

Title Insurance Issues

Legal Opinion: GHM-0017

Index: 3.280

Subject: Title Insurance Issues

December 26, 1991

MEMORANDUM FOR: Arthur J. Hill, Assistant Secretary for
Housing-Federal Housing Commissioner, H

FROM: John J. Daly, Associate General Counsel,
Office of Insured Housing and Finance, GH

SUBJECT: Title Insurance Issues

Background

Section 207.36 of Title 24 of the Code of Federal Regulations requires a mortgagee to furnish a survey and a policy of title insurance or its equivalent as a prerequisite to the closing of an insured multifamily housing loan. The requirement for project title insurance for FHA programs is not a recent one; it appeared in the original 1938 publication of the regulations. The regulation requires that the title policy must name the mortgagee and HUD as the insureds and must also provide that, upon acquisition of title by either the mortgagee or HUD, the policy will become an owner's policy running to either the mortgagee or HUD. If title insurance cannot be furnished, HUD may accept an abstract of the title and an attorneys' legal opinion, a Torrens certificate, or title evidence that conforms to certain government supervision.

If a mortgagee chooses to exercise its right to assign a mortgage to HUD, it must comply with 24 C.F.R. 207.258(b)(4)(ii). This provision requires that all policies of title insurance and evidence that are submitted have the original title evidence extended to include the date of the assignment of the mortgage. If the mortgagee elects to foreclose on the mortgage itself, or if it accepts a deed-in-lieu of foreclosure from the mortgagor, the requirements set out in 207.258(c)(8) and 207.258a apply. These sections provide that if title insurance was utilized at the time of endorsement, the mortgagee will be required to submit an owner's title policy in favor of HUD that is effective on the date that the project is conveyed to the Secretary. If however, an abstract and attorney's opinion were originally accepted at the time of endorsement, they are again acceptable. It should be noted that the aforementioned regulations either are incorporated into or have a counterpart in all parts of 24 C.F.R. that are applicable to multifamily programs.

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There are two basic title insurance policies, one for

owners/mortgagors and a second for lenders/mortgagees. Each is used in both commercial and residential transactions. The standard title policies have been written and promulgated by the industry trade organization, American Land Title Association (ALTA), for use in all jurisdictions except for a couple of notable exceptions, such as New York and Texas, that by statute require a local variation. For the last two decades, HUD has required that the 1970 ALTA format, and no other ALTA format, be used in those jurisdictions that do not otherwise require the use of a particular title policy.

Periodically, ALTA revises its approved standard title policy to provide for what it perceives as changing legal and market conditions. For its part, HUD reviews each new policy format to assess its positive or negative impact upon the specific title insurance needs of the Department. In 1987, ALTA published a new title policy that was reviewed and subsequently approved by HUD, but only upon the condition that title companies add an endorsement to the lender's policy providing that it will automatically "convert" to an owner's policy if HUD becomes the owner of the FHA-insured project as a result of foreclosure. OGC expressed the opinion that a "conversion" endorsement is necessary to comply with the requirement in 207.36(a)(1) "that upon acquisition of title by the mortgagee or the Secretary, the title policy will become an owner's policy" This endorsement condition has been strongly resisted by ALTA and some of its individual corporate members, resulting in some situations where title insurance was obtainable, but only with considerable difficulty.

Title Industry Position

The title industry argues that a lender's policy cannot be "converted" to an owner's policy as HUD has requested because there are distinctions between the two formats that bear directly upon the "value" of the coverage, cost schedules that are on file with state insurance commissioners, the unavailability of coverage to other mortgagees or private mortgage insurers, the prior practice of FHA, a different interpretation of the regulation, and the opinion that either HUD or the lender should pay the entire cost of a new owner's policy.

ALTA's main argument is that the coverage of "value" is greater under an owner's policy. An owner's policy coverage is generally written for either the sales price or market value of the property. A lender's policy, on the other hand, is only written for the amount of the outstanding principal balance of the mortgage loan. An owner's policy covers an actual loss to the owner if there is a title defect that results in a diminution

of the insured property's value. With regard to a lender's policy, unless there is a loss of priority by the lender's mortgage, the same title defect may not result in a loss to the lender if the principal balance of the loan is less than the value of the property with the defect attached. Another

distinction between the two types of policies is that, under a lender's policy, the liability of the title insurance company to the mortgagee under the title policy is terminated when the mortgage is paid in full and satisfied according to the terms of the original note. This is distinguished from the insurance coverage afforded by an owner's policy, which continues in favor of the insured even after conveyance of the property by reason of the covenants of warranty that are made by the owner at the time of conveyance.

