



Obtaining Title Insurance on Construction Loans: Avoiding Pitfalls Regarding Title Insurance Underwriting for Construction Loans

Alabama State Bar

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Overview and Risks of Construction Mortgages in Today's Economy

- Periodically disbursed after initial closing and amount of indebtedness increases with each disbursement
- Present unique circumstances requiring special considerations
- Pose significant risks for title insurers
- Highly scrutinized and require specific title underwriting analysis
- Mechanic's liens are a significant source of claims for title insurers
- Always consult with title insurance underwriter about transaction specific matters

Mechanics' Liens, so what are the risks?

- In Alabama mechanics' liens are purely statutory and codified at Ala. Code § 35-11-210 to 35-11-234
- The lien arises when the claimant makes the contribution, but remains inchoate until action is taken to enforce the lien
- Relates back to the date of the initial contribution of labor or materials and could jeopardize priority of construction mortgage
- Two types of liens
 - “Full price” lien-contract between lien claimant and owner
 - “Unpaid balance” lien-no express contract between lien claimant contributing materials and the owner.
- Lien claimant must strictly comply with statutory mandates for the perfection of any claimed lien, and if there is a failure, he becomes merely a general creditor and loses status as a lien claimant

Lienable Contributions-Labor

- Depends on the nature of the labor contributed (ex. original contractor or day laborer)
- Must be established that the labor was performed upon or contributed to something that has attached to and become part of the realty upon which the lien is claimed.
- Determined to be contribution of labor for improvement on land:
 - Clearing, grading, and site preparation of raw land
 - Demolition of existing structures
 - Site inspection by architect for progress of work
- Determined not to be contribution of labor for improvement on land:
 - Mere preparation of building plans by architect
 - Surveying, lot staking and map or plat preparation by a surveyor

Lienable Contributions-Materials

- Materials must actually be contributed to and incorporated into improvements
- Contract modifications or change orders can result in extensions of the date of maturity of the indebtedness, therefore creating a different time within to bring the civil action to perfect and enforce a lien.

Lienable Contributions-Other

- Waste disposal services
- Equipment or Machinery Rental

ALTA 2006 Loan Policy of Title Insurance

COVERED RISKS

SUBJECT TO THE EXCLUSIONS FROM COVERAGE, THE EXCEPTIONS FROM COVERAGE CONTAINED IN SCHEDULE B, AND THE CONDITIONS, The Company, insures as of Date of Policy and, to the extent stated in Covered Risks 11, 13, and 14, after Date of Policy against loss or damage, not exceeding the Amount of Insurance, sustained or incurred by the Insured by reason of:

11. The lack of priority of the lien of the Insured Mortgage upon the Title
 - (a) as security for each and every advance of proceeds of the loan secured by the Insured Mortgage over any statutory lien for services, labor or material arising from construction of an improvement or work related to the Land when the improvement or work is either
 - (i) contracted for or commenced on or before Date of Policy; or
 - (ii) contracted for, commenced, or continued after Date of Policy if the construction is financed, in whole or in part, by proceeds of the loan secured by the Insured Mortgage that the Insured has advanced or is obligated on Date of Policy to advance

ALTA 2006 Loan Policy of Title Insurance

THE EXCEPTIONS FROM COVERAGE CONTAINED IN SCHEDULE B

- Standard Mechanics' Lien Exception:

Item _____. Any lien or right to a lien for service, labor or materials heretofore or hereafter furnished, imposed by law and not shown by the public record

- By virtue of deleting the above exception, mechanics' coverage is afforded to the insured lender.

Considerations for Residential Construction Projects

- Generally mechanics' lien coverage is not given during the period of construction
- Therefore, the mechanic's lien exception should be included in construction loan policy insuring residential construction, as shown below.

Item _____. Any lien or right to a lien for service, labor or materials heretofore or hereafter furnished, imposed by law and not shown by the public record.

