

# 10 Construction Liens

In most states, a party that provides labor, services or material that becomes part of an improvement to real estate is entitled to record or file a lien against the property if not paid for the work, in recognition that the property has been increased in value as a result. Many states' laws grant such liens, commonly called either construction liens<sup>1</sup> or mechanic's liens, retrospective priority to some date related to project commencement. These liens have historically been one of the greatest sources of loss to the land title industry.<sup>2</sup> This can be attributed to the combined facts that construction liens often involve very large sums of money, and the secret nature of the liens in many states. In secret-lien states, construction liens often defy the title insurer's best efforts at risk elimination.<sup>3</sup>

This chapter addresses two main topics. Section 10.1 deals with the policy provisions concerning construction liens and construction loan disbursement. Section 10.2 addresses construction loan escrows and disbursing, as performed by title companies.

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<sup>1</sup> In this treatise, the term construction lien is used rather than mechanic's lien, for consistency and because it is more specific and descriptive of the nature of the lien right.

<sup>2</sup> See O'Connor, *Mechanic's Lien Coverage: Have the Policy Changes Changed the Coverage?*, in *Title Insurance: The New Policy Changes*, Practising Law Institute, Real Estate Course Handbook N4-4480 (1987), at p. 14. The significant mechanic lien losses suffered in the early 1970s are recounted in John E. Jensen, Accounting Procedure Slaying the IBNR Monster, *Title News*, Volume 60, Number 4 (April 1981), p. 6. See also, Ray E. Sweat, *Mechanics' and Materialmen's Lien Coverage*, in *Title News*, Volume 53, Number 1 (January 1974), p. 24, which includes a very good summary of the mechanic's lien laws in all 50 states, a summary of case law up to that point, and a thorough description of mechanic lien coverage as found in the New York Board of Title Underwriters Form policy, and the 1946, 1960, 1962, 1969 and 1970 ALTA loan policy forms. Mr. Sweat was the longtime chief underwriting counsel for Pioneer National Title Insurance Company. That article is followed by the comments of Irving Morgenroth, then chief counsel for Commonwealth Land Title, on the same subject of construction loans and mechanic lien policy coverage. These articles can be retrieved by ALTA members from the *Title News* archives at [alta.org](http://alta.org).

<sup>3</sup> The enormous risks imposed by construction liens are neither fated nor immutable, however. Insurers interested in curtailing losses should consider a serious effort at changing existing law. Construction liens are creatures of statutes, not of the common law. The laws vary in the extreme, and so does loss experience. Missouri gives almost no protection to lenders (or owners), while Wisconsin gives automatic, blanket priority to almost all classes of lenders. Michigan thoroughly overhauled its law in the 1980's, with a very balanced and rational result.

### 10.1 Construction Lien Policy Coverage

The loan policy contains a series of provisions which fit together to establish the scope of this coverage. The construction lien provisions of the policy have been much discussed by scholars.<sup>4</sup> The provisions concerning liens and construction liens that are found in the ALTA Loan policies are the following:

1. Covered Risk 2, which indemnifies the insured against loss caused by "[a]ny defect in or lien or encumbrance on the Title," and Covered Risk 10, which indemnifies against the "lack of priority of the lien of the Insured Mortgage upon the Title over any other lien or encumbrance."
2. Covered Risk 11 indemnifies the insured lender against a construction lien that obtains priority over the insured mortgage, whether recorded before or after the date of policy, if the lien is for work contracted for or commenced before the policy date, or after policy date if the work is financed at least in part by loan funds secured by the insured mortgage.<sup>5</sup>
3. These Covered Risks may be negated by a Schedule B exception for construction

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<sup>4</sup> Construction lien policy coverage is analyzed in Jones & Maessell, *Mechanic's Lien Title Insurance Coverage for Construction Projects*, 16 Real Estate L.J. 291 (1988); Urban, *Future Advances and Title Insurance Coverage*, 15 Wake Forest L. Rev. 329 (1979); Jordan, *Mechanics' Lien Coverage*, Practising Law Institute, Real Estate Course Handbook (1988); Bohan, *Mechanics' Lien Coverage in Title Insurance Policies*, in *Attorneys' Role in Title Insurance*, A.B.A. Real Property & Trust Section, (1990); Sweat, *Obligatory Advances: Mechanics' Liens and the 1987 Loan Policy*, Practising Law Institute, Real Estate Course Handbook (1988); O'Connor, *Mechanic's Lien Coverage: Have the Policy Changes Changed the Coverage?*, in *Title Insurance: The New Policy Changes*, Practising Law Institute, Real Estate Course Handbook N4-4480 (1987); J. Patterson, *Title Insurance and Mechanic's Liens*, 5 A.B.A. Real Property Financing Newsletter 20 (1985); and Joyce Palomar, *Title Insurance Law*, § 5.16.

<sup>5</sup> Covered Risk 11(a) of the 2006 ALTA Loan policy indemnifies the insured against loss due to "[t]he 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... ." A very similar provision is found in Covered Risk 7 of the 1992 ALTA Loan policy. Although the phrase "statutory lien for services, labor, or material arising from construction of an improvement" could be reasonably understood to refer only to construction or mechanic's liens, several insureds have asserted that the phrase is broader. In *BV Jordanelle, LLC v. Old Republic Nat'l Title Ins. Co.*, 2015 WL 4647894 (D. Utah 2015) (unpublished), the court rejected the insured's argument that the phrase "statutory lien" could include taxes imposed under the auspices of a special taxing district. In *380 Kings Highway, LLC v. Fidelity Nat'l Title Ins. Co.*, 2011 WL 6182117 (N.Y. Sup.), 2011 N.Y. Slip Op. 52223(U) (unpublished), a New York form of endorsement that uses the same phrasing as Covered Risk 11 concerning "statutory liens" was found to affirmatively protect against a municipal emergency repair lien for repairs done to a building. The *380 Kings Highway* decision ignored substantial evidence that the endorsement was not intended to encompass municipal repair liens, including *Cole v. Home Title Guar. Co.*, 29 A.D.2d 552, 285 N.Y.S.2d 914 (N.Y. App. Div. 1967), which said that a tax assessment is not a construction lien and does not fall under the "statutory lien" coverage of the policy.

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- liens and inchoate construction lien rights.<sup>6</sup>
4. Liens attaching after the date of policy are excluded from coverage under the post-policy exclusion.<sup>7</sup>
  5. Certain actions by the insured lender may be deemed to have been created, suffered, assumed or agreed to by it, thus negating construction lien coverage.<sup>8</sup>
  6. Construction liens arising from projects contracted for or commenced after the date of policy and not financed in whole or in part by the insured mortgage loan are excluded.<sup>9</sup>
  7. Some versions of the ALTA Loan policy do not insure the priority of construction advances made after the date of policy for which the lender was not obligated on date of policy.<sup>10</sup>
  8. The policy may contain one or more endorsements modifying the policy's terms as stated above.<sup>11</sup>

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<sup>6</sup> The ALTA-promulgated construction lien exception removes coverage as to "[a]ny lien or right to a lien, for services, labor, or material heretofore or hereafter furnished, imposed by law and not shown by the public records."

<sup>7</sup> Exclusion 3(d) of the 2006 ALTA Loan policy removes from coverage "[d]efeats, liens, encumbrances, adverse claims or other matters: ... (d) attaching or created subsequent to Date of Policy (however, this does not modify or limit the coverage provided under Covered Risk 11, 13, or 14)..."

<sup>8</sup> Exclusion 3(a) of the 2006 ALTA Loan policy removes from coverage "[d]efeats, liens, encumbrances, adverse claims or other matters: ... (a) created, suffered, assumed or agreed to by the Insured Claimant..." See §10.1.4 for a discussion of the application of this exclusion.

<sup>9</sup> The 1992 ALTA Loan policy contained Exclusion 6, for "[a]ny statutory lien for services, labor or materials (or the claim of priority of any statutory lien for services, labor or materials over the lien of the insured mortgage) arising from an improvement or work related to the land which is contracted for and commenced subsequent to Date of Policy and is not financed in whole or in part by proceeds of the indebtedness secured by the insured mortgage which at Date of Policy the insured has advanced or is obligated to advance." The 2006 ALTA Loan policy does not contain a corresponding exclusion.

<sup>10</sup> Conditions & Stipulations ¶ 8(d), which appeared in the 1987, 1990 and 1992 versions of the ALTA Loan policy, provided: "The Company shall not be liable for: ... (ii) construction loan advances made subsequent to Date of Policy, except construction loan advances made subsequent to Date of Policy for the purpose of financing in whole or in part the construction of an improvement to the land which at Date of Policy were secured by the insured mortgage and which the insured was and continued to be obligated to advance at and after Date of Policy." This provision is discussed at §10.1.4. The 2006 ALTA Loan policy does not contain a corresponding provision, but rather in the definition of "Indebtedness" it includes "(iii) the construction loan advances made subsequent to Date of Policy for the purpose of financing in whole or in part the construction of an improvement to the Land or related to the Land that the Insured was and continued to be obligated to advance at Date of Policy and at the date of the advance..."

<sup>11</sup> See §10.1.4 for a discussion of the so-called pending disbursement endorsement, including the ALTA 32 and 33

Only Covered Risk 11 protects the priority of an insured mortgage versus a construction lien filed after the policy date for work performed after the policy date, and that coverage is modified by Exclusion 3(a) and any endorsements.<sup>12</sup> The loan policy terms concerning construction lien coverage were rewritten beginning with the 1987 version of the ALTA loan policy to make them more cohesive.<sup>13</sup>

The ALTA owner's policies contain several provisions which have a bearing on coverage: Covered Risk 2, which indemnifies against "defects, liens or encumbrances" on title; Covered Title Risk 8 of the Residential policy, which specifically applies to construction liens;<sup>14</sup> Exclusion 3(a), for matters "created, suffered, assumed or agreed to;" Exclusion 3(d), for matters attaching after the date of policy; and the standard mechanic lien exception.

Because these policy provisions work in concert, the discussion of construction lien coverage below is by fact situation rather than by policy provision.

### 10.1.1 Liens Filed After Policy Date For Work Done Before Policy Date

Most state construction lien laws adopt the relation-back principle. In such states, construction liens take their priority not from the date of filing or recording but some earlier date tied to work done on the construction project, such as the first actual physical improvement on the land or the first date of work by the lien claimant. This relation-back principle is one reason construction liens are such a large risk to the title insurer.

The covered risks of both owner's and loan ALTA policies protect against inchoate lien rights that, if perfected by filing, will take their priority from before the date of policy. Covered Risk 2 of the 2006 ALTA Owner's policy indemnifies against liens rights. Coverage under the owner's policy is further analyzed at §10.1.2. The Residential policy specifically assures against loss resulting from relation-back construction liens under Covered Title Risk 8, which protects the insured if "[t]here are liens on your title, arising now or later, for labor and material furnished before the Policy Date—unless you agreed to pay for the labor and material." This coverage is in

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endorsements.

<sup>12</sup> See *Hall CA-NV, LLC v. Old Republic Nat'l Title Ins. Co.*, Hall CA-NV, LLC v. Old Republic Nat'l Title Ins. Co., \_\_\_ F.3d \_\_\_, 2021 WL 912726 (5th Cir. (Texas) 2021) (permanent citation not yet available), in which the Fifth Circuit held that Covered Risks 2 and 10 provided no coverage to the insured lender for a construction lien filed after the policy date, for work performed after the policy date. The court said that Covered Risk 11(a) was the more specific though qualified coverage. Further, that coverage was deleted and replaced by the issuance of an ALTA 32 endorsement, under which there was admittedly no coverage. The court said: "As Old Republic points out, reading Covered Risks 2 and 10 to cover a loss specifically covered by the (removed) Covered Risk 11(a) would render Covered Risk 11(a) in the standard-form ALTA contract surplusage. This would contravene both California and Nevada contract principles."

<sup>13</sup> A particularly lucid analysis of this coverage as found in the 1970 and later policies is found in O'Connor, *Mechanic's Lien Coverage: Have the Policy Changes Changed the Coverage?*, in *Title Insurance: The New Policy Changes*, Practising Law Institute, Real Estate Course Handbook N4-4480 (1987).

<sup>14</sup> "8. There are liens on your title, arising now or later, for labor and material furnished before the Policy Date -- unless you agreed to pay for the labor and material."

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keeping with the design of the Residential policy, which identifies numerous particular risks rather than classes of risks. However, the Residential policy coverage is no broader than that found in the standard form ALTA policy. See §9.14.1 regarding the coverages under the Residential policy form and §9.14.2 regarding the Homeowner's policy.

The ALTA Loan policies contain two construction lien coverages, which are Covered Risks 11(a)(i) and (ii) of the 2006 policy and 7(a) and 7(b) of the 1992 policy. The 2006 Covered Risks are:

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... .

The 1992 policy had a mirroring Exclusion 6, which is not found in the 2006 policy, perhaps because the post-policy exclusion was deemed sufficient.<sup>15</sup>

Covered Risk 11(a)(i) of the 2006 ALTA Loan policy is invoked if a lien is filed after the date of policy for work contracted for or started before the policy date, and the lien claimant asserts priority over the insured mortgage. The covered risk protects against liens filed after the date of policy. It would be superfluous if it merely referred to liens that had already been filed on the policy date, since liens generally are protected against by other covered risks. Covered Risk 11(a)(ii) states that, if the work was contracted for, or started or continued, after the date of policy, there is coverage only if the insured lender finances the work in part or in full.

The combination of these coverages has been deemed to provide a lender with full protection against any lien claimant that asserts priority over the insured mortgage, if the loan money is used to fund the construction project.<sup>16</sup> However, when the loan secured by the insured mortgage did not fund the improvement, the court in *Pullum Window Corp. v. Randy M. Deprez Custom Builder, Inc.*<sup>17</sup> found that there was no coverage for liens for work performed after the

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<sup>15</sup> Exclusion 6 of the 1992 ALTA Loan policy read: "Any statutory lien for services, labor or materials (or the claim of priority of any statutory lien for services, labor or materials over the lien of the insured mortgage) arising from an improvement or work related to the land which is contracted for and commenced subsequent to Date of Policy and is not financed in whole or in part by proceeds of the indebtedness secured by the insured mortgage which at Date of Policy the insured has advanced or is obligated to advance."

<sup>16</sup> The policy's construction lien coverage "unambiguously contemplates coverage if such [inchoate] liens attain priority over the deed of trust and a loss results." *Mid-South Title Ins. Corp. v. Resolution Trust Corp.*, 840 F.Supp. 522, 531 (W.D.Tenn. 1993).

<sup>17</sup> 2010 WL 5175404 (Mich.App.) (unpublished). In that case, liens were filed for work done two years after the purchase money mortgage was recorded. The lender paid off the liens after the insurer refused to do so. The insured

date of policy. That court said that the mere hypothesis that the lien claimants could assert that their liens related back to a date prior to the policy date did not invoke coverage, particularly when the lender settled the liens before waging a priority fight.

It can be difficult to establish whether or not the loan policy covered risk is invoked when the lender did not fund the improvement. The wording of the covered risk strongly suggests that the proper analysis is based on the start date for "the improvement," not the individual lien claimant's first work.

