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Client Alert

Capital Transactions and Real Estate Practice Group and Financial Restructuring Practice Group

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Seventh Circuit Court of Appeals: No Coverage under Title Insurance for Mechanics' Liens Arising after Construction Lender Stops Funding

On March 12, 2015, the United States Court of Appeals for the Seventh Circuit entered an opinion interpreting "the most litigated provision in the standard-form title-insurance policy purchased by real-estate lenders to protect their security interests in ongoing construction projects."[1] Exclusion 3(a) in the standard-form construction lender's title policy provides that liens that are "created, suffered, assumed or agreed to" by the insured lender will not be covered under the title policy. In *BB Syndication Services, Inc. v. First American Title Insurance Company*, the Seventh Circuit held, in the context of a failed construction project, that this exclusion applies to mechanics' liens arising as a result of a construction lender's decision to declare a default and stop funding additional loans.[2]

Background

Like most large construction projects, the "West Edge" project in Kansas City, Missouri was funded by a combination of a cash contribution from the developer, Trilogy Development Company (the "**Developer**"), and a construction loan from the lender, BB Syndication Services (the "**Lender**"), secured by the development.[3] The Lender's loan documents contained the customary provisions whereby the loan proceeds were disbursed only as the project progressed and the Lender had the ability to stop funding if the loan became "out of balance" —*i.e.*, if it became apparent that the cost of the project would exceed available funding. At closing, the Lender obtained a lender's title insurance policy from First American Title Insurance Company ("**First American**"). As the project progressed, the Lender obtained an updated title policy each time it disbursed new loan proceeds.[4]

One and a half years after construction began, the project's general contractor, J.E. Dunn Construction Co. ("**Dunn**"), asserted that design changes made by the Developer would likely increase the construction costs by $20 to $30 million. The Lender had only extended about $5 million of its $86 million loan commitment.[5] Notwithstanding Dunn's estimates of cost overruns, the Developer continued construction and the Lender continued funding. One year (and $56 million in loans) later, the Developer acknowledged that funding for the project was short by about $37 million.

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The Lender declared a default and stopped funding, and the Developer filed for bankruptcy.[6]

In bankruptcy, the Developer commenced litigation to determine the amount and priority of the liens of its various creditors. In addition to the Lender's $61 million secured claim, Dunn and several subcontractors held claims in excess of $17 million secured by mechanics' liens on the project. Because a substantial portion of the asserted mechanics' liens related to work done prior to First American's last update to the title policy, the Lender looked to First American to defend the litigation and cover any loss.[7] However, First American denied coverage, asserting that the Lender caused the mechanics' liens to arise by cutting off funding for the project and, therefore, the liens were subject to Exclusion 3(a).[8] The Bankruptcy Court held that the mechanics' liens took priority, the project was sold to a third party for approximately $10 million, and the Lender, after reaching a settlement with the other claimants, received only $150,000 on its $61 million claim.[9]

Following First American's denial of coverage, the Lender sued First American in Wisconsin state court alleging breach of the title policy and bad-faith denial of coverage. First American subsequently removed the case to federal court, where the District Court held in a split ruling that: (a) First American breached its duty to defend and thus was required to reimburse the Lender for its attorneys' fees in the bankruptcy litigation; but (b) First American did not have an obligation to indemnify the Lender for the mechanics' liens because coverage was excluded under Exclusion 3(a).[10] The Lender promptly appealed the latter ruling to the Seventh Circuit Court of Appeals.

Seventh Circuit Opinion

Exclusion 3(a) excludes from coverage any liens "created, suffered, assumed or agreed to" by the insured lender. On appeal, the Seventh Circuit reasoned that the application of this exclusion turns on whether the Lender was at "fault" for the lien. Because the liens at issue here arose from work that went unpaid as a result of the Lender's decision to stop funding, the Court concluded that the liens arose directly from the Lender's actions and thus fell squarely within Exclusion 3(a).[11]

Noting that various courts have come to differing conclusions regarding the application of Exclusion 3(a), the Court reviewed authorities from the Eighth and Tenth Circuits supporting the exclusion and authorities from the Sixth and Eighth Circuits refusing to apply the exclusion in similar (although factually distinguishable) circumstances. The Seventh Circuit concluded that Exclusion 3(a) applies to mechanics' liens arising when a construction lender declares a default and stops funding. The Court reasoned that it is appropriate for the Lender, not First American, to bear the risk of unpaid subcontractors because "construction lenders have significant ability to ensure that the projects they finance remain economically viable—both at the beginning when deciding whether to finance a project and how much money to commit, and also throughout construction."[12] In support of this conclusion, the Court noted that construction loan documents, like the ones at issue in this case, usually give a lender broad rights to monitor the project and significant discretion when advancing funds throughout the course of the project.[13]

In light of a construction lender's ability to monitor the project and any cost overruns, the Court concluded that "when liens arise from insufficient funds, the insured lender has 'created' them by failing to discover and prevent cost overruns—either at the beginning of the project or later."[14] The Court held that the Lender can be said to have "created" or "suffered" the mechanics' liens that arose from insufficient project funds because the Lender, not First American, "had the authority and responsibility to discover, monitor, and prevent" such a loss. For these reasons, the Court affirmed the District Court's conclusion that the mechanics' liens were not covered under the title policy.

Lessons Learned

The Seventh Circuit's interpretation of Exclusion 3(a) in the standard-form construction lender's title policy places the risk of loss associated with unpaid subcontractors arising from a lender's decision to stop funding squarely on the construction lender, not the title insurer. There are, however, steps that a construction lender can take to mitigate this risk of loss. For example, a construction lender can request that the standard-form title insurance policy be modified to include the so-called "Seattle endorsement," which expressly protects a lender from intervening liens in situations in which it ceases funding as a result of the borrower's default. Additionally, the lender can take steps to decrease the likelihood of default and non-payment by the borrower (*e.g.*, obtain a third-party guarantee or a performance bond). Finally, a construction lender must remain vigilant and closely monitor the progress of construction, outstanding balances owed by the borrower to subcontractors, and potential cost overruns.

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[1] *BB Syndication Servs. Inc. v. First Am. Title Ins. Co.*, No. 13-2785, 2015 U.S. App. LEXIS 3956, *1 (7th Cir. Mar. 12, 2015).

[2] *Id.* at *35–*37.

[3] *Id.* at *6.

[4] *Id.*

[5] *Id.* at *7.

[6] *Id.* at *7–*8.

[7] *Id.* at *8.

[8] *Id.*

[9] *Id.* at *9.

[10] *Id.*

[11] *Id.* at *15.

[12] *Id.* at *24–*25.

[13] *Id.* at *25.

[14] *Id.* at *29.