Considerations for Commercial Construction Projects

- Availability of mechanic's lien coverage is generally determined on a transaction specific basis with guidance and approval from the title insurer
- One should be prepared to request and obtain additional information from the borrower in order to evaluate the availability of such coverage.
- Additional time should be expected when mechanic's lien coverage is requested to properly underwrite the transaction.
- Communicate as soon as possible that the transaction involves construction and the lender is requesting mechanics' lien coverage.

Examples of items and information to be obtained and reviewed:

- Type of the proposed project (Apartment Complex, Office Building, Poultry House, Shopping Center)
- The construction contract (fixed price or cost plus)
- The construction budget
- Construction Loan Agreement
 - Obligatory or Optional Advancements
 - Disbursement Controls
 - Monitoring of project completion percentages
 - Frequency of Draw Requests
- Copy of subordination from the general contractor to the lender

Examples of items and information to be obtained and reviewed:

- Appraised amount of the project.
- Reputation and experience of general contractor.
- Who will be collecting lien waivers as construction progresses.
- Recent financial statements of the borrower and any other indemnitors.
- Payment and Performance Bond
- Will lender require issuance of date down endorsement prior to each funding of construction draw?

Commitment to Insure Construction Mortgage

- Every commitment should contain the following pending disbursement clause:

NOTE: Pending disbursement of the full proceeds of the loan secured by the Mortgage insured, this policy insures only to the extent of the amount actually disbursed without knowledge of any intervening lien or interest, but increases as each disbursement is made, up to the face amount of the policy.

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Commitment to Insure Construction Mortgage

- If a survey has not been provided the standard survey exception should remain
- If a survey is provided, specific exceptions should be made for matters reflected on survey, and additionally the following exception should be listed:

Item _____. Any matters which would be revealed by an accurate survey made upon completion of all permanent improvements to the land subsequent to the survey of _____, dated _____.

Establishing Priority of the Construction Mortgage

- It is CRITICAL to establish priority so there is no impairment or loss of the security of the insured mortgage.
- Obtain properly executed Non-Start Affidavits from the owner and contractor stating that no work has been performed and no labor or materials have been supplied to the land to be insured.
- In some cases it may be necessary to visually inspect and photograph the site to verify work has not commenced.
- Prompt recordation is essential in protecting the interests of the insured.

Lost Priority of the Construction Mortgage

- Contact title insurer immediately!
- Be prepared to satisfy additional underwriting requirements and possibly a delayed closing
- In some cases mechanic's lien coverage may not be available, or
- Exception to certain previously commenced work or supplied materials may be required
- Bond requirement

Lost Priority of the Construction Mortgage

- General requirements include:
 - Mechanics' and Materialmen's Lien Indemnity Agreement
 - Individual
 - Business Entity with Guarantors
 - Business Entity without Guarantors
 - Sworn Construction Statement as to payment of work
 - Owners and Contractors Affidavit and Agreement
 - Full or Partial Lien Waiver from General Contractor of Subcontractors
 - Subordination Agreement
 - Contractor's Affidavit and Release
- In some instances an Escrow and Indemnity Agreement may be necessary.
- Bond naming title insurer as obligee
- Financial Statements of Owner, Principal or General Contractor

Lost Priority of the Construction Mortgage

- ALTA 32 Series Construction Loan Endorsements
 - Used in situations when there is limited or no priority for the lien of the Insured Mortgage over later filed mechanic's liens and where the agent will be reviewing draw request and disbursement records whether or not the title agent is acting as the disbursement agent.
- ALTA 33-06 Disbursement Endorsement
 - Used solely in connection with the ALTA 33 Series Endorsements and acts as a date down endorsement for construction disbursements.
 - Endorsement provides for a change to the Date of Coverage as defined in the ALTA 32 Series, but does not change the Date of Policy
 - Requires the insertion of any additional exceptions resulting from the title search performed in connection with the issuance of the endorsement

Q & A

Questions & Answers



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Thank You

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