

Construction loan underwriting

In order to have a discussion regarding the endorsements, it is important to first explain the context in which they are issued.

The Covered Risks in the 2006 ALTA Loan Policy include paragraph 11(a) which, subject to the terms and conditions of the policy, provides coverage against the priority over the Insured Mortgage of mechanics liens arising out of construction already in progress.

(With upfront coverage, at each draw, lenders also requested the CLTA 122 updating their coverage and providing limited information)

With upfront coverage, the title insurer became, in effect, the guarantor that if the borrower/developer failed to pay its bills, the title insurer would do so, in essence providing a prospective payment guaranty. The recent severe economic recession illuminated the devastating effect of up front coverage because title insurance is retrospective, not prospective, in nature and because the title insurance pricing structure, with one-time premiums at a very small fraction of a bonding company's charges, was not designed for such risks. The industry does not have either the underwriting or economic tools to deal with this risk.

The title insurance industry turned to incremental coverage, which had been used in other parts of the country for years. This approach first eliminates the upfront coverage provided of Covered Risk 11(a) and then provides mechanics lien coverage on a draw by draw basis.

Two series of incremental endorsements are operative in the market today, the ALTA 32 series and the First American (FA) 61 series. They are similar in that they convert the upfront coverage into incremental coverage. The 122 also provides similar coverage but is designed to be used when the initial policy gave upfront coverage. (But, as stated below, this endorsement can be modified to be issued in conjunction with draw by draw incremental coverage endorsements.)

Incremental Coverage Series of Endorsements

ALTA 32, 32.1 and 32.2 – Pending Disbursement Endorsement included in the policy

All three endorsements contain the following:

- Deletes Covered Risk 11 (a), which is the mechanics lien coverage under the loan policy jacket.
- Coverage is provided for the Construction Loan Advances as defined in the endorsement

Paragraph 3 of the three endorsements varies as follows:

- Paragraph 3(a) of each endorsement the same – insures that the Construction Loan Advance is secured by the Insured Mortgage.
- Paragraph 3(b) of each endorsement is the same – insures the priority of the Construction Loan Advance over recorded matters.
- Paragraph 3(c) of each endorsement differs though:
 - ALTA 32 – covers only unrecorded MLs filed by contractors/suppliers specifically listed in the draw package documents as disbursed by or on behalf of the lender.
 - ALTA 32.1 – covers only unrecorded MLs filed by contractors/suppliers specifically paid by the title insurer or lender with title insurer’s written approval.



- ALTA 32.2 – covers only unrecorded MLs filed by contractors/suppliers specifically paid by or on behalf of the lender on or before Date of Coverage.
 - Each of these is a bit more conservative than the one before it, chosen by the title insurer depending on the degree of risk the particular transaction might pose
- There are Exclusions from Coverage as well under each endorsement:
- Paragraph 4(a) of each endorsement is the same, excluding coverage for work after Date of Coverage.
 - Paragraph 4(b) of each endorsement differs though matching the different coverage offered in paragraph 3(c):
 - ATLA 32 – excludes coverage for contractors/suppliers not specifically shown in the draw package documents.
 - ALTA 32.1 – excludes coverage for contractors/suppliers who were not directly paid by the title insurer or lender with title insurer's written approval.
 - ALTA 32.2 – excludes coverage for contractors/suppliers who were not directly paid by or on behalf of the lender.

ALTA 33 – Endorsement is issued with each draw once the draw package has been reviewed and title updated

- The Date of Coverage over mechanics liens is advanced at each draw.
- This coverage, or another form of incremental coverage, is often the only form of mechanics' lien coverage available when there is broken priority on a transaction.
- Receipt of draw packages / pay applications would need to be provided title insurer, regardless of whether or not the title insurer or lender is handling the construction disbursements.
- Each draw must be underwritten by the title insurer and the requirements to insure; the documents that will need to be reviewed may differ between transactions but they will generally include the draw request, including a statement by the borrower of who did the work or supplied materials or equipment, invoices therefor, conditional lien waivers therefor and unconditional lien waivers that relate to past draws.

FA 61 Series of Incremental Coverage of Endorsements:

- Covered Risk 11 (a) deleted and replaced with the language in the endorsement.
- Carves out retainage since the lender is holding the funds that can pay off the lien claimant.
- Fully dates down the entire policy (via the FA 61.1 endorsement issue at each draw), not just the mechanics lien coverage. Differs from ALTA 32/33 Series of endorsements in this respect.
- Provides full mechanics' lien coverage, not just tied to the contractor's or borrower's sworn statements or other documents submitted with the draw package to support payment. Differs from ALTA 32/33 Series of endorsements in this respect.
- FA Series 61, 61.1, 61.2 provides broader coverage than the ALTA 32/33 Series as well as the older CLTA 122 endorsements, since the CLTA 122 endorsements do not date down the title policy at all.

Use of the FA 61 Series Endorsement Coverage:

- This coverage, or another form of incremental coverage, is often the only form of mechanics' lien coverage available when there is broken priority on a transaction.
- Receipt of draw packages / pay applications must be provided to title insurer, regardless of whether or not the title insurer or lender is handling the construction disbursements.
- Each draw must be underwritten by the title insurer and the requirements to insure; the documents that will need to be reviewed may differ between transactions but they will generally include the draw request, including a statement by the borrower of



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who did the work or supplied materials or equipment, invoices therefor, conditional lien waivers therefor and unconditional lien waivers that relate to past draws.

When we give upfront coverage

CLTA 122 Endorsements:

No endorsement is added at policy issuance

- Covered Risk 11 (a) is unmodified.
- The endorsement is requested at each draw by the lender simply to confirm status of title at the time.
- The date of policy is not advanced, except for states that have the ability to amend this endorsement such as Washington
- Paragraphs 1 & 2 provide a record date down and a tax date down
- Paragraph 3 confirms current vesting
- Paragraph 4 insures that the draw is secured by the Insured Mortgage
- Paragraph 5 insures the priority of the Insured Mortgage with respect to the advance
- Paragraph 6 gives mechanics' lien coverage with respect to the advance;
- If this endorsement is issued for the draws after giving the incremental coverage endorsement (ALTA 32 series or FA 61 series) in the policy; paragraph 6 of the CLTA 122 is deleted. This is due to the conflicting language in the incremental coverage endorsements contained in the policy.

Use of the CLTA 122 Endorsements:

- This form of coverage is generally only available if there is documented, “pristine”, unbroken priority at the time of the loan closing.
- The title insurer may require copies of the draw packages for its review and files.
- Each transaction must be underwritten by the title insurer and the requirements to insure, and the documents that will need to be reviewed, will differ between transactions.

To date this has been the preference of HUD for those states that offer this coverage.

When we are asked to give any of the above endorsements we request the following documents:

1. The construction contract and the budget including sources and uses
2. Financials of the borrower/or the financial strength behind the borrower if they are a single asset entity
3. Financials from contractor (maybe, it would depend on no. 2 above)
4. Construction loan agreement
5. Indemnity (from the financial strength for borrower and/or contractor)

It can be helpful to add the title underwriting company as a co-obligee to the Payment Bond; however this is not necessarily a requirement.

Additional requirements may be necessary after review the above.

Not all states have incremental coverage or have all of the above referenced endorsement. Please verify coverage availability with the title company underwriter.

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