The essence of the relation-back doctrine in many states is that all construction lien claims relate back to the visible commencement of the improvement. However, in most states, the lien claimant is not required to state on the filed lien what date he believes to have been the date of visible commencement for the improvement. In most such states, the lien claimant's own first date of work, which usually *is* recited on the lien, is not the relation-back date. The visible commencement date usually cannot be determined until there is lien priority litigation.

Therefore, it is industry custom for the title insurer to adopt a "watchful waiting" posture in most cases when the insured submits the claim after a lien has been filed but before the priority issue has been joined in litigation. See §3.1 regarding watchful waiting. The title insurer will typically caution the lender that any resolution of the lien claim will invoke the voluntary settlement provision unless the insurer grants its prior written consent, voiding coverage. See § 2.14 regarding the voluntary settlement provision. If the lender does settle the liens without getting a priority determination, its policy rights are typically negated, as in the *Pullum Window Corp.* case discussed above.

The "standard" construction lien exception removes the coverage provided by the Covered Risks. The most commonly-used exception negates coverage for "[a]ny lien, or right to a lien, for services, labor, or material heretofore or hereafter furnished, imposed by law and not shown by the public records." The "right to a lien" phrase refers to the inchoate lien right. The word "heretofore" makes it clear that the exception applies to work already done on the date of policy. The phrase "and not shown by the public records" further makes plain that the exception applies to inchoate lien rights existing on date of policy, for work already done, but for which no lien has yet been filed. The exception in the form recited above does not apply to liens already filed on the date of policy.

### 10.1.2 Lien Coverage On Owner's Policies

In all or most states, the risk in removing the construction lien exception from the owner's policy is much greater than on a loan policy. The insured owner incurs a loss immediately when a lien is recorded. See §3.2.4 regarding the cases discussing the owner's "immediately diminished"

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produced a building permit report showing that the liens might have related back to a commencement date for the project before the policy date. The court said this was "merely a smokescreen." It found the liens not to be covered by Covered Risk 7(a) of the 1992 policy, and its companion Exclusion 6. Even if the liens related back to a pre-policy date, the court said, "for purposes of negotiated title insurance coverage at issue in this case, we decline to overlay the relation back principle of the Construction Lien Act on the parties' insurance contract." The court also noted that, under Michigan's lien law, a lender can salvage "broken" priority by accurate disbursement, so that its loss of priority would not be automatic. *Pullum* was distinguished in *Lower Town Project, LLC v. Lawyers Title Ins. Corp.*, 2011 WL 3319710 (E.D.Mich.) (unpublished), which held that there was policy coverage for construction liens that clearly related back to a first actual physical improvement date prior to the policy date.

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title versus the lender's obligation to also show that the loan is in default and that the lender's security has been impaired by the lien. The only defenses ordinarily available to an owner relate to the validity or amount of the lien. By comparison, the loan policy insures only that the lender's lien has priority over the construction lien. Thus, in addition to any defenses as to the construction lien's validity, the insurer may fully protect an insured lender by establishing that the mortgage has priority over the construction lien. In many situations, a construction lien which causes a loss to the owner insured does not result in a corresponding loss to the insured lender.

Because of the difference in risk, it is not uncommon for an insurer to give protection against construction liens to a lender but not the owner in the same transaction. The insurer has no duty to notify the purchaser of the difference in coverage between the two policies. Absent active misrepresentation, the purchaser has no cause of action against the insurer for breach of contract, fraud, or similar cause of action, for not so advising the owner.<sup>18</sup> Also, an owner is not a beneficiary of construction lien coverage given only to the lender,<sup>19</sup> as is fully discussed at §7.7.

In addition, when construction lien coverage is given to an owner while a construction project is pending, liens may arise as a result of the insured's refusal to pay a lien claimant.<sup>20</sup> Exclusion 3(a) is often an appropriate defense if it was within the insured's power to avoid the filing of the lien, or if the lien resulted from a dispute between the insured and the lien claimant. See §11.2.9 concerning Exclusion 3(a) and owner's policies.

### 10.1.3 Liens For Work Done After Policy Date

#### FORM 43, Appendix A Construction lien filed after policy date

The owner's policy does not protect against any construction liens for work done after the date of policy. See §11.5 regarding Exclusion 3(d), for post-policy matters.

Exclusion 6 of the 1992 ALTA Loan policy removed coverage for liens filed for work

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<sup>18</sup> See *Clements v. Mississippi Valley Title Ins. Co.*, 612 So.2d 1172 (Ala. 1992). The dissent in *Clements* would have required the insurer to advise the owners that their policy excepted construction liens while the loan policy did not. The dissent seemed to think that the insurer sought to benefit from the purchaser's ignorance: "At the closing here, everybody in the room, except the Clementses, knew that there were outstanding debts owed by the seller to subcontractors, and knew that the Clementses would be liable for liens filed against the property after the closing, but failed to tell them that the policy about to be issued would exclude coverage for those very liens. Mississippi Valley and its attorney agent had a duty to disclose those facts." 612 So.2d at 1177. The majority, however, found no support for this view.

<sup>19</sup> See, for example, *Walters v. Marler*, 83 Cal.App.3d 1, 147 Cal.Rptr. 655 (Cal.App. 1 Dist. 1978) and *Pippin v. Kern-Ward Bldg. Co.*, 8 Ohio App.3d 196, 456 N.E.2d 1235 (8th Dist. 1982). However, in *Johnson v. U.S. Title Agency, Inc.*, 91 N.E.3d 76, 2017 -Ohio- 2852 (Ohio App. 8 Dist. 2017), the court held that the borrower was a third party beneficiary of KeyBank's escrow instructions, distinguishing *Pippin* on a pretext.

<sup>20</sup> However, note that, in *Johnson v. U.S. Title Agency, Inc.*, 91 N.E.3d 76, 2017 -Ohio- 2852 (Ohio App. 8 Dist. 2017), the court ignored an owner's policy construction lien exception, Exclusion 3(a) and the post-policy exclusion to hold that the policy might cover construction liens filed after the policy date after the owner insured refused to pay the contractors. There is a strong dissenting opinion.

contracted for or commenced after date of policy and not fully or partially funded by the insured mortgage loan. Thus, generally, the policies do not protect against liens for work done after the date of policy.<sup>21</sup>

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<sup>21</sup> *Wheeler v. Real-Estate Title Ins. & Trust Co. of Philadelphia*, 160 Pa. 408, 28 A. 849 (1894). In a case involving very unusual facts, a mortgage was found to have priority over later-filed construction liens, but the court found the insurer liable for payment of the liens. In *Lawyers Title Ins. Corp. v. Honolulu Federal Savings & Loan Ass'n*, 900 F.2d 159 (9th Cir. 1990), the insured mortgage was a lien on a lessee's interest. The lease provided that the lessor could terminate the lease and wipe out the mortgage if construction liens were filed and foreclosed. The right to terminate the lease because of the liens was found sufficient to create a duty of the insurer to pay the liens, despite the fact that the mortgage was superior to the liens. The *Honolulu Federal* decision should be limited to its unique facts. In *Johnson v. U.S. Title Agency, Inc.*, 91 N.E.3d 76, 2017 -Ohio- 2852 (Ohio App. 8 Dist. 2017), the court ignored an owner's policy construction lien exception, Exclusion 3(a) and the post-policy exclusion to hold that the policy might cover construction liens filed after the policy date after the owner insured refused to pay the contractors. There was a strong dissenting opinion. In *Hall CA-NV, LLC v. Old Republic Nat'l Title Ins. Co.*, \_\_\_ F.3d \_\_\_, 2021 WL 912726 (5th Cir. (Texas) 2021) (permanent citation not yet available), an insured lender, Hall, sought protection against a lien filed after the policy date for work performed after the policy date. It argued that the post-policy exclusion did not apply because, under state law, the lien priority related back to the first date of work. The essence of Hall's argument was its attempt to exploit the fact that mechanic lien statutes and court decisions are sometimes rather imprecise in their use of terms, suggesting that a lien that is recorded or filed after date of policy nonetheless "existed" as of the date of first work. In fact, however, the relation-back doctrine is a lien priority issue only. The mechanic lien takes its priority versus other liens not from the date of recording, but from the date on which the first visible work was performed. The first-shovel rule is justified by the doctrine of inquiry notice. A lender could know on the day it records its mortgage or deed of trust that work has commenced, and that if the workers are not paid their liens will relate back in priority to the date of commencement. The district court had effectively accepted Hall's argument. The appeals court did not. In a footnote, the Fifth Circuit said that it was "far from clear" that Hall was correct in asserting that the mechanic liens existed on the Date of Policy, under California and Nevada law. It quoted from *Picerne Constr. Corp. v. Castellino Villas*, 244 Cal.App.4th 1201, 199 Cal. Rptr. 3d 257, 263 (2016), which said that the mechanic's lien claimant must record a claim of lien within the prescribed period of time and that, "once recorded," the lien "constitutes a direct lien on the improvement and the real property." It also noted that Nev. Rev. Stat. § 108.226 says that, to "perfect a lien," the lien claimant must record a notice of lien with the county recorder. From these sources, the court concluded that: "At a minimum, it is dubious that a mechanic's lien (even an inchoate one) could have existed before Penta (a) continued to work on the project and (b) was left unpaid for that work. This was not a situation where, 'as of Date of Policy,' there was 'an inchoate lien where the only remaining act was the filing of the lien.'"

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### 10.1.4 Pending Disbursement Endorsement And Disbursing Agreement Limitations

In certain jurisdictions, it is common for an insurer to provide construction lien coverage in connection with or dependent on a construction loan disbursement escrow. See §10.2 regarding construction loan disbursement escrows. It is also common in many jurisdictions for the title insurance policy to contain a pending disbursement clause, which is inserted in Schedule B, and which states that coverage is limited by the terms of an endorsement to be issued with each loan advance, which the industry terms a pending disbursement endorsement.<sup>22</sup> It is typical to have both a disbursing escrow agreement and pending disbursement endorsements on a project. In such cases, the insurer reviews draw requests, collects lien waivers, disburses the lender's funds, and increases the policy coverage against construction liens by a pending disbursement endorsement.<sup>23</sup>

In giving construction lien coverage by pending disbursement endorsements, the insurer limits its liability for construction liens to lien rights that have accrued on or before the date of the endorsement, and also limits the amount of its liability, either for construction liens or for all policy purposes, to the amount stated in the endorsement.<sup>24</sup> By so limiting the construction lien coverage, the insurer agrees to defend against only those liens that result from work done before the date of the last endorsement. If the pending disbursement endorsement extends the date of policy as to matters other than construction liens, the insurer may except from coverage all matters that first appear of record or come to the insurer's notice after the previous endorsement date. All such matters become excepted from the coverage of the policy, as so modified.<sup>25</sup>

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<sup>22</sup> A reference to a pending disbursement endorsement in a commitment gives evidence that the policy will contain the endorsement. *First American Title Ins. Co. v. Seaboard Sav. & Loan Ass'n*, 227 Va. 379, 315 S.E.2d 842 (1984). In *First Federal Sav. & Loan Assn. of Beaumont v. Stewart Title Co.*, 732 S.W.2d 98 (Tex.App. 1987), two policies were to be issued. One commitment contained a reference to a pending disbursement endorsement and the other did not. The court found that there was a question of fact as to whether or not there was a difference in coverage under the two forms of policy.

<sup>23</sup> There is no industry standard pending disbursement endorsement, in large part because of the wide variation in state construction lien laws.

<sup>24</sup> The pending disbursement endorsement typically would explicitly alter policy coverage when issued under a 1992 ALTA Loan policy or other policy forms that contained Conditions & Stipulations 8(d), which imposed a limitation on coverage for post-policy construction advances.

<sup>25</sup> In *Lawyers Title Ins. Corp. v. Bank of New York*, 1992 U.S. Dist. LEXIS 8355 (S.D.N.Y.), No. 95-7514, 12/13/95 (2nd Cir. N.Y.) (unpublished), a lawsuit was filed that attacked the validity of the leasehold estate to which the construction mortgage attached. The insurer made exception for the lawsuit in its pending disbursement endorsement, which the bank considered a breach of contract. The court found, however, that the bank misunderstood the limitations of the pending disbursement endorsement: "The ... 'pending disbursement' provision ... insures all covered risks up to the amount already disbursed by the Bank; however, if a 'defect in, or objection to, title' should arise, Lawyers Title may cap its coverage for that risk at the amount already paid out. The incremental nature of the insurance allows the insurer to limit its exposure for any sums paid out by the Bank after a defect or objection arises." The bank also argued that the pending disbursement endorsement's own terms did not allow the insurer to except the lawsuit, because the endorsement provided that the insurer could except any matter which was a "defect in, or objection to, title." The bank argued that the lawsuit was neither a defect nor an objection, under New York law on title insurance and marketability of title. The court found, however, that the cases and policy provisions cited do "not alter the District Court's plain-meaning reading of the 'pending disbursements' clause to mean that the filing of a lawsuit is an 'objection'".

When the insurer attaches a pending disbursement endorsement to the policy or commitment, the lender must make any advances under the construction loan according to the terms of that endorsement to obtain extended coverage in future endorsements. Thus, when the commitment attached a pending disbursement clause and called for waivers and contractor's statements, but the requirements were not met and subsequent draws were not presented to the insurer, there was no coverage for liens filed for work done after date of policy.<sup>26</sup>

The pending disbursement endorsement system alters the provisions of Conditions & Stipulations 8(d)(ii) of the 1992 ALTA Loan policy, which states that the insurer is not liable for construction loan advances made after the date of policy except construction loan advances which finance improvements to the land which the lender was obligated to make on date of policy. Most pending disbursement endorsements issued in conjunction with the 1992 ALTA Loan policy specifically amended that provision. The 2006 ALTA Loan policy does not contain a corresponding provision.

Very often, the endorsement is written to extend the date of policy coverage through the date of disbursement, even though the last work paid for by the advance was done days or weeks prior to the disbursement date. This creates a gap period for which the lender receives coverage against lien rights for work for which the lender has not paid. The explicit or implicit agreement in disbursing escrows is that the lender will continue to advance money to pay for gap work.

Historically, the terms of pending disbursement endorsements varied considerably from company to company and state to state, due in large part to the variations in state law concerning the priority of construction liens versus mortgages under the relation-back doctrine. In February of 2011, American Land Title Association adopted several pending disbursement endorsements, with the intent of standardizing the language of such endorsements. The ALTA endorsements are the 32.0-06, 32.1-06, 32.2-06 and 33.0-06. The endorsements were modified in 2013. The names of the endorsements were changed in 2018.

The ALTA 32 endorsement is issued with the policy. Paragraph 1 of the endorsement deletes Covered Risk 11(a), the standard construction lien coverage. Paragraph 2 provides several definitions for terms used in the endorsement. In this discussion of the endorsements, the terms defined in paragraph 2 are capitalized for clarity's sake. Paragraph 3 states the coverage that replaces Covered Risk 11(a). Paragraph 4 recites limitations on the endorsement's coverage.

