan made by Central Pacific Bank (and participating lender Preferred Bank) (collectively, the “Bank”) to finance the construction of a residential development on Tract No. 29843 in Hemet, California. Fidelity National Title Company (FNT) acted as the underwritten title company for the bank with respect to the original \$35 million construction loan pursuant to written lenders closing instructions in 2006, as well as a loan modification in 2007. Fidelity National Title Insurance Co. (FNTIC) was the title insurer of the bank's deed of trust.

The title insurance covered lots 1-120 on Tract No. 29843, excluding lots 121-125, which, according to county

records, were owned by Temecula Valley LLC, not PCG-Peppertree LP, the borrower. Before the loan in question was made, PCG-Peppertree owner **William Lo** had sold a controlling interest in Pacific Century Homes (PCH) to Lennar Homes, which formed Temecula Valley to develop more than 10,000 home sites originally controlled by PCH, including the subject property. Temecula Valley owned the property from 2003 until 2005. Lennar chose not to develop the property further and sold the project back to Lo. In November 2005, Peppertree bought the property back from Temecula, but only lots 1-120, according to the legal description on the grant deed recorded after the sale.

In 2008, PCG-Peppertree failed to repay the construction loan and abandoned the development with millions of dollars of mechanic's liens and stop notices arising from unpaid work performed by project contractors. Following PCG-Peppertree's abandonment, numerous lawsuits were filed against the Bank by sub-contractors and suppliers seeking to foreclose mechanic's liens and assert related causes of action. Following its default, PCG also informed the Bank that its deed of trust did not cover Lots 121-125. The Bank tendered the underlying mechanics lien actions to FNTIC in April 2008. The Bank also tendered a separate claim to FNTIC in July 2008 for coverage of Lots 121-125. FNTIC accepted the defense of the mechanics lien claims under a reservation of rights. In December 2008, FNTIC denied coverage as to Lots 121-125.

FNTIC retained the Luce Forward law firm to defend the bank against mechanic's lien claimants, paying more than \$1 million in attorneys' fees to defend the bank in those cases. The insurer also paid approximately \$700,000 under a reservation of rights to the mechanics to help settle the claims.

Central Pacific Bank's allegations

In its complaint against Fidelity, in which the bank sought recovery of the full amount of the loan, plus interest, attorneys' fees, receiver fees and punitive damages, in an amount exceeding \$50 million, the bank alleged that FNT breached the lenders closing instructions and its fiduciary duties, and fraudulently concealed information about Lots 121-125 from the bank.

"Had FNT complied with the escrow instructions and its fiduciary duties, it could not have closed the construction loan or the subsequent loan modification and could not have distributed the construction loan or the modification and disbursed the construction loan funds in the first instance," the bank alleged.

"One of FNT's obligations under the escrow instructions was to obtain an American Land Title Association (ALTA) loan policy of title insurance with specific required endorsements that insured Central Pacific Bank's deed of trust was a first priority lien," the bank continued. "FNT obtained a title insurance policy from its sister company, FNTIC. However, the policy did not satisfy the requirements of the escrow instructions. Moreover, FNTIC subsequently wrongfully denied insurance coverage under the policy that FNT did obtain, causing Central Pacific Bank further damages and forcing Central Pacific Bank to file this action to establish the existence of the title insurance that FNT was required to obtain."

Among other things, the bank alleged that FNT failed to attach an accurate legal description to the recordable documents or verify the accuracy of the legal description.

"Instead, FNT prepared and attached a legal description that it knew was materially incorrect and internally inconsistent," the bank alleged. "Although FNT knew that property covered by the construction loan included all

lots within Tract 29843, and further knew that Tract 29843 consisted of numbered lots 1 through 125, the legal description it prepared and then attached to the recordable documents failed to expressly refer to lots 121-125 in Tract 29843.”

The bank further alleged that FNT failed to inform it that the title insurance policy did not cover all lots within Tract 29843 and did not insure that the construction deed of trust was a first lien on the property.

“Had FNT undertaken to strictly comply with the closing instructions and to fulfill its fiduciary duties as escrow agent, it could not have closed the construction loan because it could not satisfy its obligations under the closing instructions,” the bank alleged. “In addition, it would have recognized all of the disabling problems and learned any of the material facts described above that were not actually in its possession prior to the close of escrow. At a minimum, FNT was required to advise Central Pacific Bank of the facts described, to ask the inescapable questions arising from those facts and to seek further written instructions, in which case the construction loan would not have closed and Central Pacific Bank would have avoided the massive losses and the costs described.”

According to the bank, before the loan modification took place, PCG-Peppertree requested FNT update the legal description to include the originally omitted lots, 121-125. The bank further alleged that FNT did not advise the Bank of PCG-Peppertree’s request.

“Had FNT informed Central Pacific Bank of PCG-Peppertree’s Aug. 16, 2007, communication, Central Pacific Bank would not have proceeded with almost \$6 million in additional advances and would have had an opportunity to mitigate its damages,” the bank alleged. “Moreover, as with the original construction loan, FNT prepared a revised legal description that was used in connection with the loan modification which again contained an erroneous legal description.”

