# The New ALTA Commercial Endorsements

**By Robert S. Bozarth**

Last October the American Land Title Association (ALTA) Board of Governors adopted twelve new "commercial" endorsements for title insurance policies. In the past, ALTA issued at most only two new endorsements in any single year. The number of new endorsements in 2003 speaks volumes about the title insurance industry's current emphasis on new products and coverages.

Although the endorsements were designed primarily for commercial transactions, some may be used for residential transactions as well. Don't let that word "commercial" or, indeed, the names given to these endorsements discourage you from exploring other applications for them. The names of these new endorsements appear to add nothing new. ALTA kept the familiar names to reassure you that the coverages you sought in the past are now found in these new endorsements, but you should be aware that the coverages have been broadened substantially. So, if the new Mezzanine Financing endorsement now works as well with unsecured loans as it does with mezzanine loans, so much the better.

*Probate & Property* is not a suitable medium for displaying the text of these new endorsements, so you must look elsewhere to find them. I recommend the ALTA web site—www.alta.org—for the official text in Adobe Acrobat PDF format. If you prefer text-editable copies, you can probably find them on the web site of your title insurance company. The twelve new endorsements are organized into six groups of one-to-three endorsements. This article discusses some important features and issues presented concerning the new endorsements.

### The ALTA 14 Future Advance Endorsements

Future advance or revolving credit endorsements should be obtained if there is *any* chance of a future advance in a secured loan. These endorsements are necessary to counteract Sections 8(d) and 9(b) of the Conditions and Stipulations and Exclusion 3(b) of the basic loan policy, because advances are not protected by a basic loan policy.

Section 8(d) relieves the insurer from liability for "indebtedness created subsequent to Date of Policy," except for advances made to protect the lien of the mortgage or to prevent deterioration of the improvements (protective advances) or for certain construction advances. Unless the insurer either modifies this provision or updates the policy with each advance, Section 8(d) blocks insurance of the advance.

Section 9(b) was intended to reassure lenders that the insurer's liability would increase to recognize accrued interest and protective advances up to the Amount of Insurance. In doing that, however, it also indicated that the Amount of Insurance declines with each payment on the loan. It confused fluctuations in the insurer's liability for loss with the Amount of Insurance, so its original purpose to reassure lenders on interest and protective advances became lost in the threat of declining coverage. Section 9(b) is a classic application of the law of unintended consequences, but knowing that is little comfort to a concerned lender, especially if the mortgage secures a revolving credit line in which the amounts advanced and re-advanced might exceed the credit limit secured by the mortgage. If the aggregate repayments on readvances also exceed the credit limit, it appears that Section 9(b) would reduce the title insurance to zero. Lenders often require title insurers to neutralize Section 9(b) with "Last Dollar" endorsements that confirm that the title coverage remains intact until the borrower has repaid the "last dollar" of its obligation.

Exclusion 3(d) frees the title insurer from liability for "Defects, liens, encumbrances or other matters attaching to or created subsequent to Date of Policy"—in other words, precisely those matters that can intervene between recording a mortgage and making an advance. If Exclusion 3(d) is left unchanged, the policy will not insure the priority of an

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advance even if Sections 8(d) and 9(b) have been amended.

These policy provisions might appear to be a trap for the unwary set by a devious title insurance industry, but all states require a future advance mortgage to give notice of, at a minimum, its credit limit and the potential for future advances, either by statute or in their case law. Virginia, for example, requires three additional elements in a deed of trust that secures a credit line. Va. Code Ann. § 55–58.2. First, it requires a caption on the first page to alert a reader that a deed of trust secures a credit line. Second, it requires the deed of trust to state the "maximum aggregate amount of principal to be secured at any one time." Finally, the deed of trust must identify the noteholder and its address. If a mortgage fails to comply with a state's requirements, it may not secure future advances or give them its priority. A prudent title insurer must check the mortgage for compliance with local future advance requirements before agreeing to insure the security and priority of advances.

Lenders occasionally trust the title policy to protect the advances without realizing that it must be modified to protect future advances. This is especially likely in loans in which the future advance features are just included in the "boilerplate" of the loan documents but were never a significant concern in the loan as it was originally conceived. Years later, the borrower and lender may decide to take advantage of the mortgage's capacity to secure future advances—but face a title policy set up only to insure a term loan. If the policy had been structured to insure future advances from the start, the borrower and lender could proceed with advances without getting a modification of the title policy.

The ALTA 14 *Future Advance—Priority Endorsement* is designed for use in states that have future advance statutes giving *optional advances* either (1) with the same priority as obligatory advances or (2) with priority as of the date the mortgage was filed.