The ALTA 33 endorsement is issued with each subsequent advance under the construction loan. There is only one version of the ALTA 33 endorsement. Each time an ALTA 33 endorsement is issued, the Date of Coverage as to Mechanic's Liens is extended. However, the Date of Policy is not altered, and no other coverage is extended forward by the ALTA 33 endorsement. The ALTA 32 endorsement supplies the defined term Date of Coverage in order to distinguish between that date and the Date of Policy.

It is necessary to understand the defined terms in order to understand the coverages of the ALTA 32 endorsement. The Date of Coverage is the later of the policy date or the date of a subsequently-issued ALTA 33 endorsement. A Construction Loan Advance is an advance made by the insured for construction purposes that becomes part of the debt secured by the insured

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that justifies the insurer in declining to provide coverage for any disbursements made after the objection is lodged."

<sup>26</sup> *First American Title Ins. Co. v. Seaboard Sav. & Loan Ass'n*, 227 Va. 379, 315 S.E.2d 842 (1984).

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mortgage. Mechanic's Lien is defined using the familiar phrase "any statutory lien or claim of lien, affecting the Title, that arises from services provided, labor performed, or materials or equipment furnished."

There are three versions of the ALTA 32 endorsement. All versions of the ALTA 32 endorsement provide three coverages. Paragraph 3(a) indemnifies the insured if the insured mortgage is found to be invalid or unenforceable as to a Construction Loan Advance made on or before the Date of Coverage. Paragraph 3(b) indemnifies the insured if a Construction Loan Advance made on or before the policy date lacks priority over any lien or encumbrance that existed on the policy date and that is not excepted in Schedule B.

Paragraph 3(c) provides the central construction lien priority coverage. It indemnifies the insured against the priority of certain Mechanic's Liens not filed in the Public Records on the Date of Coverage over the lien of the insured mortgage, as to specified Construction Loan Advances. The three variations in the ALTA 32 endorsement are necessary to modify the coverage in paragraph 3(c) to conform to the method that will be used to disburse the construction loan money. Each version of the ALTA 32 endorsement contains two limiting phrases. The variation in the endorsements is found in the wording of those limiting phrases.

In the ALTA 32.0-06 endorsement, the Mechanic's Lien priority coverage is limited as follows:

... but only to the extent that the charges for the services, labor, materials or equipment for which the Mechanic's Lien is claimed were designated for payment in the documents supporting a Construction Loan Advance disbursed by or on behalf of the Insured on or before Date of Coverage.

This version of the endorsement is to be used when the insured lender reviews the draw requests, disburses the money itself, and makes payment to the general contractor and not to the subcontractors and suppliers.

In the ALTA 32.1-06 endorsement, the Mechanic's Lien priority coverage is limited as follows:

... but only to the extent that direct payment to the Mechanic's Lien claimant for the charges for the services, labor, materials or equipment for which the Mechanic's Lien is claimed has been made by the Company or by the Insured with the Company's written approval.

This version of the endorsement is to be used when the title insurer reviews the draw requests, disburses the money on the lender's behalf, and makes payment to the subcontractors and suppliers. It may also be used when the lender reviews the draw requests and disburses the money directly to the subcontractors and suppliers, but the insurer gives its written approval for the disbursements.

In the ALTA 32.2-06 endorsement, the Mechanic's Lien priority coverage is limited as follows:

... but only to the extent that direct payment to the Mechanic's Lien claimant for the charges for the services, labor, materials or equipment for which the Mechanic's

Lien is claimed has been made by the Insured or on the Insured's behalf on or before  
Date of Coverage.

This version of the endorsement is to be used when the insured lender reviews the draw requests, disburses the money itself, and makes payment directly to the subcontractors and suppliers.

Thus, some variant of the ALTA 32 endorsement may be used when the insured lender disburses the money itself, when the title insurer reviews the draws and disburses the money, when the general contractor is paid, and when payments are made directly to subcontractors and suppliers. See further discussion of direct payment to subs and suppliers in §10.2.2.

Each version of the ALTA 32 endorsement contains two other limitations, found in paragraph 4. Limitation 4(a) is the same in each version of the endorsement. It states that there is no coverage against a Mechanic's Lien that arises from services, labor, materials or equipment "furnished after Date of Coverage." This statement reiterates that the coverage provided by each ALTA 33 endorsement protects only against construction lien rights that had accrued as of the endorsement's Date of Coverage. This is a limitation common to all forms of pending disbursement endorsements.

The second limitation found in paragraph 4(b) is different in each of the three versions of the ALTA 32 endorsement. Again, each version is tailored to the disbursing method that will be used.

Paragraph 4(b) of the ALTA 32.0 endorsement says that the insurer will not indemnify against a Mechanic's Lien that arises from work that was performed but that was "not designated for payment in the documents supporting a Construction Loan Advance disbursed by or on behalf of the Insured on or before Date of Coverage." Paragraph 4(b) of the ALTA 32.1 endorsement says that the insurer will not indemnify against a Mechanic's Lien that arises from work performed "to the extent that the Mechanic's Lien claimant was not directly paid by the Company or by the Insured with the Company's written approval." Paragraph 4(b) of the ALTA 32.2 endorsement says that the insurer will not indemnify against a Mechanic's Lien that arises from work performed "to the extent that the Mechanic's Lien claimant was not directly paid by the Insured or on the Insured's behalf."

The ALTA 32.0 endorsement provides coverage to the insured against a Mechanic's Lien that is later filed for work that was performed before the Date of Coverage in an ALTA 33 endorsement, and which work was "designated for payment in the documents supporting a Construction Loan Advance" and for which the insured lender advanced payment. There is no coverage against a Mechanic's Lien, even if the work was performed before the endorsement's Date of Coverage, if the work for which the lien was filed was *not* "designated for payment in the documents supporting a Construction Loan Advance..." There also is no coverage even if the work was performed before the Date of Coverage, and the work *was* designated for payment in the draw request, if the insured lender did not make a disbursement for that work. The ALTA 32.0 endorsement thus provides limited construction lien coverage. However, the ALTA 32.0 endorsement does protect the lender against one of the biggest risks in construction lending, that the general contractor receives payment from the lender but fails to pay the subcontractors and suppliers that it listed in its draw request as having performed the lienable work for which payment was sought.

The ALTA 32.1 endorsement is designed for use when direct payment is made to

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subcontractors and suppliers, and payment is made either by the insurer or the insured with the insurer's written approval. The 32.1 provides coverage to the insured against a Mechanic's Lien that is later filed for work that was performed before the Date of Coverage in the endorsement, but "only to the extent that direct payment to the Mechanic's Lien claimant for the charges for the services, labor, materials or equipment for which the Mechanic's Lien is claimed has been made by the Company or by the Insured with the Company's written approval." There is no coverage "to the extent that the Mechanic's Lien claimant was not directly paid by the Company or by the Insured with the Company's written approval." In other words, for coverage to be invoked, the Mechanic's Lien must be for work performed before the endorsement's Date of Coverage; the work must have been performed by a contractor, subcontractor or supplier who was actually paid as part of that draw request; and the Mechanic's Lien must be for the same work for which the insurer made payment. There is no coverage for a Mechanic Lien filed by a party who did work before the date of the endorsement, if that party was not paid through the draw request for which the endorsement was issued. There also is no coverage against a Mechanic's Lien filed by a party that was paid with the draw request, even if the work was performed before the endorsement's Date of Coverage, if the work for which the lien was filed was *not* paid for through the draw request. The ALTA 32.1 endorsement thus provides limited construction lien coverage. However, the ALTA 32.1 endorsement does protect the lender against the risk that the insurer inaccurately disbursed the money. It also protects the insured if the lien claimant disputes the amount of the payment, the validity of any waiver it delivered, or asserts that its lien rights were not extinguished because it did not provide a lien waiver.

The ALTA 32.2 endorsement is designed for use when direct payment is made to subcontractors and suppliers, and payment is made by the insured lender. The 32.2 provides coverage to the insured against a Mechanic's Lien that is later filed for work that was performed before the Date of Coverage in the endorsement, but "but only to the extent that direct payment to the Mechanic's Lien claimant for the charges for the services, labor, materials or equipment for which the Mechanic's Lien is claimed has been made by the Insured or on the Insured's behalf on or before Date of Coverage." There is no coverage "to the extent that the Mechanic's Lien claimant was not directly paid by the Insured or on the Insured's behalf." In other words, for coverage to be invoked, the Mechanic's Lien must be for work performed before the endorsement's Date of Coverage; the work must have been performed by a contractor, subcontractor or supplier who was actually paid as part of that draw request; and the Mechanic's Lien must be for the same work for which the lender made payment. There is no coverage for a Mechanic Lien filed by a party who did work before the date of the endorsement, if that party was not paid through the draw request for which the endorsement was issued. There also is no coverage against a Mechanic's Lien filed by a person who was paid with the draw request, even if the work was performed before the endorsement's Date of Coverage, if the work for which the lien was filed was *not* paid for through the draw request. The ALTA 32.2 endorsement thus provides limited construction lien coverage. However, the ALTA 32.2 endorsement does protect the lender insured if the lien claimant disputes the amount of the payment, the validity of any waiver it delivered, or asserts that its lien rights were not extinguished because it did not provide a lien waiver.

The courts have interpreted pending disbursement endorsements a number of times.<sup>27</sup>

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<sup>27</sup> In *Hall CA-NV, LLC v. Old Republic Nat'l Title Ins. Co.*, 440 F.Supp.3d 596 (N.D.Tex. 2020), app. filed March

Several courts have held that the lender does not obtain policy coverage for liens filed for work done in the gap between the last work date for which the draw was submitted and the endorsement date. In *Bankers Trust Co. v. Transamerica Title Ins. Co.*,<sup>28</sup> the construction project was apparently short of money from the beginning. The shortage was made worse when the lender permitted the owner to use draw from the loan account for non-construction purposes. The lender eventually demanded that the owner make up the shortfall, which it failed to do. The lender declared a default, at which time there was a balance of \$260,000 in the loan account. Liens of about \$300,000 were then filed. The lender refused to use the loan balance to pay the liens. Instead, it demanded that the insurer pay them. The insurer refused, on the basis that it had only given coverage through the disbursement date because the lender had promised in the loan disbursement escrow agreement to continue to fund in subsequent draws. The court characterized the insurer's argument this way:

Counsel for Transamerica argued that the contractual relationship between Transamerica and Bankers was clear, i.e., that Transamerica simply agreed to guarantee Bankers that any disbursements it made of loan funds advanced to it from Bankers would be paid on valid, proper invoices to those who performed work or services or supplied materials and that none of the disbursements would be made to other than bona fide claimants.<sup>29</sup>

The court agreed that the policy only covered liens for work done in the time period covered by the draw:

Bankers characterizes the obligation of Transamerica under the disbursement agreement as a responsibility to pay the loan proceeds in such manner as would protect both the borrower and the plaintiff from mechanics' liens to the extent of the funds disbursed. That is accurate. Here, however, the difficulty is that the cost of the work performed was greater than the money made available for payment. Transamerica was obliged to protect against the possibility of plaintiff paying twice for the same work. The defendant did not assume any obligation to pay for this project itself if neither Bankers nor Breaks provided the necessary funds.<sup>30</sup>

Further, the court agreed that the disbursing escrow agreement "clearly contemplated that

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11, 2020, the policy contained an ALTA 32 endorsement, and the insurer issued a series of ALTA 33 endorsements as the lender disbursed the construction loan. However, when it sought payment for later-filed liens, the lender asserted coverage under Covered Risks 2 and 10, not the endorsements. The court's analysis of the endorsements was limited to the statement that the endorsements "address prospective title risk from a lack of priority of Hall's mortgage as security for each construction loan advance," which the court said was "simply not the dispute at issue in Hall's claim."

<sup>28</sup> 594 F.2d 231 (10th Cir. 1979).

<sup>29</sup> Id. at 233 (emphasis added).

<sup>30</sup> Id. at 234 (appellate court quoting trial court with approval).

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adequate funds were to be made available to Transamerica in order to satisfy claims,"<sup>31</sup> and that the insurer had relied on that promise. Thus, the lender was obligated to advance loan money to pay for liens arising from the "gap" period:

In effect, it is claimed that by the issuance of a title insurance policy, Transamerica became a guarantor of payment for all work actually performed. That is more than the insurance contract calls for. Where, as here, work was performed and payment was not made up to the amount of the lender's loan commitment, the resulting mechanics' liens must be considered to have been created or suffered by the insured claimant and such liens are expressly excluded from coverage by the language of the title policy.<sup>32</sup>

*Bankers Trust* was relied on in the second case, *Brown v. St. Paul Title Ins. Corp.*<sup>33</sup> In *Brown*, the disbursing escrow agreement required the insurer to endorse the policy through the date of each disbursement. On the ninth draw, the waivers and contractor statements were dated about two weeks prior to disbursement. The lender stopped funding after that draw, and liens were filed for work done in part during that gap period. The insurer refused to remove the liens, on the basis that the insured had "suffered" or "agreed to" them by halting funding. The court agreed, ruling that the insurer protected through the disbursement date in reliance on the lender's implicit promise to fund through that date with the next draw. The court reasoned:

While CMIT admittedly was under no obligation to continue funding the project after the default, it seems clear that the parties contemplated that CMIT would provide adequate funds to pay for work completed prior to the default. To hold otherwise would give the insured an unwarranted windfall and would place the title insurer in the untenable position of guaranteeing payment of work for which loan funds were never advanced.<sup>34</sup>

*Bankers Trust* and *Brown* remain good law.<sup>35</sup> However, they have been distinguished in later cases, in which lien coverage was given without a corresponding disbursing escrow

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<sup>31</sup> 594 F.2d at 233.

<sup>32</sup> Id. at 234 (appellate court quoting trial court with approval) (emphasis added).

<sup>33</sup> 634 F.2d 1103 (8th Cir. 1980).

<sup>34</sup> *Brown v. St. Paul Title Ins. Corp.*, 634 F.2d 1103, 1110 (8th Cir. 1980).

<sup>35</sup> One article, Patterson, *Title Insurance and Mechanic's Liens*, 5 A.B.A. Real Property Financing Newsletter 20 (1985), criticized the decisions as imposing too great a limitation on coverage, opining that "if a lender must always disburse all its funds or have sufficient funds to pay all construction costs, then there is no need for insurance against prior liens because none will ever exist." However, the bulk of lien claims do not involve "gap" liens. They arise because of a host of other problems, including that a party is not shown on the contractor's statement or shown but no waivers obtained, or the waiver was forged or obtained by coercion.

agreement.<sup>36</sup> These cases held that the *Brown* and *Bankers Trust* rule requiring that the lender continue funding was created by the terms of the construction escrow agreement, not the policy. Thus, the later cases found no implied duty to continue funding. For example, one court stated:

The fact that committed funds under the loan agreement remained undisbursed has no bearing on the potential or actual lien losses under the title policy *unless* or *until* an actual or implied duty arises between the parties to the title policy to provide the funds. In *Bankers Trust* and *Brown*, this duty was impliedly created by the disbursement agreement. However, absent a contractual relationship ancillary to the insurance contract at issue, there was no implied duty between these parties that all committed loan funds must have been expended.<sup>37</sup>

In one later case, the parties had entered into a disbursing escrow agreement.<sup>38</sup> However, the court emphasized in that decision that the agreement stated that its terms did "not affect coverage under the title insurance policy." The court ruled that this phrase released the lender from the obligation to fully fund the construction loan.