ALTA posits that title companies are required to file fee schedules in many states that regulate the issuance of title insurance and they make no provision for the type of additional coverage that HUD is requesting. The title insurance industry is also concerned that similar coverage is not available to either mortgagees or private mortgage insurers and that this situation might make title companies vulnerable to litigation alleging an unfair trade practice if they provide the coverage to HUD and not to the rest of the industry. ALTA points out that from 1937 to 1987 FHA never required a conversion endorsement even though the regulation in question has been in existence during that entire time. It is ALTA's assertion that "HUD attorneys appear to have reconstrued the 35-year old regulation to require a new kind of title insurance coverage and then used the regulation to justify a requirement for a title insurance endorsement to lock in a special rate for an owner's policy." It is ALTA's premise that the phrase "will become an owner's policy" is a term of art that should actually be interpreted as "continues in force." Their reasoning is that no new policy is issued and the coverage that "continues in force" is the same coverage as that afforded by the original lender's policy on the date that it was first issued. Upon an additional payment by the lender, the coverage afforded by the original loan policy is extended from the date of the endorsement of the note to, and including, the date of the assignment of the mortgage to HUD and thus the original policy "continues in force." Under current procedures the only gap in insurance coverage that remains is the time period between the date of assignment and the date that HUD takes title following a foreclosure. ALTA lastly argues that if HUD wants an owner's title policy after it forecloses, as opposed to the continuing coverage offered by the lender's policy then in force, it should pay the entire cost of that policy just like any other lender or mortgage insurer.

Present Procedure Followed By HUD

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At the present time, HUD acquires title to a project in a few different ways. The most common situation is for the mortgagee to assign the mortgage to HUD when there is a default. As part of the assignment process, the mortgagee is required, at its own expense, to extend the coverage of the original mortgagee policy to include the time period between the dates of endorsement and assignment. This is most typically accomplished by means of a limited title search and a date-down endorsement of the existing title policy, but may also be done through the

purchase of an entirely new lender's policy. After assignment of a mortgage, if the default continues, it is HUD's policy to employ an attorney who practices in the jurisdiction where the project is located to act as a commissioner or trustee in the foreclosure. It is the responsibility of the foreclosure commissioner to perform a limited title search covering the time period between the assignment of the mortgage to HUD and the institution of proceedings under the Federal Foreclosure Act. Even though no title policy is obtained by HUD as a result of the foreclosure commissioner's findings and report, HUD does retain the right to bring a malpractice action against the licensed attorney who acted as the foreclosure commissioner if the work product is flawed.

A lender may also elect not to assign, but to institute foreclosure proceedings on its own. With the prior approval of the F.H.A. Commissioner, a lender is also permitted to accept a deed-in-lieu of foreclosure from the mortgagor conveying title to the property either to the lender or directly to the F.H.A. Commissioner. After the lender obtains title to the project by means of foreclosure or a deed-in-lieu, it is entitled to transfer title to the F.H.A. Commissioner. If the lender chooses to proceed in this manner, 207.258a requires that it purchase, at its own expense, an owner's title policy "effective on or after the date of the recording of the conveyance to the Commissioner."

We have recently been advised by ALTA that as of October 1, 1991, the only ALTA approved title policy will be the 1990 format. This creates a problem from HUD's standpoint because the 1990 policy has not been approved by the Department, and by the fact that ALTA has added an exclusion (the "bankruptcy exclusion") that will preclude the use of a deed-in-lieu of foreclosure as an alternative to assignment and foreclosure, unless affirmative coverage deleting the exclusion is issued by the title company. Section 207(k) of the National Housing Act also gives HUD the option of either proceeding to foreclosure or taking a deed-in-lieu directly from the mortgagor, following the assignment of the project mortgage to the Secretary. Under the U.S. Bankruptcy Code, a trustee in bankruptcy can set aside a deed-in-lieu of foreclosure transaction during the period ending one year from the date of the transfer, if the mortgagor was insolvent at the time the transfer was made and the court

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determines that the value of the property was greater than the outstanding balance of the loan. Under this scenario, HUD could pay a mortgage insurance claim based upon a deed-in-lieu of foreclosure (rather than an assignment) and would not have any title insurance protection against the deed-in-lieu being set aside. In other words, HUD would be taking title subject to a risk which had not heretofore been present.

ALTA has informed this Office that affirmative coverage may be offered by title insurance companies on a case-by-case basis, but only after a full disclosure is made as to the nature of the

transaction and the financial status of the parties. However, ALTA is of the opinion that "it is unlikely that the states in which title insurance is highly regulated -- New York, Florida, and Texas -- will permit the kind of endorsement contemplated." Although the use of a deed-in-lieu is comparatively rare, it does offer particular advantages to certain types of project mortgagors and lenders; however, the creditors' rights exclusion will preclude the use of the deed-in-lieu option.

Based upon the discussion that appears above, it is our recommendation that HUD approve the 1990 ALTA format, but with the requirement that in those states where affirmative coverage is offered by the title companies, a lender must obtain a title insurance policy that includes affirmative coverage deleting the bankruptcy exclusion therefrom. In those states where affirmative coverage cannot be obtained, the Department either could not accept a deed-in-lieu or would have to accept the risks involved if it did accept one. However, we make the recommendation to accept the 1990 ALTA format subject to whatever additional action may be required under the title insurance option to be chosen by you from those that are discussed below.