If the statute limits priority for advances made after the lender has received actual or written notice of any form of lien, then the proper form is the ALTA 14.1. The lender's classification of its advances as "obligatory" will not, alone, qualify the mortgage for the ALTA 14. No lender ever obligates itself to advance funds directly to its borrower without some minimal conditions. If the borrower fails to meet those conditions, the advance is optional. A title insurer cannot determine if the borrower will be in compliance at the time of an advance simply by reading the loan agreement before the closing.

The ALTA 14 is the basic endorsement in this group. It begins by modifying Exclusion 3(d) and Sections 8(d) and 9(b) of the Conditions and Stipulations. Section 1 defines "Advance" and connects the insurance to the provisions of the note or loan agreement. The definition does not distinguish between obligatory and optional advances, because it was intended to cover both equally. It does expressly include "protective" advances in this definition, even though the basic policy includes some coverage for them. With the endorsement, the insured is given the freedom to make a protective advance without checking to see if its advance matches the description for "protective advances" in Section 2(c) of the policy.

Section 2 of the endorsement gives the basic coverages against loss caused by the unenforceability, invalidity, or loss of priority of the lien of the insured mortgage as it secures advances. Shortly before the 2003 endorsements were adopted, a comment raised the concern that the original language of paragraph 2(b) might not protect a lender if a competing creditor was given equal priority to the advance, although it was clear that the lender was protected if it lost priority to the competing creditor. The provision was changed so that it should protect against loss caused by equal priority as well as lost priority.

Section 2 also ensures that the lender can re-advance funds and the lien will not fail if the outstanding balance of the loan equals zero. Section 3 gives the lender ALTA 6 variable rate mortgage coverage in addition to future advance coverage.

Section 4 contains exceptions from coverage for advances made after the borrower's bankruptcy, loss of priority to real estate taxes and assessments, federal tax liens, environmental liens, or usury. It has an optional exception for mechanic's liens if the lender fails to achieve statutory priority over unfiled liens. The ALTA 14.1 *Future Advance—Knowledge Endorsement* differs from the ALTA 14 only by adding one exception to Section 4 of the endorsement. The exception, in paragraph 4(d), excludes coverage if the insured had actual knowledge of an intervening lien.

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> 4. This endorsement does not insure against loss or damage (and the Company will not pay costs, attorneys' fees or expenses) resulting from: . . .
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> d. The loss of priority of any Advance made after the insured has knowledge of the existence of liens, encumbrances or other matters affecting the land intervening between the Date of Policy and the Advance, as to the intervening lien, encumbrance or other matter.

Many states will give priority over an advance to a lien subordinate to the mortgage if the subordinate lienholder gives the mortgagee notice of the subordinate lien before the advance. The ALTA 14.1 must be used in those states. If a lender argues that it should have full priority coverage because the loan agreement makes advances "obligatory," the title insurer can add a second sentence to paragraph 4(d) to the effect that "Paragraph 4(d) does not apply if the advance is obligatory." By adding that sentence, the policy does not ensure that an advance is obligatory, but if a court determines that it was obligatory the endorsement will then ensure that it had priority.

The ALTA 14.2 *Future Advance—Letter of Credit* should be used when the mortgage secures a reimbursement obligation for a letter of credit or surety bond. It insures "advances" that are given special protection in bankruptcy and against federal tax liens. Bankruptcy law and the federal tax

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code grant special protection to advances made under standby letters of credit and surety bonds because the holder of these instruments entered into a transaction with the "borrower" only because the issuing bank or insurance company substituted its credit for the suspect credit of the borrower. If the beneficiary draws on the letter of credit or bond, the issuer must fund the draw, even if the borrower is in bankruptcy (see *In re Compton Corp.*, 831 F.2d 586, 589 (5th Cir. 1987)) or has a federal tax lien (see 26 U.S.C. § 6323(c)(1)(A)(iii)) filed against it.

The ALTA 14.2 was adopted without the ALTA 6 coverage because letters of credit do not include variable rate interest features. Eliminating the ALTA 6 coverage puts the endorsement exceptions in Section 3 instead of Section 4, and it has exceptions only for real estate taxes and environmental liens. There is no exception for advances made after the borrower's bankruptcy or loss of priority to a federal tax lien created under 26 U.S.C. § 6321, as there is in the ALTA 14 and 14.1. There is an optional exception for mechanic's liens if the mortgage did not achieve statutory priority over the inchoate rights of providers of services, labor, or materials.

### "Non-imputation" Coverage

For decades, title insurers have issued proprietary non-imputation endorsements. They can give an investor in the entity owning title to land protection similar to the protection of the recording acts for buyers of the land itself. Most have been limited to protecting a new owner from the effect of policy Exclusion 3(b) only. It excludes loss or damage caused by matters known to the insured but not found in the public records and not known or disclosed to the title insurer. Investors object to Exclusion 3(d) because a title insurer might apply it even for matters the investors did not know about by imputation arising from their position as a partner, shareholder, or member of the insured.