In *Home Federal Savings Bank v. Ticor Title Ins. Co.*,<sup>39</sup> the title company issued pending disbursement endorsements with each draw, but there was no separate disbursing agreement between lender and title company. The lender elected not to advance the money to pay Wilhelm, the former general contractor. Wilhelm sued to foreclose its \$6 million mechanic's lien. Ticor refused to defend Home Federal. The district court ruled in Ticor's favor, based on *Brown* and *Banker's Trust*. On appeal, the Seventh Circuit found that the insurer had a duty to defend the lender in the mechanic's lien foreclosure action. Because it did not, the court held that it was estopped to deny coverage based on Exclusion 3(a). The court might have stopped there, but continued its analysis anyway. The court reversed the district court's ruling that Exclusion 3(a) barred the claim. It said the *Banker's Trust* ruling that the lender had suffered liens by breaching its agreement to fund the loan in full did not apply:

In this case, there was no disbursement agreement, and it was Home Federal rather than Ticor that both secured lien waivers and disbursed the funds when due under the loan agreement. Unlike in *Bankers Trust* and *Brown*, nothing in the insurance policy or the course of dealings indicates that Home Federal was bound to disburse

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<sup>36</sup> *American Sav. & Loan Ass'n v. Lawyers Title Ins. Corp.*, 793 F.2d 780 (6th Cir. (Tenn.) 1993); *Mid-South Title Ins. Corp. v. Resolution Trust Corp.*, 840 F.Supp. 522 (W.D. Tenn. 1993); *Resolution Trust Corp. v. Ford Mall Associates*, 819 F.Supp. 826 (D.Minn. 1991); *Chicago Title Ins. Co. v. Resolution Trust Co.*, 53 F.3d 899 (8th Cir. 1995); and *Home Federal Savings Bank v. Ticor Title Ins. Co.*, 695 F.3d 725 (7th Cir. (Ind.) 2012), reversing 2011 WL 4479080 (S.D.Ind.) (unpublished).

<sup>37</sup> *Mid-South Title Ins. Corp. v. Resolution Trust Corp.*, 840 F.Supp. at 528.

<sup>38</sup> *Chicago Title Ins. Co. v. Resolution Trust Co.*, 53 F.3d 899 (8th Cir. 1995).

<sup>39</sup> *Home Federal Savings Bank v. Ticor Title Ins. Co.*, 695 F.3d 725 (7th Cir. (Ind.) 2012), reversing 2011 WL 4479080 (S.D.Ind.) (unpublished).

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the entirety of its loan commitment to Altra even if Altra was in default.<sup>40</sup>

A short time after the Seventh Circuit Court of Appeals issued the *Home Federal* decision, however, that court expressed strong reservations about a bright line test in which the insurer may assert Exclusion 3(a) only when it has entered into a separate loan disbursing agreement. In *BB Syndication Services, Inc. v. First American Title Ins. Co.*,<sup>41</sup> the court held that a construction lender "created" or "suffered" mechanic's liens that piled on a project that began with no fixed budget, which the lender allowed to go further out of balance as work progressed, and on which the lender refused to disburse its entire loan amount. The title insurer and lender had entered into a loan disbursing agreement in *BB Syndication*, which distinguished the case from *Home Federal* based on the latter decision's own analysis. However, Justice Sykes noted that the liens piled on simply because the lender stopped funding without telling the contractors that it had done so:

The liens at issue here relate to outstanding work that remained unpaid when BB Syndication cut off loan disbursements due to insufficient funds to complete the project. As such, the liens arose directly from BB Syndication's action as the insured lender, so coverage seems squarely foreclosed by Exclusion 3(a).

The court said that *American Savings* and its progeny wrongly ignore the fact that it is the lender, not the title insurer, who has the authority to make sure that the project is fully funded at the beginning, and to keep it in balance as construction progresses, and the lender also has the sole ability to inform contractors that it will not pay for work going forward. Together, the court recognized, these are the most common reasons why construction liens are filed, and thus the lender's decisions control the insurer's risk in giving lien coverage, as discussed further in §10.1.5.1. The court concluded that, given the lender's authority to control the construction lien risk, there is no sound basis for the *Home Federal* ruling that Exclusion 3(a) applies only when the lender also enters into a construction disbursing agreement:

More fundamentally, placing decisive weight on the existence of a disbursement agreement produces anomalous results. Under *Home Federal* a title insurer that also acts as a disbursing agent would not have to cover liens arising from insufficient funds, whereas a title insurer (using the same standard-form policy) that does not act as a disbursing agent would have to cover them. The nondisbursing title insurer would thus be assuming a greater risk. But if a title company is both title insurer and disbursing agent, then it has more control over whether mechanics' liens will arise because it can ensure that loan funds are disbursed to the right people and in the proper amounts.

The observation in *BB Syndication* that *Home Federal* was wrongly decided was adopted

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<sup>40</sup> 695 F.3d at 734.

<sup>41</sup> 780 F.3d 825 (7th Cir. (Wis.) 2015).

without reservation in *Fidelity Nat'l Title Ins. Co. v. Osborn III Partners LLC*.<sup>42</sup> In that case, there was no separate disbursing agreement. The lenders urged the court to adopt *Home Savings* in order to avoid having it apply the reasoning of *BB Syndication* and *Captiva* that the lender negated mechanic lien coverage by allowing the project to fall out of balance. The court rejected the lenders' argument that Exclusion 3(a) applies only when there is a separate disbursement agreement. It observed that *BB Syndication* "expressly and persuasively disapproved of this distinction." It agreed with *BB Syndication* that such a rule would produce peculiar results, because it would "insulate a title insurer that acts as a disbursing agent from covering liens arising from insufficient funds precisely when the insurer's control over proper disbursement gives it greater control over whether mechanics' liens will arise."

### 10.1.5 Unrestricted Lien Coverage

In many states, it is common for the title insurer to give a lender making a construction loan to obtain protection against construction liens that is not subject to the terms of pending disbursement endorsements, whether or not there is a disbursing escrow agreement. The circumstances vary widely, and change over time. In some jurisdictions, this coverage is afforded because the lien law says that a mortgage obtains priority over construction liens if it is recorded before the visible commencement of the improvement. In such states, if the lender records the mortgage after the first visible work, it is considered to have "broken" priority. Nonetheless, during times in which the real estate market is relatively healthy, a title insurer will sometimes give unrestricted lien coverage to a lender with broken priority. One court described how construction lien coverage was underwritten in Minnesota during a good real estate market:

If work has already begun on a project, the title company must decide if it is nonetheless willing to guarantee priority. Such coverage is known as "early start" coverage, meaning that the insurer, fully aware that lien rights may have already been created, nevertheless agrees to indemnify the insured against any losses it may suffer as a result of the prior liens. A title company that agrees to cover an early start will normally protect itself against financial exposure by insisting on disbursing the loan proceeds in order to monitor the project, to ensure that the proper parties get paid and to remain fully informed on the condition of the financing and the progress on the project.<sup>43</sup>

The insurer sometimes gives this coverage based on the fact that it will have the ability to control the collection of lien waivers through a disbursing escrow agreement. In other cases, this "blanket" lien coverage is granted solely on the strength of an indemnity.<sup>44</sup> When unrestricted construction lien coverage is given, based on whatever rationale, reported decisions have admitted few

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<sup>42</sup> \_\_\_ P.3d \_\_\_, 2021 WL 868913 (Ariz.App. 1 Div. 2021) (permanent citation not yet available).

<sup>43</sup> *Resolution Trust Corp. v. Ford Mall Associates*, 819 F.Supp. at 833, fn. 4.

<sup>44</sup> See *American Savings & Loan Ass'n v. Lawyers Title Ins. Corp.*, 793 F.2d 780 (6th Cir. 1986).

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limitations on the coverage given.<sup>45</sup> One court made this comment:

The simple fact that is controlling in this case is that two sophisticated business entities entered into this contract—the title policy. It insured against losses due to unrecorded liens on this project. It did not exclude lien coverage until all loan funds were expended. It did not exclude liens that arose from work and materials for which loan funds had not already been advanced.<sup>46</sup>

Courts have acknowledged little or no obligation of the lender, even when its disbursement practices caused the liens in full or in part, as one court admitted:

... [T]he title company accepted the risk of unpaid labor and materialmen's liens. It did this for a fee, relying on the affidavits and guaranty [of the owner]. The fact that this risk has matured cannot now be avoided by the argument that the insured lender must accept additional losses on the loan due to exactly one of the contingencies for which the title policy was acquired—unpaid lien claimants. A smaller loss does not constitute a windfall profit... . The court agrees that the ... policy placed the title company in the unenviable position of having to pay off lien claims that under different circumstances might well have been paid by the loan funds, but that is what their contract provides.<sup>47</sup>

Nonetheless, title insurers have consistently raised two coverage defenses, both based on Exclusion 3(a): that liens caused by a shortage in project funding were "created" or "suffered" by the lender, and that the lender will obtain an unearned windfall if the insurer is required to pay for improvements that should have been paid for with money the lender holds or held undisbursed in the loan account. These defenses are discussed in turn below.

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<sup>45</sup> The courts rejected various arguments made by insurers to limit the lien coverage based on policy exclusions in the following decisions: *American Savings & Loan Ass'n v. Lawyers Title Ins. Corp.*, 793 F.2d 780 (6th Cir. (Tenn.) 1993); *Mid-South Title Ins. Corp. v. Resolution Trust Corp.*, 840 F.Supp. 522 (W.D. Tenn. 1993); *Resolution Trust Corp. v. Ford Mall Associates*, 819 F.Supp. 826 (D.Minn. 1991); *Chicago Title Ins. Co. v. Resolution Trust Co.*, 53 F.3d 899 (8th Cir. 1995); and *Home Federal Savings Bank v. Ticor Title Ins. Co.*, 695 F.3d 725 (7th Cir. (Ind.) 2012), reversing 2011 WL 4479080 (S.D.Ind.) (unpublished).

<sup>46</sup> *Mid-South Title Ins. Corp. v. Resolution Trust Corp.*, 840 F.Supp. 522, 531 (W.D. Tenn. 1993).

<sup>47</sup> 840 F.Supp. at 528.

### 10.1.5.1 Failure To Keep Project In Balance

Construction liens often arise because the combined equity and loan funds are not enough to pay for the whole project. The relative obligations of the lender and the escrowee to keep the project in balance are fully discussed at §10.2.3. Two modern decisions have held that, when construction liens arose because the lender failed to keep the project in balance, the lender "created" or "suffered" the risk, negating policy coverage. Earlier decisions either refused to employ this reasoning, or limited its application to situations in which the lender and title insurer entered into a disbursing agreement.

For many years, courts mostly rejected the project in balance argument. In *American Savings & Loan Ass'n v. Lawyers Title Ins. Corp.*,<sup>48</sup> the insurer removed the construction lien exception based on an indemnity from the owners. The lender paid out its entire loan account. It then paid off lien claimants, sold the property and sued the insurer for the amount of the liens. The trial court held that the lender had created or suffered the lien claims because the lender retained "the 'business' risk that the developer would fail to obtain adequate financing in violation of the loan agreement and that material suppliers consequently would not be paid and would achieve prior liens is one that the lender typically bears."<sup>49</sup> The trial court relied on *Brown v. St. Paul Title Ins. Corp.*<sup>50</sup> The Sixth Circuit reversed. Because American Savings had advanced all of its loan funds, unlike *Brown*, the court reasoned that the lender had fully performed its duties. The court said that the insurer, not the lender, was responsible for paying for work for which neither lender nor borrower had committed any funds. It reasoned:

[A]llowing American to recover from its insurer would not make Lawyers Title the guarantor of work for which loan funds were committed but never advanced, but rather, the guarantor of work for which loan funds were never committed. ... In essence, the insurer would, among other things, be insuring against the risk that the developer would not fulfill its obligation to obtain sufficient additional financing. This is the type of risk that insurance policies typically cover, the risk that another party, beyond the insured's control would fail to perform its obligations with injury resulting to the insured.<sup>51</sup>

Similarly, in *Chicago Title Ins. Co. v. Resolution Trust Co.*,<sup>52</sup> the lender did various things to accommodate cost overruns, including foregoing some interest payments. Eventually, however, the project was halted and liens were filed. The lender and insurer each paid half of the liens, agreeing to adjudicate their rights later. The lender took title to the project and finished it. The

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<sup>48</sup> 793 F.2d 780 (6th Cir. (Tenn.) 1993).

<sup>49</sup> 793 F.2d at 785.

<sup>50</sup> 634 F.2d 1103 (8th Cir. 1980).

<sup>51</sup> 793 F.2d at 786.

<sup>52</sup> 53 F.3d 899 (8th Cir. 1995).

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insurer then sued to get back its half of the lien claims. As in *American Savings*, the district court held that the liens were caused by the lender's failure to keep the project in balance, invoking Exclusion 3(a). The Eighth Circuit reversed, refusing to find that the lender had caused the lien claims by not keeping the project in balance. The court emphasized that the lender had eventually paid out more than its original loan amount, and had made other loan concessions as a result of the overruns. In reliance on *American Savings*, the court found that the purpose of construction lien coverage was to cover liens for which the lender had not committed loan funds.

The insurer's attempt to interpret the language in the agreement broadly would mean the endorsement would provide no coverage unless the insured itself put up sufficient funds to complete the project. Since there would be no need for coverage under those circumstances ... this interpretation would effectively nullify the lien coverage secured by the endorsement.<sup>53</sup>

In the 2012 decision of *Home Federal Savings Bank v. Ticor Title Ins. Co.*,<sup>54</sup> the insurer issued pending disbursement endorsements with each draw, but there was no separate disbursing agreement between lender and title company. The lender elected not to advance the money to pay Wilhelm, the former general contractor. Wilhelm sued to foreclose its \$6 million mechanic's lien. The Seventh Circuit found that the insurer had a duty to defend the lender in the mechanic's lien foreclosure action. Because it did not, the court held that it was estopped to deny coverage based on Exclusion 3(a). It also held that the lender was not unjustly enriched even though Ticor was required to pay for the improvements the lender had refused to fund, because the lender did obtain endorsements but there was no disbursing agreement under which the lender had promised to keep funding the project.

However, the rationale of *American Savings*, *Chicago Title v. RTC* and *Home Federal* was thoroughly debunked in *BB Syndication Services, Inc. v. First American Title Ins. Co.*<sup>55</sup> In that decision by the Seventh Circuit, the court held that the construction lender "created" or "suffered" mechanic's liens due to the lack of a fixed budget, made worse when the lender allowed the project to go further out of balance as work progressed, and on which the lender refused to disburse the full loan amount. The court held that the lender has the power to make sure that the project is in balance before work begins, and to keep it that way as construction progresses:

It was clear early on in the life of [this] project that cost overruns would put the loan out of balance. At that time BB Syndication had only disbursed \$5 million in loan funding, yet it kept the spigot open, ultimately releasing more than \$61 million in loan funds before declaring the project unfinishable and halting the flow of money. BB Syndication insists that its forbearance demonstrates good faith—a

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<sup>53</sup> 53 F.3d at 907.