Title Insurance Options Available To HUD

There are three possible solutions to the problem presented by 24 C.F.R. 207.36(a)(1) and its requirement that "upon acquisition of title by the mortgagee or the Secretary, the lender's policy will become an owner's policy. . . ." First, HUD could decide to continue to follow the requirement for a special endorsement to multifamily lender's policies. This prerequisite to the acceptance of the 1987 ALTA title policy format, which would now be applicable to the 1990 ALTA format, was set out in a memorandum dated August 30, 1990 that was issued to all field counsel and which reads as follows:

An endorsement wherein, in the event of foreclosure or deed-in-lieu of foreclosure, the issuer of the policy format to the 1987 ALTA owner's policy format "agrees to convert" the lender's policy format

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to the 1987 ALTA owner's policy format at the request of the lender or HUD. Also, the issuer must agree to charge only for such additional title research as will be necessary to issue the owner's policy. A specified amount should be reflected in the endorsement which should also state that there will be no further charges in the event an owner's policy is issued to HUD or the lender at the time of foreclosure or deed-in-lieu of foreclosure.

Lender's are required by 24 C.F.R. 207.258(b)(4)(ii) to obtain a limited title search and extension of the original lender's title policy to include the date of an assignment of the mortgage to the Secretary. This still leaves a gap in title insurance coverage between the date of assignment and the subsequent

foreclosure. The aforementioned requirement permits a title company to charge FHA a premium based only on a limited title search and update of the existing lender's policy. We do not consider this first option to be a realistic alternative due to the strident opposition expressed by both the American Land Title Association and its individual member companies for the reasons set forth by us earlier in this memorandum.

A second option would be for HUD to amend its regulations, and add a new subparagraph to 207.36. The new subparagraph would provide for the addition of a special endorsement to the lender's title policy to the effect that upon a conveyance of the property to the Secretary, the title company will issue an owner's title policy in the name of the Secretary. The owner's policy would be executed as of a date to include the recordation of the deed for a sum certain or, alternatively, the "reissue rate" for an owner's policy prevailing or filed with the appropriate state insurance commissioner. If this new subparagraph is added, it would also be advisable to amend

207.36(a)(1) by deleting the phrase "it will become an owner's policy running to the mortgagee or the Secretary as the case may be," and substituting "it will continue to provide the same coverage as the original policy, and will run to the mortgagee or the Secretary, as the case may be." ALTA has provided us with information that this is a viable option but it is important to note this option will result in greater expense to FHA because the premium charged will be based on a full title search, whereas the present requirement only anticipates a premium charge for a limited title search. Most commonly, a reissue rate of 60% of the original premium is charged if the new owner's policy is issued within ten years of the date of issuance of the existing lender's policy. Reissue rates are not available in all fifty states, and they are not available at all more than ten years after the date that the original lender's policy was issued.

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A third possible option is not to require a specific endorsement requiring the issuance of an owner's title policy, but to give HUD flexibility to make such a determination on a case-by-case basis. In order to implement this alternative, HUD would have to amend 207.36(a)(1) deleting the phrase "it will become an owner's policy running to the mortgagee or the Secretary as the case may be," and substituting "it will continue to provide the same coverage as the original policy, and will run to the mortgagee or the Secretary, as the case may be" in the same fashion as indicated above for the second alternative. However, by not having a regulatory requirement in 207.36 to purchase an owner's policy, HUD could either purchase an owner's title policy after a foreclosure (or a date-down endorsement which is possible in some states--particularly in the West), negotiating the best possible premium to be paid, or HUD could choose to self-insure the time period between the assignment of the mortgage to the Secretary and the foreclosure. If the decision were made to self-insure, FHA would have to rely on the title policy issued at the time of the assignment of the mortgage to the Secretary and the attorney's opinion issued by the trustee

or commissioner in the foreclosure proceeding to fill the time period gap between assignment and foreclosure.

Please let us know which of the three following options you wish to follow. We are, of course, available to discuss these and any other solutions.

TITLE INSURANCE OPTIONS AVAILABLE TO HUD

- OPTION ONE ---- Continue our present policy of requiring a "conversion endorsement" to all HUD-approved lender's title policy formats.

- OPTION TWO ---- Amend the regulations to require a special endorsement to each lender's title policy that provides for the issuance of an owner's title policy for a sum certain, or in the alternative, a "reissue rate" premium.

- OPTION THREE -- Amend the regulation deleting the phrase "it will become an owner's policy running to the mortgagee or the Secretary as the case may be," and substituting "it will continue to provide the same coverage as the original policy, and will run to the mortgagee or the Secretary, as the case may be." If this option is selected,

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HUD could decide on a case-by-case basis to either purchase an owner's policy at its own expense, or self-insure the time period between assignment and foreclosure.