The ALTA Forms Committee reported three non-imputation endorsements to ALTA. They broaden the coverage to protect the party from the operation of Exclusions 3(a), 3(b), and 3(e) as they apply to existing or former participants in the entity owning the insured land. Just before submitting the endorsements for approval, the Forms Committee trimmed the terms "actual knowledge" to "knowledge" in these endorsements because the policy defines "knowledge" as "actual knowledge" in Section 1 of the Conditions and Stipulations.

At the same time, the Forms Committee also recognized that an insured might suffer a loss that would have been excluded by Exclusions 3(a), 3(b), or 3(e) without actually having knowledge "imputed" to it. The endorsement drafts, however, seemed to require "imputation of knowledge" as a trigger to the coverage. To broaden the coverage, the phrase in the endorsements was changed from "imputed to the insured by operation of law" to "whether or not imputed to the insured by operation of law."

One important caution about non-imputation endorsements should be considered. A prudent title insurer must manage the risk that the selling party has not created any off-record matter that might emerge at a later time to cause a loss. It limits the coverage to matters that occurred *before* the Date of Policy. Limiting the risk to past events permits the title insurer to manage the risk by requiring the existing party to affirm that there is no off-record matter that might affect title. Although limiting the coverage to the past is necessary, as we shall see with the ALTA 15.1, such a limitation might create a coverage gap if the practitioner fails to pay attention to the details.

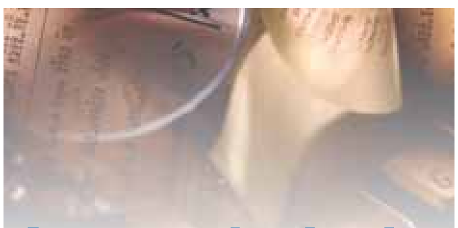
The ALTA 15 *Non-imputation—Full Equity Transfer Endorsement* was created for transfers of the entire ownership of the entity owning the land to new parties. It protects the incoming owners against defenses that the title insurer may have had against the outgoing owners of the landholding entity under Exclusions 3(a), 3(b), or 3(e). It is designed for a new policy issued to protect those incoming owners.

The ALTA 15.1 *Non-imputation—Additional Insured Endorsement* is similar to ALTA 15, but it is formatted for situations in which the existing entity is the named insured in the policy to protect an incoming partner, member, or shareholder. This endorsement might continue a flaw that began with the earliest non-imputation endorsements. It does not bring the Date of Policy forward, so it either misses the period of greatest risk to the additional insured, or, if it is construed as insuring the period from the Date of Policy to the date of the endorsement, it may lull an issuing office or agent into issuing it without conducting a fresh title rundown.

The ALTA 15.2 *Non-imputation—Partial Equity Transfer Endorsement* is also similar to the ALTA 15. It is designed for an incoming partner, member, or shareholder, as the named insured in its own policy, when the landholder is a partnership, limited liability company, or corporation.

### Mezzanine Financing

A mezzanine lender usually has a security interest in the ownership interests of the entity that holds title to the land. Its security occupies the "mezzanine" between lenders secured with a mortgage on the land and lenders with unsecured loans. A mezzanine lender can seek UCC insurance of this security interest, and most title insurers can either issue or obtain the UCC policy for the lender. The UCC



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policy is another policy to buy, however, and it is an additional expense for a junior loan.

If a mezzanine lender or first loss piece lender has no ownership interest, or mortgage, does it have any insurable interest in land at all? Its interest cannot be insured with a loan title insurance policy because there is no lien to insure. These lenders will not have an ownership interest in the land unless the mezzanine lender realizes upon its pledges of the ownership interests, so it appears that these lenders have no traditional insurable interest in the land or in a mortgage on the land.

These lenders, however, have recently sought title insurance coverage in the owner's policy with a "loss payable" provision similar to those found in a typical property/casualty homeowner's policy. The borrower has an insurable interest because it is the landowner. A mezzanine lender can bargain for the right to receive any title insurance proceeds that the borrower might receive from its owner's policy.

New York has a Mezzanine Financing Endorsement, but it applies only after the lender has taken possession of ownership interests in the entity holding title to the land. The ALTA 16 *Mezzanine Financing Endorsement* discards that restriction, so it will serve an unsecured lender as well. Perhaps the endorsement is misnamed, but it fits current requirements for mezzanine financing and avoids the confusion that might be caused by a renamed endorsement. The ALTA 16 can be issued with a new policy when the loan is closed or can be issued to amend an existing owner's policy held by the borrower.