<sup>54</sup> *Home Federal Savings Bank v. Ticor Title Ins. Co.*, 695 F.3d 725 (7th Cir. (Ind.) 2012), reversing 2011 WL 4479080 (S.D.Ind.) (unpublished).

<sup>55</sup> 780 F.3d 825 (7th Cir. (Wis.) 2015).

willingness to do everything possible to see the project through—so the fault for the liens cannot be laid at its feet. Perhaps. An alternative interpretation is that its poor business judgment precipitated the liens.

Either way, BB Syndication's argument exposes a flaw in the reasoning of *American Savings* and *Chicago Title*. Contrary to the assumption underlying those decisions, 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. The contractual arrangements in this case are commonplace and demonstrate the lender's broad authority. As a condition to closing, BB Syndication required Trilogy to submit, for its approval, various documents that would allow it to assess the project's viability before closing the loan... .

The loan agreement also allowed BB Syndication to monitor the project throughout construction to ensure its continued viability. It could request financial reports from Trilogy and conduct monthly on-site inspections of the project. If at any point BB Syndication determined that the loan was out of balance, it could require Trilogy to supply a cash infusion. If the developer's available funds were insufficient to complete the project, BB Syndication could choose to cut off disbursements—or not. BB Syndication had the discretion to continue funding even a doomed project. ...

In short, at the first sign of trouble, BB Syndication could have used the threat of default to force the developer to supply additional funds. If Trilogy was unwilling or unable to do so, BB Syndication's losses would have been less than \$5 million—and most likely zero—since the land alone was worth roughly \$12 million. Instead, BB Syndication chose to continue funding the project. That was its prerogative, of course, but in the end this risky business decision resulted in \$17 million in liens from unpaid work.

BB Syndication now looks to First American to cushion its losses, but this stretches title insurance too far. Finding coverage in this situation—where the insured lender has the sole discretion to either continue or cease funding a project that is or has become unfinishable—would raise a serious question of moral hazard. Most work on a construction project increases its value (and in turn the value of the lender's security interest), but if the title company has to cover the costs while the lender retains the benefit, then the lender obtains a windfall by shifting a business risk to the title insurer. ... Since the amount of unpaid work will depend on the timing of a doomed project's inevitable termination, lenders might strategically delay. That is exactly the type of problem that Exclusion 3(a) is there to prevent.

The line drawn in *American Savings* and *Chicago Title*—that Exclusion 3(a) does not apply if the insured lender has disbursed all of its loan proceeds—does not grapple with this hazard. Knowing that unpaid contractors' claims will be covered by title insurance once the loan proceeds run out may in some circumstances encourage lenders to continue to fund a project even after it becomes clear that it has no chance of succeeding.

A better interpretation is that Exclusion 3(a) excludes coverage for liens that

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arise as a result of insufficient funds. This interpretation makes the most sense of the respective roles of the insured lender and the title insurer in this context. Only the lender has the ability—and thus duty—to investigate and monitor the construction project's economic viability. 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. This interpretation also has the advantage of being a clear rule that parties can bargain around.<sup>56</sup>

*BB Syndication* correctly posits that a title insurer does not contract to pay for work for which no money was ever allocated, or improvements built after the lender has stopped making advances. *BB Syndication* also acknowledged in a footnote that the Seventh Circuit's own decision in *Home Federal*, issued just a few years earlier, was fundamentally flawed because it had found the existence of a disbursing agreement to be a necessary predicate for Exclusion 3(a) to apply.

In *Captiva Lake Investments, LLC v. Fidelity Nat'l Title Ins. Co.*,<sup>57</sup> the court adopted the reasoning of *BB Syndication* and expanded on it, to hold that the insured lender suffered or created millions of dollars of mechanic's liens due to its faulty construction loan disbursing practices, reversing a ruling by the district court.

*Captiva* was the first decision applying Exclusion 3(a) based squarely on the premise that the lender can and ordinarily does exert much influence over the borrower during the course of a construction loan, and thus has the power to keep a project in balance. The Eighth Circuit admitted that the title insurer has no similar authority to keep a project in balance, even when there is a disbursing agreement between the lender and insurer. The court cited numerous authorities and learned treatises that explain these principles.<sup>58</sup> It also quoted from the loan documents for this project to establish the lender's contractual rights to require that the borrower keep the project in balance, which had been a condition to the lender's obligation to continue funding of draws. The court noted that, nonetheless, the *Captiva* project was not in balance when the loan was made, that the lender permitted the deficiency to grow as construction progressed, and that many liens were the result of contractors who continued to work for months after the bank had secretly halted disbursements. Also, the lender never advanced the full amount of the loan.

The Eighth Circuit applied the exclusion although there was no disbursing agreement between lender and title insurer, unlike the facts in *BB Syndication*. The Eighth Circuit said that the district court had construed Exclusion 3(a) too narrowly, as applying only if the lender "engaged in intentional misconduct or inequitable dealings... ." Thus, the trial court had abused its discretion "when it excluded evidence regarding Fidelity's Exclusion 3(a) defense." The court

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<sup>56</sup> 780 F.3d at 834-836.

<sup>57</sup> 883 F.3d 1038 (8th Cir. (Mo.) 2018).

<sup>58</sup> The court cited, in particular, Michael F. Jones & Rebecca R. Messall, *Mechanic's Lien Title Insurance Coverage for Construction Projects*, 16 Real Estate L.J. 291 (1988). It also recited this quote from 1 Grant S. Nelson et al., *Real Estate Finance Law* § 12.1 (6th ed.), Westlaw: "A construction loan provides funds for the construction of improvements on land. The developer and the lender enter into a construction loan agreement, which sets forth the terms of the loan and "generally incorporates by reference the project's plans and specifications, includes a budget that the developer must follow, and specifies the project completion date."

relied on its own prior decision in *Brown v. St. Paul*, to conclude as a matter of law that the exclusion barred coverage:

We conclude that Exclusion 3(a) can apply under Missouri law even if the insured did not engage in intentional misconduct or inequitable dealings. ... In *Brown*, we held that the construction lender's cessation of disbursements following the developer's default under the construction loan agreement "created or suffered" the liens that consequently arose due to insufficient funds. 634 F.2d at 1110. "While [the lender] admittedly was under no obligation to continue funding the project after the default, it seems clear that the parties contemplated that [the lender] would provide adequate funds to pay for work completed prior to the default." *Id.* Requiring the insurer to indemnify the lender "would give the insured an unwarranted windfall and would place the title insurer in the untenable position of guaranteeing payment of work for which loan funds were never advanced." *Id.*

The court also said it believed that "the Missouri Supreme Court would adopt the well-reasoned analysis of the United States Court of Appeals for the Seventh Circuit in *BB Syndication Services*" that "Exclusion 3(a) excludes coverage for liens that arise as a result of insufficient funds," as quoted above. The Eighth Circuit distinguished its own prior decision in *Chicago Title v. RTC*, which construed Minnesota rather than Missouri law. *Captiva* thus adopted the suggestion made in *BB Syndication* that Exclusion 3(a) bars coverage that would provide a windfall to the insured lender, whether or not there was a disbursing agreement between the lender and title agent or insurer.

In *Hall CA-NV, LLC v. Old Republic Nat'l Title Ins. Co.*,<sup>59</sup> a Texas federal court applied *BB Syndication* and *Captiva* to hold that Exclusion 3(a) barred coverage for a construction lien filed after the policy date, for work performed after policy date, but which lien obtained priority over the insured deed of trust based on the relation-back doctrines in the two states where the property was located, Nevada and California. The *Hall* court quoted the statement from *BB Syndication* that there would be a moral hazard in obligating the title insurer to pay for work that was left unpaid because the construction lender insured stopped disbursing before its committed loan money had been exhausted. It also quoted the analogous statement in *Captiva* that:

Requiring the insurer to indemnify the lender would give the insured an unwarranted windfall and would place the title insurer in the untenable position of guaranteeing payment of work for which loan funds were never advanced.

The court thus concluded that "if the issue is Hall stopping loan advances after the policy date and Penta filing a lien for such work, then Exclusion 3(a) applies to bar coverage." The *Hall* decision was affirmed on appeal, although the Fifth Circuit Court of Appeals did not address *BB Syndication*

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<sup>59</sup> *Hall CA-NV, LLC v. Old Republic Nat'l Title Ins. Co.*, 440 F.Supp.3d 596 (N.D.Tex. 2020), app. filed March 11, 2020.

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or *Captiva* in its decision.<sup>60</sup>

*BB Syndication* was embraced and extended in *Fidelity Nat'l Title Ins. Co. v. Osborn III Partners LLC*.<sup>61</sup> The court accepted the premise that the lender and not the title insurer has the power to keep the project in balance.<sup>62</sup> It held that the lender invoked Exclusion 3(a) by shorting the project in two ways: by disbursing \$414,000 from the construction impound account to cover interest owed on the loan, and then by halting funding with \$1.1 million of committed money left in the loan account. Although the loan agreement permitted the lender to stop funding on default, that right did not affect policy coverage. The court accepted the position of *BB Syndication* and *Captiva* that, by failing to fully fund the loan, the lender "created" or "suffered" the mechanic's liens. The court went further, rejecting the principle of *American Savings* that Exclusion 3(a) cannot apply if the lender does fully disburse the loan money, because that rule ignores the fact that the lender alone has the power to keep the project in balance.<sup>63</sup> Further, the *Osborn* court rejected the contention in *Chicago Title Ins. Co. v. Resolution Trust Corp.*, 53 F.3d 899 (8th Cir. 1995), that employing Exclusion 3(a) to limit mechanic lien coverage would "effectively nullify the mechanic's lien coverage" of the policy.<sup>64</sup> Having suffered the mechanic's liens, the court held

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<sup>61</sup> \_\_\_ P.3d \_\_\_, 2021 WL 868913 (Ariz.App. 1 Div. 2021) (permanent citation not yet available).

<sup>62</sup> "The rule we adopt also better tracks 'the respective roles of the insured lender and the title insurer in this context' and allocates the risk associated with a funding shortfall to the party with knowledge and control over funding issues. ... '[C]onstruction 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.' *BB Syndication*, 780 F.3d at 834. Before agreeing to lend, a lender can require a developer to provide it with financial statements, appraisals, contracts, and plans that will enable the lender to assess the financial viability of a project at the outset. *Id.* Thereafter, the lender can require the developer to deliver regular reports documenting the project's progress, allowing the lender to monitor the continuing financial viability of the project so that it can demand the developer provide a cash infusion if the project is heading out of balance. *Id.* at 834–35. The loan agreement here, for example, gave Mortgages Ltd. broad authority to monitor the project's economic viability: it had the power to insist that all loan proceeds be used for construction; to inspect for satisfactory progress and to see that prior disbursements had been paid out for construction before making progress payments; to declare a default if the project became out of balance; and to demand the developer contribute additional funds to cover construction costs, including cost overruns." 2021 WL 868913 at \*10.

<sup>63</sup> "¶55 The lender's ability to monitor the project and control funding also underscores the flaw in the alternative rule—that Exclusion 3(a) does not apply once the lender has fully funded its loan commitment—proposed by two cases on which the Successors rely (although we note that here, Mortgages Ltd. had not disbursed all loan proceeds). ... As the Seventh Circuit observed, 'construction lenders have significant ability to ensure that the projects they finance remain economically viable ... throughout construction.' *BB Syndication*, 780 F.3d at 834. These tools allow a lender to determine when a loan is out of balance or heading that way, and to protect its interests when that happens. Moreover, shifting the burden of any resulting lien simply because a lender has fully disbursed its commitment would compound the resulting moral hazard created when the lender's security is increased by the work of contractors for which the lender has not disbursed funds: 'Knowing that unpaid contractors' claims will be covered by title insurance once the loan proceeds run out may in some circumstances encourage lenders to continue to fund a project even after it becomes clear that it has no chance of succeeding.'" 2021 WL 868913 at \*10.

<sup>64</sup> The *Osborn* court described the appropriate nature and limits of the policy coverage: "As the Seventh Circuit put it, coverage for mechanics' liens insures against faults in the payment process (once the lender has disbursed the funds), not the lender's business risks. *Id.* Mechanics' lien coverage in a lender's title policy still will protect the lender

that the lender could not shift any part of that risk back onto the insurer even though the dollar amount of the mechanic's liens was more than the amount that the lender diverted or failed to fund.<sup>65</sup>

### 10.1.5.2 Unjust Enrichment Or Windfall To Lender

In certain decisions issued between 1979 and 2012, title insurers asserted that Exclusion 3(a) should prevent the lender from receiving a windfall by having the insurer pay for improvements, particularly if the lender refused to advance all of the loan money to pay for those same improvements. This argument was based on the valid premise that a construction lien is a lien, but one that has favored status because it represents the cost of the value added to the property by an improvement, and the lender gets that improvement for free when it forecloses.<sup>66</sup>

The windfall principle was accepted by the courts in *Bankers Trust* and *Brown v. St. Paul*.<sup>67</sup> In *American Savings & Loan Ass'n v. Lawyers Title Ins. Corp.*,<sup>68</sup> the court twisted the principle, holding that an insured lender did not obtain a windfall unless it refused to pay out the full amount of its loan.

Several later decisions went even further, knocking down the *American Savings* principle that a lender must fully fund the loan in order not to receive a windfall. In *Mid-South Title Ins. Corp. v. Resolution Trust Corp.*,<sup>69</sup> the lender disbursed \$8,028,000 of a \$9,800,000 loan and then

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against the risk of paying twice for the same work—just not provide a windfall by allowing the lender not to pay even once. *Id.* Moreover, a lender seeking protection against this kind of risk has other options—performance bonds, third-party guarantees, or even a separately negotiated endorsement not to invoke Exclusion 3(a) in these circumstances. *Id.*" 2021 WL 868913 at \*11.

<sup>65</sup> "Here, as a matter of law, Exclusion 3(a) excludes coverage for the Successors' claim because Summit's lien resulted from Mortgages Ltd.'s cutoff of funding. While the developer also helped create the title defect (it began construction before the second deed of trust was filed, giving Summit's later-filed mechanics' lien priority over Mortgages Ltd.'s security interest), Mortgages Ltd. itself created or 'suffered' the mechanics' lien by allowing funds to be diverted from the construction impound account and ultimately by cutting off funding entirely, even though the loan agreement allowed it to do so. ... This holds true even though, as the Successors note, the face value of the mechanics' liens initially filed exceeded the amount of funding that Mortgages Ltd. diverted or withheld—although we note that the value of Summit's lien (and the value the Successors paid to settle with Summit) was much closer to that amount. ... While Mortgages Ltd.'s loan agreement with the developer did not require it 'to continue lending good money after bad,' ... the Successors cannot now shift to Fidelity the obligation to pay for work that presumptively increased the value of Mortgages Ltd.'s security interest but for which Mortgages Ltd. did not pay." 2021 WL 868913 at \*11.