The bank also alleged that FNTIC wrongfully and in bad faith denied coverage as to Lots 121-125.

“FNTIC denied insurance coverage as to lots 121-125 in Tract 29843 and refused to act reasonably to promptly settle mechanic’s lien claims to mitigate Central Pacific Bank’s losses,” the bank alleged. “Adding insult to injury, FNTIC’s denial of insurance coverage is bootstrapped from FNT’s own failure to prepare a correct legal description of the real property, which faulty description FNTIC subsequently incorporated into the ALTA loan policy it issued to Central Pacific Bank then used as a circular and pretextual basis to deny insurance coverage.

“Moreover, rather than respond simply to Central Pacific Bank’s claims, Fidelity conducted a purported ‘investigation’ for more than nine months, forcing Central Pacific Bank to provide tens of thousands of documents at significant cost, only to deny coverage based upon purported facts in its possession the entire time,” the bank alleged.

The bank made claims for breach of contract, breach of the implied covenant of good faith and fair dealing, declaratory relief, reformation of the scope of the title insurance policy, reformation of endorsements to the policy, breach of closing instructions, breach of fiduciary duty, negligence, fraud and negligent misrepresentation.

Fidelity’s response

In its trial brief, both Fidelity entities maintained that they did nothing wrong and the bank's loss was due to its own actions.

"Before making the loan the bank calculated that over the two-year course of the loan, PCG-Peppertree would construct and sell over 400 housing units, enabling it to repay the loan," Fidelity stated. "When the two years had passed, only 29 units had been built, only 13 sales of units had closed and at the end of the day, only seven units were inhabited. The property is strewn with construction defects, and the cost of fixing those defects, taken together with the drop in value of the property thanks to the real estate collapse, renders the entire Peppertree property literally worthless. Fidelity, of course, had nothing to do with any of these decisions or occurrences. The cause of the bank's loss has nothing to do at all with Fidelity. Undaunted, however, the bank — with \$37 million gone and a worthless property as security — has fashioned its creative lawsuit to seek a bailout from Fidelity for its disastrous underwriting practices. The bank tries to turn Fidelity into the super guarantor of all things related to property. The bank's theories, its case and all of its causes of action fail."

Fidelity noted that the bank had retained outside lender's counsel to handle the loan and that FNT followed the bank's counsel's lenders closing instructions, by attaching the proper legal description to the bank's deed of trust. Fidelity also maintained that the legal description in the Preliminary Report in question clearly informed the bank that only Lots 1-120 were going to be covered (this notwithstanding the bank's contention that the address line on the Preliminary Report, and APNs appearing on the report, allegedly provided otherwise).

"After the borrower defaulted, the bank asserted that it discovered for the first time that the legal description was missing lots 121-125," Fidelity stated. "And conveniently, only after this lawsuit was filed did the bank inform Fidelity for the first time that it did not retain [its attorney] to make sure that the bank had fully and properly secured its \$35 million loan. If the bank in fact limited [the attorney's] representation in this regard, it violated longstanding lending industry custom and practice. If it did not, then the bank should have sued the law firm for malpractice. Yet the bank claims it has no tolling agreement with the firm. A title officer follows instructions and he did just that. An attorney, as well as the bank's in-house loan officers, are, pursuant to industry custom and practice, the ones who make sure the bank has all of its collateral. The bank and its counsel both failed miserably. All of the claims against FNT (breach of the closing instructions, negligence, breach of fiduciary duty and fraud) simply lack merit. Nevertheless, the bank has the temerity to argue in this case that the instructions were violated (because the deed of trust was missing the five lots), and thus the loan never should have closed, and therefore, that FNT should reimburse the bank for the entirety of its terrible loan."

While defending the bank as to its mechanic's lien claims, Fidelity retained the law firm of Miller Starr Regalia to conduct the coverage investigation as to those claims and the claim regarding Lots 121-125.

"The policy is clear on its face that those lots are not covered, and the underlying investigation revealed that Fidelity never intended to provide coverage for the missing lots, and indeed, that neither Peppertree nor the bank ever expressed anything to Fidelity to the contrary," Fidelity stated. "And they are not covered because the bank, its outside counsel and in-house loan officers, were asleep at the wheel when the deed of trust was created, and the policy was negotiated and issued."

Fidelity also noted that the borrower, Lo, had offered the bank to reform the deed of trust to include the missing lots, and yet the bank had failed to inform Fidelity of this offer. "Inexplicably, the bank never took Peppertree up

on its offer,” Fidelity stated. “The bank could have had all of the lots it claims it so badly wanted, but never received, within weeks of its discovery of the purported problem with these lots. Instead, the bank apparently has used this purported title defect as a pretext to seek a complete bailout from Fidelity for the bank’s disastrous loan to Peppertree.”

“In short, and at the end of the day, this is a case brought by a grossly negligent bank and a team of clever attorneys, who will put forth any argument they think can possibly fly to cause Fidelity to bail out the bank,” the insurer stated.

After deliberating for less than a day, the jury issued a complete defense verdict, answering all questions in favor of Fidelity.

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