In addition to recognizing the mezzanine lender as a loss payee, the title insurer agrees to add some other protections to enhance the coverage. Paragraph 2 allows the mezzanine lender a veto to any later change in the insured's policy coverage. Paragraph 4 gives it non-imputation coverage. Paragraph 6 is a "Fairway" provision protecting the mezzanine lender in case it acquires ownership interests pledged to it. Paragraph 8 includes a standstill provision for the title insurer's right of subrogation against the insured, the borrower, or a guarantor of the mezzanine loan. To assign these rights, both the insured and mezzanine lender must execute the endorsement.

### Access

The basic ALTA policies insure against loss if the insured has no legal right of access to the land. Courts have even found legal access as insured by the policy, however, in cases in which substantial physical barriers impede passage to the land from a public street. *Magna Enterprises, Inc. v. Fidelity National Title Ins. Co.,* 127 Cal. Rptr. 2d 681 (Cal. Ct. App. 2002). For many, that policy coverage just wasn't enough.

The ALTA 17 *Access and Entry Endorsement* augments the policy coverage by insuring against loss if (1) the land does not abut a public street, (2) the street is not physically open and publicly maintained, (3) the insured has no "actual vehicular and pedestrian access," and (4) the land has no existing curb cuts or entries. The express wording of the endorsement limits the insurance to the state of facts existing at the Date of Policy, so it should not be construed as insuring the policyholder's rights to its first choice for development.

The concept of "vehicular and pedestrian access" is unclear. The author is aware of the use of that phrase in only one case, *Marriott Fin. Servs., Inc. v. Capitol Funds, Inc.,* 217 S.E.2d 551 (N.C. 1975). Unfortunately the *Marriott* court decided that a title insurance policy's access coverage implies "vehicular access," and it defined "vehicular access" to mean that the landowner must have a right to driveway permits on the land. No other court has followed *Marriott,* but using the term "vehicular and pedestrian access" in title insurance would raise a question about what is meant.

The ALTA Forms Committee sees the language as meaning that the land has some form of existing curb cut or entry to allow a vehicle to drive onto the land. As a result, the endorsement would be inappropriate for many urban and suburban properties that have no curb cut or drive for entry onto the land.

### Tax Parcel

The ALTA 18 is a conventional tax parcel endorsement that insures against loss if the tax parcel includes more or less land than is described in Schedule A. The ALTA 18.1 introduces tax parcel coverage for developments that include fee parcels and easement parcels. It also insures against loss due to "the easements, if any, described in Schedule A being cut off or disturbed by the non-payment of real estate taxes or assessments imposed on the servient estate by a governmental authority." There is certainly a risk that a taxing jurisdiction will assert that its lien takes priority over existing easements. When a title insurer issues this endorsement, it accepts that risk.

### Contiguity

A project might require the assembly of several adjacent properties into one parcel large enough for development. Insuring the title to each individual property does not protect the developer against the risk of gaps or gores between the properties. This risk may be addressed by either developing a new perimeter description of the assembled parcel or by adding a contiguity endorsement to a policy insuring the individual properties. The ALTA 19 insures the contiguity of an assemblage of two or more parcels described in Schedule A of the policy. The endorsement describes specified lines that are contiguous to each other and insures against loss if there are "any gaps, strips or gores separating any of the contiguous boundary lines."

The ALTA 19.1 is designed for insuring that the land described in the policy is contiguous to adjacent land not insured by the policy. It might be useful if a landowner buys adjacent land and wants insurance that the new lot is contiguous to the old lot. It could apply also if the insured buys a site within a larger parcel, for example, a shopping center, and wants insurance that nobody owns any rights between its site and the rest of the shopping center.

### Why Standardized Forms?

In residential transactions bound for the mortgage secondary market, the title insurance system places a premium on immutable standard forms because residential lending is a volume business. No lender wants to take time to hire and train people skilled in reading and reviewing title insurance policies to determine if the policies meet the loan underwriting requirements of the secondary market. It is much easier to require a standard form and verify that the closer included that form in the returned loan package.

Standard coverages are not as useful in commercial transactions as they are in residential transactions. A standard coverage may not fit the structure or facts of the transaction, or the local law applied to it. There is no reason to limit a customer to "off the shelf" endorsement coverages just because some standard endorsements now exist. Of course, if a provision within an endorsement is changed, it must not be represented as an unmodified "ALTA __." The caption of the endorsement should alert a reviewer that the language has been changed.

### Conclusion

Buyers and lenders of commercial and industrial lands expect the title insurance underwriting process to parallel the due diligence process of the transaction and address the specific items found in the record title and on the survey. These new commercial endorsements reflect that need for title insurance coverages tailored to the structure and facts of a transaction. Title insurers have stabbed at these coverages over the years in their own proprietary endorsements, but if there has been a baseline endorsement for that coverage it was probably developed by the California Land Title Association. Although CLTA has many endorsements, they have been around for decades. With these commercial endorsements, ALTA makes a fresh start to develop new baselines with more aggressive coverages for title insurance customers. ■