<sup>66</sup> Once a lender has foreclosed, the issue is no longer the relative priority of the liens. After foreclosure, the lender owns the property, and the insurer is being asked to pay for the improvements that the insured now owns. See *Drilling Service Co. v. Baebler*, 484 S.W.2d 1 (Mo. 1972). Every payment by the insurer to a construction lien claimant thus reduces the lender's cost in acquiring the project.

<sup>67</sup> *Bankers Trust Co. v. Transamerica Title Ins. Co.*, 594 F.2d 231 (10th Cir. 1979); *Brown v. St. Paul Title Ins. Corp.*, 634 F.2d 1103, 1110 (8th Cir. 1980).

<sup>68</sup> 793 F.2d 780 (6th Cir. (Tenn.) 1993).

<sup>69</sup> 840 F.Supp. 522 (W.D. Tenn. 1993).

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finished the project for an additional \$502,000, making a total outlay of about \$8,500,000. The liens in dispute totaled about \$200,000. The court rejected the windfall argument because there was no disbursing agreement creating a contractual obligation to fund the entire loan. The windfall argument was also rejected in *Resolution Trust Corp. v. Ford Mall Associates*,<sup>70</sup> despite the fact that the lender did not advance the entire loan amount. The court again based its ruling on the fact that the lender had made no commitment to the insurer to advance all of the loan money, and had negotiated for full mechanic lien coverage in its policy.

In *Home Federal Savings Bank v. Ticor Title Ins. Co.*,<sup>71</sup> the insurer issued pending disbursement endorsements with each draw, as in *Brown*, but there was no separate disbursing agreement between lender and title company as in *Bankers Trust*. The lender refused to pay the general contractor, which filed a \$6 million mechanic's lien. The Seventh Circuit held that the lender was not unjustly enriched by making Ticor Title pay for the improvements the lender had refused to fund with the loan it had committed to make. The court used this rationale:

Home Federal paid an extra premium for the mechanic's lien endorsement... . [The Wilhelm lien] would have ... reduced the amount of its recovery from the proceeds of the foreclosure sale by \$6 million. However dim Wilhelm's prospects of success, that was precisely what Home Federal had insured against in the mechanic's lien endorsement. ... Bearing those costs is a risk against which Home Federal had already insured through its policy with Ticor by paying for the mechanic's lien endorsement. As we see the case, Home Federal was seeking only the peace of mind it had paid for, not a windfall.<sup>72</sup>

However, the rationale of *Home Federal* and the earlier decisions was found to be being fundamentally flawed in *BB Syndication, Captiva* and *Osborn*, discussed above. In *Hall CA-NV, LLC v. Old Republic Nat'l Title Ins. Co.*, a Texas court built on *BB Syndication* and *Captiva* to hold that Exclusion 3(a) barred the insured from obtaining windfall coverage for construction liens that were filed because the lender refused to advance committed loan funds to pay for the work.<sup>73</sup> The *Hall* court quoted the statement in *BB Syndication* that there would be a moral hazard in obligating the title insurer to pay for work that was left unpaid because the construction lender insured stopped disbursing before its committed loan money had been exhausted. It also quoted the analogous statement in *Captiva* that:

Requiring the insurer to indemnify the lender would give the insured an unwarranted windfall and would place the title insurer in the untenable position of

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<sup>70</sup> 819 F.Supp. 826, 833 (D.Minn. 1991).

<sup>71</sup> *Home Federal Savings Bank v. Ticor Title Ins. Co.*, 695 F.3d 725 (7th Cir. (Ind.) 2012), reversing 2011 WL 4479080 (S.D.Ind.) (unpublished).

<sup>72</sup> 695 F.3d at 735.

<sup>73</sup> *Hall CA-NV, LLC v. Old Republic Nat'l Title Ins. Co.*, 440 F.Supp.3d 596 (N.D.Tex. 2020), app. filed March 11, 2020.

guaranteeing payment of work for which loan funds were never advanced.

The court thus concluded that "if the issue is Hall stopping loan advances after the policy date and Penta filing a lien for such work, then Exclusion 3(a) applies to bar coverage," and the court so held. The *Hall* decision was affirmed on appeal, although the Fifth Circuit Court of Appeals did not address *BB Syndication* or *Captiva* in its decision.<sup>74</sup>

### 10.1.6 Measure Of Loss--Loan Policy

The loss resulting from a construction lien is measured in the same manner as other types of loan policy losses. A full discussion of the measure of loan policy losses is found at §3.2.4. Certain unusual fact situations warrant mention under this chapter, however.

Dueling mortgage and construction lien foreclosures can force the lender to spend money to preserve its position. If the insurer is litigating the validity of the liens or otherwise clearing title, such expenses may be compensable. For example, a lender was found to have suffered a loss when it was forced to redeem the property from a superior construction lien claimant's foreclosure sale, in order to preserve the lien of the insured mortgage.<sup>75</sup> A second mortgagee suffered loss equal to the surplus from the first mortgagee's foreclosure sale, when that surplus was paid to intervening lien claimants.<sup>76</sup>

An insurer has the right to clear title by litigating the validity of the construction liens. See §3.4 for a complete discussion of the right to cure title. However, the lien claimant's foreclosure action can affect the insurer's effort to clear title.<sup>77</sup> There can be a tension between the lender's desire to complete or sell the unfinished project and the insurer's right to protect the insured's lien priority.<sup>78</sup>

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<sup>75</sup> *Minnesota Title Ins. & Trust Co. v. Drexel*, 70 F. 194 (8th Cir. (Minn.) 1895).

<sup>76</sup> *American-First Title & Trust Co. v. First Federal Savings & Loan Ass'n of Coffeyville*, 415 P. 2d 930 (Okla. 1965).

<sup>77</sup> In *Trigiani v. American Title Ins. Co.*, 392 Pa.Super 427, 573 A. 2d 230 (Pa.Super. 1990), a claimant's foreclosure sale was held while the insurer was attempting to cure title. The court found that the lender was not required to "throw good money after bad" to preserve its position by bidding at the sale.

<sup>78</sup> In *The Tokai Bank v. Chicago Title Ins. Co.*, 125 F.3d 859 (Table), 1997 WL 632599 (9th Cir. (Cal.)) (unpublished), the insurer defended the lender against construction lien foreclosures under a reservation of rights. When the owner filed bankruptcy, the lender viewed its options as being to have the stay lifted and proceed with foreclosure, provide financing to complete the project, or to support a Section 363(f) sale by the trustee free of liens. The lender obtained appraisals of the unfinished project and elected to support a sale free and clear for a price that matched the appraised value. The buyer finished the project for \$8 to \$10 million less than the lender itself had estimated as the cost of completion. The lender then sued the insurer for the difference in value. It claimed that the coverage question raised by the reservation of rights had forced it to support a Section 363 sale rather than complete the structure or finance its completion. The court found that the lender decided to back the sale because the appraisals supported the sale price, rather than because of the coverage question. Therefore, the insurer was not liable to the lender for the claimed difference in value.

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### 10.1.7 Premature Or Voluntary Payment Of Liens By Insured Lender

As stated above, an insured lender does not prove a loss merely on showing that a prior construction lien exists. The lender must also establish that the loan is in default, and that the lender is undersecured as a result of the construction lien. A lender that pays a lien but is unable to show that the lien impaired its security has not proven a loss.<sup>79</sup> The insurer is not required to pay off liens on demand by the insured, or to permit the insured to do so.<sup>80</sup> Such a payment by the lender will ordinarily invoke the voluntary settlement provision, discussed at §2.14.

## 10.2 Construction Loan Escrows

The second half of this chapter discusses the duties that the escrowee assumes when it disburses loan funds under a construction escrow.<sup>81</sup> General escrow principles are discussed in Chapter 13. As stated above, construction lien laws vary widely. As a result, the construction escrow does not exist everywhere. Such escrows are found primarily in states in which a construction lender receives little or no statutory protection against construction liens.

### 10.2.1 Nature Of Agreement Generally

Construction escrows vary, but a common procedure is as follows. The owner or contractor delivers to the escrowee a project breakdown, also known as a schedule of values, with or before the first request for an advance (known as a draw). With each draw request, the contractor deposits an affidavit or certificate as to the work completed to date, showing the line items for which payment is sought, together with waivers from each listed subcontractor and supplier. The owner and lender each send written consents to the draw request and direct the escrowee to disburse the loan advance. The draw package may also include an architect's certificate as to the percentage of completion, a separate inspector's statement as to workmanship, an owner's affidavit as to work for which it has separately contracted, invoices for all work for which payment is sought, and a survey (foundation or as-built).

The escrow agreement typically says that the escrowee is to review each draw "package" and notify the lender as to whether or not the insurer is prepared to extend the construction lien policy coverage forward in time through the date of draw funding, and upward in amount to include all advances made to date. This coverage is normally provided by a "pending disbursement"

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<sup>79</sup> *Ring v. Home Title Guar. Co.*, 168 So.2d 580 (Fla.App. 1964).

<sup>80</sup> In *Diversified Mortgage Investors v. U.S. Life Title Insurance Co. of New York*, 544 F.2d 571 (2d Cir. 1976), a construction lender wished to settle with lien claimants before it made additional advances. It was denied an injunction prohibiting the insurer from raising the voluntary settlement defense against the lender if it settled.

<sup>81</sup> Construction escrows and construction lien liability are further analyzed in Jones & Maessell, *Mechanic's Lien Title Insurance Coverage for Construction Projects*, 16 Real Estate L.J. 291 (1988); Urban, *Future Advances and Title Insurance Coverage*, 15 Wake Forest L. Rev. 329 (1979); Jordan, *Mechanics' Lien Coverage*, Practicing Law Institute, Real Estate Course Handbook (1988); Bohan, *Mechanics' Lien Coverage in Title Insurance Policies*, in *Attorneys' Role in Title Insurance*, A.B.A. Real Property & Trust Section, (1990); Sweat, *Obligatory Advances: Mechanics' Liens and the 1987 Loan Policy*, Practicing Law Institute, Real Estate Course Handbook (1988); J. Patterson, *Title Insurance and Mechanic's Liens*, 5 A.B.A. Real Property Financing Newsletter 20 (1985); Palomar, *Title Insurance Law*, § 6.12, pp. 6-78 to -83.

endorsement.<sup>82</sup> See §10.1.4 and following for a complete discussion of the cases construing pending disbursement endorsements. If the escrowee is prepared to issue the endorsement, the lender deposits the amount of the construction draw with the escrowee and payment is made. If the insurer is unwilling to issue an endorsement, the agreement usually provides several options.

In most jurisdictions, the escrowee is liable only to the principal or principals to the escrow or disbursing contract.<sup>83</sup> The construction escrowee is most commonly alleged to have duties of the following types:

1. To verify payment to all subcontractors
2. To keep the project in balance
3. To pay the proper parties
4. To inspect the property

These subjects are discussed in turn below. There is a series of published decisions from Missouri. The author's view is that the cases are indicative of the great deference Missouri statutes and courts give to construction lien claimants, at the expense of owners, lenders and insurers. The more extreme Missouri holdings should not be considered authoritative in states which give a better balance to the competing interests of the parties.

The final portion of this section discusses the escrowee's defenses to negligence claims and sources of recoupment by or against the escrowee.

### 10.2.2 Paying Subcontractors And Collecting Lien Waivers

Construction projects are typically disbursed in stages, known as draws, as the work progresses. The disbursing instructions tell the escrowee which person or parties to pay with each draw, and identify those documents that are to be received in exchange for payment.

The most common arrangement is for draws to be paid to the general contractor. However, the disbursing agreement sometimes orders the escrowee to pay subcontractors directly, meaning that separate payments are to be made to every person that has provided services, labor or materials during the draw period.<sup>84</sup> The general contractor provides the escrowee with a list of

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<sup>82</sup> The form of endorsement varies widely. One form is the ALTA Construction Loan Policy Endorsement A, designed to be used in connection with the Construction Loan Policy.

<sup>83</sup> In *Elsebaei v. Philip R. Seaver Title Co., Inc.*, 2015 WL 7079068 (Mich.App.) (unpublished), the court found that a title company that reviewed construction draw requests and issued pending disbursement endorsements under a contract with the lender did not owe a duty to the borrower-owners, and thus could not be liable to them for the contractor's theft of loan money. The court said that the disbursing agreement was incidental to the title agent's role in giving construction lien coverage to the lender under its title insurance policy. Michigan has held that a title agent is not directly liable to third parties, including the insured, in relation to the policies that it issues. See *Mickam v. Joseph Louis Palace Trust*, 849 F.Supp. 516 (E.D.Mich. 1993) and *Wormsbacher v. Seaver Title Co.*, 284 Mich.App. 1, 772 N.W.2d 827 (2009).

<sup>84</sup> See Allan R. Burke, *Lien-Free Construction Through Direct Disbursement*, in *Title News*, Volume 62, Number 8 (October 1983), p. 7, for a still-relevant and thorough description of the way in which lenders and title insurers can limit the construction lien risk by paying subcontractors and suppliers directly. ALTA members can retrieve the article from the *Title News* archives at [alta.org](http://alta.org).

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subcontractors and suppliers who have worked to date and showing the total dollar amount of work for which payment is requested. It is common for the general contractor to be required to furnish to the escrowee with each draw lien waivers from the subcontractors and suppliers who have provided services, labor or materials to date. The instructions may require those waivers to be either unconditional or conditional on payment to be received.

The escrowee is liable for losses suffered by an escrow party that were proximately caused by the escrowee's failure to follow its instructions and which were reasonably foreseeable by the escrowee. An instruction to pay subcontractors and suppliers directly was not altered by owner's authorization forms that stated that payment was to be made to the general contractor.<sup>85</sup> A violation of instructions is normally a breach unless the parties consent to the change, even if done with the sincere goal of compensating for or avoiding a potential lien problem.<sup>86</sup> However, the construction escrowee is not liable for minor or technical errors that do not cause a loss to the escrow principals.<sup>87</sup>

An escrowee may be found to have made improper disbursements by paying on a draw request that includes a contract extra, change order not approved by all parties to the escrow, or an increase from the original budget for a particular subcontract item.<sup>88</sup> Also, when a lien is filed for work done in the time period for a previous draw, the escrowee may not unilaterally take funds from a later draw to pay the lien claimant.<sup>89</sup>

A Missouri decision found the escrowee liable to a subcontractor for not making sure that he was paid when the escrowee knew that he was on the job, but no request was made for payment of that work.<sup>90</sup> However, Missouri stands alone in making subcontractors third party beneficiaries

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<sup>85</sup> *R and B Kapital Development, LLC v. North Shore Community Bank and Trust Co.*, 358 Ill.App.3d 912, 832 N.E.2d 246, 295 Ill.Dec. 95 (Ill.App. 1 Dist. 2005) (disbursing agreement controls contradictory statement in owner's authorization form).

<sup>86</sup> The construction escrow agreement has been said to create "a responsibility to pay the loan proceeds in such manner as would protect both the borrower and the [lender] from mechanics' liens to the extent of the funds disbursed." *Bankers Trust Co. v. Transamerica Title Ins. Co.*, 594 F.2d 231 (10th Cir. 1979).

<sup>87</sup> In *Meyers v. TrustTexas Bank, S.S.B.*, 2018 WL 6072158 (Tex.App.-Austin) (unpublished), several small communication errors by the title company escrowee and bank in disbursing a construction loan were found not to have caused any loss to the borrowers, who thus were not entitled to recover against the escrowee.

<sup>88</sup> *H.B.I. Corp. v. Jiminez*, 803 S.W.2d 100 (Mo. 1990); *Pioneer Nat'l Title Ins. Co. v. Cranwell*, 369 S.E.2d 678 (Va. 1988).

<sup>89</sup> *Pioneer Nat'l Title Ins. Co. v. Cranwell*, 369 S.E.2d 678 (Va. 1988).

<sup>90</sup> *O'Neil Lumber Co. v. Allied Builders Corp.*, 663 S.W.2d 326 (Mo.App. 1983); *Title Ins. Co. of Minn. v. Construction Escrow Service, Inc.* 675 S.W.2d 881 (Mo.App. 1984). In *Hoida, Inc. v. M & I Midstate Bank*, 688 N.W.2d 691, 2004 WI App 191 (Wis.App. 2004), the court found that the escrowee had a duty to a subcontractor "to refrain from any act which [would] cause foreseeable harm," and that it "was foreseeable that the failure to obtain lien waivers could harm subcontractors." Nonetheless, the court found that recovery by the subcontractor against the agent should be denied on grounds of public policy. The court found that the legislature had achieved a delicate but deliberate balance in the state construction lien law between the rights of owners and contractors. It noted that the subcontractor had lien rights, which it chose not to employ, and thus it would be repugnant to give it an additional means of recovery. This holding was affirmed on appeal, and the above language cited with approval, by the state supreme court in *Hoida*,

of the construction disbursing agreement, however, a subject discussed in full at §10.2.6.

Most escrow instructions obligate the escrowee to obtain waivers of lien from the contractor and subcontractors as payments are made. The instructions may state that the waivers are to be for all work done through the time of the payment (current waivers), or through the prior disbursement (draw delay), or some combination of the two. In most circumstances, a forged waiver is of no effect. The escrowee has a duty of reasonable care in reviewing waivers of lien. It may be liable to its principal if reasonable scrutiny of the waiver would reveal that it is a forgery. However, the escrowee is not responsible for loss suffered from a forged waiver that is facially proper and not suspicious looking.<sup>91</sup> In a second case, an errors and omissions carrier denied a duty to defend an agent against a claim based on the failure to spot a fraudulent waiver. The E & O policy excluded coverage when the agent failed to obtain "appropriate" waivers of lien. The court found the policy ambiguous because "appropriate" was not a defined term. The policy:

... neither indicates from whose perspective or at what time we determine whether the lien waivers were appropriate. It is unclear whether appropriateness is determined by reference to purpose or simply form. From Cherryland's perspective at the time it obtained the waivers, the lien waivers were suitable, fit, or proper because they were indeed lien waivers from the contractor before payment. ... [T]he exclusion [must be] measured from the escrow agent's view at the time it obtains the lien waivers. Cherryland therefore obtained appropriate lien waivers from O'Brien even though the lien waivers were later found to be fraudulent.<sup>92</sup>

Insured purchasers of newly-constructed houses sometimes claim there is an implied escrow or other duty of the insurer to verify that all potential lien claimants have been paid. This claim sometimes arises when the insurer has not acted as escrowee during construction, and does not insure the purchaser against inchoate lien rights. There is no such implied duty to verify payment. See §10.1 regarding construction lien coverage and the construction lien standard exception.

The general contractor sometimes resents the escrowee's direct communication with subcontractors and suppliers, and the loss of its control over them when those parties are paid directly by the escrowee. The escrowee has the right to communicate with subs and suppliers in order to orchestrate payment in exchange for waivers. An escrowee was found not liable to the builder for disclosing information about the sale price of the home, which allegedly caused the subcontractor to refuse to accept a discounted payment for his work.<sup>93</sup>

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*Inc. v. M & I Midstate Bank*, 291 Wis.2d 283, 717 N.W.2d 17, 2006 WI 69 (Wis. 2006).

<sup>91</sup> *Fantino v. Lenders Title and Guar. Co.*, 303 Ill.App.3d 204, 707 N.E.2d 756, 236 Ill.Dec. 629 (Ill.App. 2 Dist. 1999).

<sup>92</sup> *Simpson v. Title Industry Assurance Co., et al.*, 590 N.W.2d 282 (Table), 224 Wis.2d 644, 1999 WL 19307 (Wis.App.) (unpublished).

<sup>93</sup> *Wilcher v. AmeriTitle, Inc.*, 212 Or.App. 498, 157 P.3d 790 (2007).

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Similarly, in *Creative Hardwood Floors, Inc. v. Schafer*,<sup>94</sup> the construction lender appointed a title agency to disburse its construction loan funds for a house to be built for the owners. The work was not finished when the last draw was requested. The draw was funded, but the contractor went out of business, and did not pay Creative Hardwood Floors, which filed a lien and a foreclosure action. The owners claimed that an employee of the title agency assured them that it was common practice to submit a final draw request before work was done, and that the work would be done. The employee denied making the statements. The Schafers sued the agency and lender on various theories, including negligent misrepresentation. The lender obtained summary judgment. The cause of action against the title agent was not at issue in the appeal.

In *Gordon v. New Mexico Title Co.*,<sup>95</sup> the insurer conducted the escrow for the permanent loan on a new house. It accepted affidavits from the purchaser and the builder to the effect that all work was complete and all laborers paid. Liens were later filed. The insurer was sued, on the theory that local custom and practice created an implied duty of the escrowee to investigate whether or not all lien claimants had really been paid, rather than to rely on affidavits. The appellate court reversed a judgment against the insurer. It found no proof of such a custom and practice, and therefore no such duty. In fact, the evidence at trial showed that the insurer had previously conducted loan escrows with the same builder in which it relied on the builder's affidavit without further investigation. The *Gordon* case illustrates the fact that, when a project goes awry, purchasers and lenders sometimes seek to create implied duties of the escrowee in order to obtain recovery for project debts.<sup>96</sup>

### 10.2.3 Keeping Project In Balance

#### FORM 73, Appendix A Construction escrow negligence

The construction escrowee is not responsible for keeping the construction project in balance.<sup>97</sup> When the escrowee is also the title insurer, its policy liability can be seriously affected by the fact that the project gets out of balance. That subject is addressed in §10.1.5.

The shortage of money to pay for the project is a common source of construction lien problems. This can occur in a number of ways, including: the lack of a fixed-price contract,<sup>98</sup> the

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<sup>94</sup> 1998 WL 515783, 1998 Ohio App. LEXIS 1959 (Ohio App. 5 Dist.) (unpublished).

<sup>95</sup> 77 N.M. 217, 421 P.2d 433 (1966).

<sup>96</sup> See §10.2.4 below discussing the alleged implied duty to inspect the premises on behalf of the homeowner, addressed in *Frieberger v. Lawyers Title Ins. Co.*, 831 S.W.2d 731 (Mo.App. 1992).

<sup>97</sup> *Nichols v. Chicago Title Ins. Co.*, 107 Ohio App.3d 684, 669 N.E.2d 323 (Ct.App. 8 Dist. 1995).

<sup>98</sup> "There are several methods of fixing the cost of a construction project with the builder or contractor. The most common are the simple, fixed price contract, the cost plus fixed fee arrangement, and cost plus fixed fee with a guaranteed maximum 'upset' price. ...Even when the contractor has agreed with the owner on a fixed or maximum cost, cost control and budgeting should still concern the owner, just as it does the construction lender. The project should not be allowed to become out of balance, that is, the cost to complete must never exceed the undisbursed sum

lender's failure to insist on an accurate and complete schedule of values based on final plans and specifications before the project commences,<sup>99</sup> the lack of an adequate contingency reserve,<sup>100</sup> the owner's failure to obtain additional money when the project budget increases, change orders that increase the cost, construction delays, increases in the cost of materials, subcontractors who fold and whose work must be done by new parties at increased cost, contractor diversion of funds, or change of construction conditions.

The lender, not the title insurer, is responsible for analyzing the project cost before making the construction loan. A banking practices handbook states:

The bank next determines if there are sufficient funds available to complete the development. This is critical, as one of the primary requirements is that all funds necessary to complete, including a reasonable contingency, must be available at the time the loan records.<sup>101</sup>

Further, it is the lender that has the obligation of keeping the loan in balance as work progresses:

From the time administration commences with the execution and recording of the construction mortgage, the prudent construction lender will carefully monitor the project as though the lender might one day become its owner. It will have its own architect ... perform an oversight function, reviewing plans and specifications, work in progress, draw requests, and myriad other matters. It will carefully and

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agreed to or budgeted for the project. While it is true that the economic risk of cost overruns is assumed by the contractor in a fixed or guaranteed maximum-cost arrangement, unapproved extras and probable overruns are still a serious danger sign for the owner. The contractor may not be able to sustain the economic loss, which could lead to financial failure and suspension of the work. At the very least, a general contractor that perceives that cost overruns have eliminated its profit on a job and are likely to result in a loss may lose enthusiasm to proceed diligently and competently with the work." Richard Harris, *Construction and Development Financing*, Warren, Gorham & Lamont, ¶ 7.1[a], pp. 7-3 -4.

<sup>99</sup> "To facilitate the computation of the amount to be paid under progress payments in a fixed-price contract, the contractor is generally required to submit to the design professional a schedule of values before the first application for payment. This schedule, when approved, constitutes an agreed valuation of designated portions of the work. The aggregate of the schedule should be the contract price." Justin Sweet, *Legal Aspects of Architecture, Engineering, and the Construction Process*, Fourth Edition, § 26.02(B), p. 478. Similarly, another construction lending text states: "The lender should require that the disbursements for the project be based upon a budget approved by both the borrower and the lender." John G. Cameron, Jr., *A Practitioner's Guide to Construction Law*, § 1.02(b)(2), p. 1-7.

<sup>100</sup> "Finally, the lender must consider that despite the most candid presentation and the most careful evaluation of projected costs, there are inherent uncertainties in the construction process that cannot be eliminated. *Inclusion of an adequate contingency reserve in project costs is critical.* While the amount of the reserve will depend on the type of project and the degree to which costs are fixed at the time the loan is underwritten and disbursed, a reserve of 5 percent of both hard and soft costs has been a rule of thumb." Alvin L. Arnold, *Construction and Development Financing*, (Second Edition), § 3.03[2][a], p. 3-13 (emphasis added).

<sup>101</sup> R. Harris, *Construction and Development Financing*, § 4.20 (Warren, Gorham & Lamont, 1982) (1987 Supp.), quoted in Jones & Maessell, *Mechanic's Lien Title Insurance Coverage for Construction Projects*, 16 Real Estate L.J. 291, 293 (1988).

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continuously monitor the loan to confirm that it remains "in balance" at all times.<sup>102</sup>

The owner has the same obligation as the lender to keep the project in balance.<sup>103</sup> The escrowee, by contrast, is not responsible for keeping track of the budget unless the agreement says so.<sup>104</sup> Thus, if the escrowee complies with all written instructions, and issues pending disbursement endorsements limited to dates and amounts disbursed, it is not liable as escrowee if liens are filed because the project is underfunded.<sup>105</sup> However, a statement in the disbursing agreement that the escrowee was not responsible for assuring that there will be sufficient funds available for completion of the project was found not to place an obligation on the lender to fund a shortage, or to "enforce" the loan agreement by obligating the owner to produce the additional money.<sup>106</sup> Also, when the escrow specifically required the insurer-escrowee to obtain additional owner equity funds if the contract amount changed, the escrowee violated that instruction by accepting change orders without requiring the owners to deposit funds to cover the increase in the contract amount.<sup>107</sup>

### 10.2.4 Inspection Of Property

The escrowee's duties regarding inspections of the property, if any, are derived from the disbursing agreement. The disbursing agent has no implied duty to inspect the property or have it

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<sup>102</sup> Jones & Maessell, *Mechanic's Lien Title Insurance Coverage for Construction Projects*, 16 Real Estate L.J. 291, 293 (1988).

<sup>103</sup> See *Nichols v. Chicago Title Ins. Co.*, 107 Ohio App.3d 684, 669 N.E.2d 323 (Ohio App. 8 Dist. 1995). In that case, the owner took the lowest of three bids to build his house. There was a significant price differential, and the owner had reason to believe that it was not possible to build the house for the low bid amount. The owner eventually fired the contractor and paid \$125,000 above the original contract price to complete the house. The owner sought to make the insurer-escrowee or lender pay the difference. The court ruled that the overruns were not "the 'natural and necessary consequence of' nor 'proximately caused by' an alleged breach of duty by Chicago Title" or the lender." Rather, the "only rational explanation for there being insufficient funds to complete construction of the house is that the construction price was incorrectly calculated by the architect or builder in the first place." Further, the insurer-escrowee did not become liable for the cost overruns by not advising the owner that funds were being held back with draws based on the inspector's percentage-of-completion assessments. "Nothing in the loan agreement prohibited Chicago Title from disbursing less than the amount shown on the draw request." *Id.* at 330.

<sup>104</sup> See Jones & Maessell, *Mechanic's Lien Title Insurance Coverage for Construction Projects*, 16 Real Estate L.J. 291 (1988). Also, in *Nichols v. Chicago Title Ins. Co.*, 1995 Ohio App. LEXIS 5297, the owner claimed that the insurer was obligated to keep track of a builder which was running over budget on a fixed-price contract. The owner argued that, if the escrowee had warned the owner of the cost overruns, it could have scaled back the project. The court disagreed, noting that no such express duty existed under the escrow instructions, and that the escrowee had complied with instructions in making disbursement. In addition, the owner had approved draw requests, which gave it equal knowledge of the cost overruns.

<sup>105</sup> See *Bankers Trust Co. v. Transamerica Title Ins. Co.*, 594 F.2d 231 (10th Cir. 1979) and *Brown v. St. Paul Title Ins. Corp.*, 634 F.2d 1103 (8th Cir. 1980).

<sup>106</sup> *Chicago Title Ins. Co. v. Resolution Trust Co.*, 53 F.3d 899, 907 (8th Cir. 1995).

<sup>107</sup> *H.B.I. Corp. v. Jiminez and Ticor Title Ins. Co.*, 803 S.W.2d 100 (Mo. 1990).

inspected.<sup>108</sup> When the construction escrow agreement stated that the escrowee "has not been employed and has no responsibility to supervise construction or determine adequacy of design and compliance with plans and specifications," the court ruled that the escrow was not ambiguous, and "Lawyers Title did not owe a duty to homeowners to inspect to insure work was proceeding in a workmanlike manner before disbursing funds."<sup>109</sup> If the escrowee or lender perform inspections, they are not done for the benefit of the owner unless such is the explicit agreement.<sup>110</sup>

The insurer-escrowee also has no duty to determine that improvements have reached the intended stage of completion, or that the improvement has been built according to plans and specifications. A Texas court, however, found an escrowee to have a general "duty of loyalty" to the lender in connection with inspections. That duty, the court suggested, might have been breached by escrowee's failure to note from a survey that construction had commenced prior to recording of the insured mortgage, rendering it subordinate to construction liens. The court did not find that the escrowee had a duty under the escrow to assure the lender that it had a first lien, however. In addition, the court found that any breach by escrowee would have to be weighed against the lender's own knowledge of its loss of priority, since the lender also received the survey.<sup>111</sup>

The insurer also does not have a duty to inspect the property that is implied from the title insurance policy.<sup>112</sup> When the insurer removed the standard exceptions for the lender and noted in its file that the property had been "inspected," the insured owner was not an intended beneficiary of the loan policy contract, and had no cause of action against the insurer for failing to inspect and discover that the building slab encroached.<sup>113</sup>

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<sup>108</sup> *Frieberger v. Lawyers Title Ins. Co.*, 831 S.W.2d 731 (Mo.App. 1992); *Rosario v. Absolute Construction*, 178 Wis.2d 590, 506 N.W.2d 170 (Table), 1993 WL 266240, 1993 Wis.App. LEXIS 905 (unpublished); *Fantino v. Lenders Title and Guar. Co.*, 303 Ill.App.3d 204, 707 N.E.2d 756, 236 Ill.Dec. 629 (Ill.App. 2 Dist. 1999); *231 W. Scott, LLC v. Lakeside Bank*, 80 N.E.3d 753, 414 Ill.Dec. 610, 2017 IL App (1st) 161131 (Ill.App. 1 Dist. 2017) (relying on *Fantino*).

<sup>109</sup> *Frieberger v. Lawyers Title Co. of Missouri*, 831 S.W.2d 731, 734 (Mo.App. 1992).

<sup>110</sup> *Zlatanov v. Bank One, N.A.*, 2005 WL 32952 (Cal.App. 6 Dist.) (unpublished) (bank's independent inspector owed no duty to the home owner on the theory that the inspector estimated completion percentages too generously, and owners should have contracted for their own inspections); *M & I Bank of Southern Wisconsin v. Poehling*, 277 Wis.2d 873, 690 N.W.2d 885 (Table), 2005 WI App 1 (Wis.App.) (unpublished) (title company inspections not performed for benefit of owners, and lender had no duty to arrange for inspections for owners' benefit).

<sup>111</sup> *First Federal Sav. & Loan Assn. of Beaumont v. Stewart Title Co.*, 732 S.W.2d 98 (Tex.App. 1987).

<sup>112</sup> *Walters v. Marler*, 83 Cal.App.3d 1, 147 Cal.Rptr. 655 (Cal.App. 1 Dist. 1978); *Gates v. Chicago Title Ins. Co.*, 813 S.W.2d 10 (Mo.App. 1991); *Sterling v. Stewart Title Guar. Co.*, 822 S.W.2d 1 (1991).

<sup>113</sup> *Walters v. Marler*, 83 Cal.App.3d 1, 147 Cal.Rptr. 655 (Cal.App. 1 Dist. 1978).

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The construction escrowee may assert the same types of defenses to liability as it has under other forms of escrows. See §13.11 for a full discussion of an escrowee's defenses. The escrowee may also assert claims against third parties.

An insurer may recoup its policy loss from an agent-escrowee that caused the loss by its escrow negligence. In *Pioneer Nat'l Title Ins. Co. v. Cranwell*,<sup>114</sup> an insurer was found to have a cause of action against its approved attorney for negligent disbursement of escrow funds.

Frequently, one insurer disburses a construction loan but a second insurer is asked to insure the permanent financing or the purchaser of the recently-completed house. In *Title Ins. Co. of Minn. v. Construction Escrow Service*,<sup>115</sup> the construction escrow was handled by an independent escrow company, which certified that construction was complete and that full payment had been made. The insurer on the construction loan relied on the certification in issuing its policy giving construction lien coverage. Liens were filed, and the title insurer was permitted to recover against the escrowee. The insurer was not a party to the escrow. However, the court found that the insurer was "an intimate and essential party to the entire transaction" and therefore could sue because of the misrepresentation in the certification to recover the amount of the liens paid.

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<sup>114</sup> 369 S.E.2d 678 (Va. 1988).

<sup>115</sup> 675 S.W. 2d 881 (Mo.App. 1981).

### 10.2.6 Escrowee's Duties To Lien Claimants

The relationship between the escrowee and the contractor and subcontractors is determined primarily by the escrow agreement. A lien claimant or general contractor is not a third party beneficiary of the agreement in most jurisdictions.<sup>116</sup> Similarly, in a Texas case decided in federal court, a lien claimant sought to enforce a construction lien indemnity given to the insurer, as a third party beneficiary. The court found that the claimant was not automatically barred because it was not a party to the indemnity agreement. Again, the agreement clearly stated who the intended beneficiaries were, and the claimant was not on the list, and that expression of intent was binding on the claimant. The court refused to find a third party beneficiary obligation "by implication."<sup>117</sup> Wisconsin has also held that, as a matter of public policy, a disburser is not liable to lien claimants even when negligent, because the lien claimants have a statutory remedy that protects them.<sup>118</sup>

Missouri cases, by contrast, have held that the general contractor is a third party beneficiary, and may sue for negligent disbursement.<sup>119</sup> However, Missouri has an extremely strong bent toward favoring lien claimants and its decisions in this area have not been followed by other courts.

There are numerous factors which militate against the general contractor as a third party beneficiary. In the typical situation, these would include that the contractor is not a signatory, that the agreement's stated purpose is to allow the insurer-escrowee sufficient control over funding for it to give construction lien coverage to the lender, that the agreement states who the intended beneficiaries are, and that the contractor has not sought to be made a party to the agreement.

The escrowee has a lesser duty, if any, to subcontractors and material suppliers. It is not in privity with these claimants.<sup>120</sup> Subcontractors are not owed a fiduciary duty, and are not third

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<sup>116</sup> *Superior Construction Services, Inc. v. Moore*, 2007 WL 1816096 (Minn.App.) (unpublished) (bank escrowee disbursing insurance proceeds for repairs owed no duty of care to contractors to assure that they would be paid, and was not liable when they waived lien rights but owner failed to pay them); *P.E.M. Construction & Development Co., Inc. v. EnCap Gold Holdings, LLC*, 2011 WL 3802244 (N.J.Super.A.D.) (unpublished) (subcontractor was not intended third-party beneficiary of construction project escrow, and was not entitled to be paid from it, particularly when conditions for disbursement had not been met); *Christenson v. Commonwealth Land Title Ins. Co.*, 666 P.2d 302 (Utah 1983) (contractor not in privity with construction loan disburser and disburser owes it no duty other than to refrain from misrepresenting the facts). In *Bescor, Inc. v. Chicago Title & Trust Co.*, 113 Ill.App.3d 65, 68 Ill.Dec. 812, 446 N.E.2d 1209 (Ill.App. 5 Dist. 1983), the court held that a subcontractor was not a third party beneficiary of the construction escrow, and that "a fair reading of the balance of the agreement shows that its foremost purpose was to protect the security interests of the lender against possible mechanics' lien claims." Thus, it said, "we do not believe it plausible that the subcontractors, including Bescor, were any more than mere incidental beneficiaries of the express trust." 446 N.E.2d at 1214.

<sup>117</sup> *Goldberg v. R.J. Longo Construction Co.*, 54 F.3d 243 (5th Cir. 1995).

<sup>118</sup> *Hoida, Inc. v. M & I Midstate Bank*, 291 Wis.2d 283, 717 N.W.2d 17, 2006 WI 69 (Wis. 2006).

<sup>119</sup> *O'Neil Lumber Co. v. Allied Builders Corp.*, 663 S.W. 2d 326 (Mo.App. 1983); *H.B.I. Corp. v. Jiminez and Tigor Title Ins. Co.*, 803 S.W.2d 100 (Mo. 1990).

<sup>120</sup> See *Arizona Title Ins. & Trust Co. v. O'Malley Lumber Co.*, 14 Ariz.App. 486, 484 P.2d 639 (Ariz.App. 1971), and *Christenson v. Commonwealth Land Title Ins. Co.*, 666 P.2d 302 (Utah 1983), which approved the *O'Malley* analysis.

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party beneficiaries.<sup>121</sup> The escrowee is not a trustee holding funds for the sole benefit of the claimants.<sup>122</sup>

The escrowee does, however, have a duty to give accurate information to a lien claimant if the insurer might reasonably expect that the lien claimant will rely on that information. One court held that an escrowee may be liable for negligent misrepresentation to subcontractors, based on the following reasoning:

while it was not the 'end and aim' of Arizona Title's business in its capacity as Builder's Control escrow agent to give out information as to the amount of construction funds it had on hand, it was the end and aim of its business to see to it that the contractors got paid for their work out of whatever funds were available. As the builder's disbursing agent to the contractors, Arizona Title was necessarily and intimately involved with the contractors in the most vital kind of business relationship.<sup>123</sup>

The escrowee told subcontractors there was enough money in its possession to finish the job, when it knew or should have known that there was not. The court explained that the escrowee:

... did not owe the contractors the duty of making any calculations to ascertain whether sufficient funds would or would not be available to pay the contractors for their work. In other words, Arizona Title had no duty to speak or respond to the contractors' inquiries at all. But if it chose to speak, we think that under all of the circumstances its business relationship with the contractors carried with it a duty to exercise reasonable care in making representations about presently ascertainable facts.<sup>124</sup>

The court further held that the escrowee, because it is not in privity with subcontractors, may only be liable to the party to whom a misrepresentation is made, and not others who might also act on that information unbeknownst to the escrowee.

In a closing or post-closing escrow, a lien claimant that is to be paid from the escrow has the same status as other non-party payees. In most jurisdictions, an escrowee has no duty to non-party payees. The subject is fully discussed at §13.4. In *Joe Keresztury Homes, Inc. v. Commerce Land Title of San Antonio, Inc.*,<sup>125</sup> an escrow agreement created because of a dispute with a

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<sup>121</sup> *Bescor, Inc. v. Chicago Title and Trust Co.*, 113 Ill.App.3d 65, 446 N.E.2d 1209, 1213 (1983).

<sup>122</sup> In *Arizona Title Ins. & Trust Co. v. O'Malley Lumber Co.*, 14 Ariz.App. 486, 484 P.2d 639 (1971), the trial court granted the escrowee summary judgment on this issue, which was not the subject of the appeal.

<sup>123</sup> *Arizona Title Ins. & Trust Co. v. O'Malley Lumber Co.*, 484 P.2d at 645.

<sup>124</sup> *Id.*

<sup>125</sup> 1998 WL 130245 (Tex.App.-San Antonio) (unpublished).

drywaller stated that the escrowee had the right, "at its sole election and discretion," to deliver the funds to the drywaller. The lien was not resolved, and the lien claimant sued. The escrowee then paid the drywaller. All claims were dropped except the builder's suit against the escrowee, in which it claimed attorney's fees incurred in the suit and the difference between the escrowed amount and what the builder thought it should have received. The court found that the escrow language left the "decision to the discretion of" the escrowee, and failure to release the funds sooner was not a breach of the agreement. However, when the lien claimant is a party to the escrow, the escrowee is responsible for failing to follow its instructions, as with any other principal. In a case involving escrow instructions given for the closing of a sale of the property, a New York case held an escrowee responsible to a mechanic lien claimant for "failing to follow closing instructions received from" the claimant, as a result of which the lien claimant did not get paid.<sup>126</sup>

### **10.2.7 Recovery By Escrowee Against Other Parties**

Insurer-escrowees often take indemnities as security for the granting of construction lien coverage. The indemnity may specify what action the owner or contractor must take when a construction lien claim is made. In addition, insurer-escrowees almost always rely on owner and/or contractor affidavits. Owner's affidavits are used to assure the insurer that all workmen have been paid. Contractor affidavits are supplied with each draw and state that the named parties are the only ones who have done work. See §5.10.2 for a complete discussion of recovery under construction lien indemnities.

### **10.2.8 Punchlist And Completion Escrows**

When property is sold before a newly-built structure has been completed, it is common for the parties to enter into a "punchlist" or completion escrow. The escrowee holds a certain sum to be released to the builder after the improvement is completed. Although these escrows go by many names, a punchlist escrow is commonly understood to be one in which a list of repairs (the punchlist) are to be made. The escrow provides that the builder will receive the escrowed funds when the repairs are made. A completion escrow is used when a portion of the work is not finished when the sale from the builder closes. On residential construction, this is often landscaping or paving that cannot be performed until the ground has settled or a harsh weather season has passed. Money is also deposited on completion escrows, to pay for the remaining work as it is performed. If the escrowee is also the title insurer, it often wishes to control the escrow in order to exchange payment of the escrowed funds for construction lien waivers, especially if it has protected against inchoate construction lien rights.

The most common dispute about a punchlist or completion escrow is the conditions for the release of the escrowed money. In *Maratea v. Greater Metropolitan Abst. Corp.*,<sup>127</sup> punchlist escrow instructions contained a drop-dead date for return of the funds, but said in the alternative that the money would be paid in exchange for evidence that the work had been performed. The seller paid the contractors, and demanded the return of the escrowed money, only to learn that the

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<sup>126</sup> *F & C General Contractors Corp. v. Atlantic Mutual Mortgage Corp.*, 268 A.D.2d 556, 703 N.Y.S.2d 196 (N.Y.A.D. 2 Dept. 2000).

<sup>127</sup> 305 A.D.2d 381, 759 N.Y.S.2d 162 (N.Y.A.D. 2 Dept. 2003).

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title company escrowee had already paid out the money to settle the same claims. The court found that the plaintiff had a good cause of action, especially since the title company escrowee "proffered no explanation for the 90-day period set forth in the agreement."

In *Joe Keresztury Homes, Inc. v. Commerce Land Title of San Antonio, Inc.*,<sup>128</sup> an escrow agreement created because of a dispute with a drywaller stated that the escrowee had the right, "at its sole election and discretion," to deliver the funds to the drywaller. The lien was not resolved, and the lien claimant sued. The escrowee then paid the drywaller. All claims were dropped except the builder's suit against the escrowee, in which it claimed attorney's fees incurred in the suit and the difference between the escrowed amount and what the builder thought it should have received. The court found that the escrow language left the "decision to the discretion of" the escrowee, and failure to release the funds sooner was not a breach of the agreement.

The damages for failure to complete a punchlist escrow have been held to be the cost of performing the work, even if that cost is greater than the amount which the parties agreed to escrow. In *Cater v. Barker*,<sup>129</sup> the parties entered into a punchlist escrow that called for the seller of an existing residence (not new construction) to deposit money into escrow, to be returned to the seller after she had made certain post-closing repairs. The seller did not make the repairs, and insisted that her sole duty was to deposit the money. The buyer sued for the cost of completing the work, which was triple the amount escrowed. The appeals court affirmed a judgment in that amount.

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<sup>128</sup> 1998 WL 130245 (Tex.App.-San Antonio) (unpublished).

<sup>129</sup> 172 N.C.App. 441, 617 S.E.2d 113 (N.C.App. 2005), *aff'd per curiam*, 360 N.C. 357, 625 S.E.2d 778 (N.C. 2006).

