

TITLE INSURANCE: New Form of Protection

Subcontractors' Powers to Demand Payment Increased Through Lien Laws



By C. Daniel Clemente

No one will take issue with the fact that these are very difficult days for those of us deeply involved in the building industry. Builders, developers, general contractors, sub-contractors, lending institutions and title insurance companies alike are buffeted by forces beyond their control.

Sub-contractors may find, however, that these very difficulties have given birth to a new form of protection which will greatly increase their power to demand payment through their state's mechanics lien statutes.

Today construction lenders have their hands full with the problems precipitated by skyrocketing interest rates, cost overruns, the unavailability of permanent financing and the evaporation of tenant and buyer prospects. Builders and developers are literally waiting in line to request loan increases, interest payment moratoriums or other restructuring of loans that are already seriously in default.

All across the country losses are mounting with building companies, large and small, defaulting on their construction loans and turning to the bankruptcy court.

Sub Fails, Too

With every construction firm failure, no matter how substantial the company, an innocent sub-

contractor invariably fails also. In this time of abnormally high failure rates it is vital that the sub-contractor have a good working knowledge of the mechanics lien rights afforded him by his state's statutes.

Generally speaking most courts around the country have an inclination to afford every protection to local tradesmen and suppliers against financial institutions. Even when the local statute grants the lender priority at the time his mortgage or deed of trust is recorded, the courts have more and more frequently found reasons to circumvent this priority.

As a result, the task of assuring priority of mortgage liens has become an impossible one for many multi-state construction lenders and their attorneys.

The construction lenders as a group have turned to the title insurance companies for relief. Enlightened construction lenders today require in their commitment letter that the developer furnish the lender a title insurance policy granting the lending institution affirmative coverage with respect to mechanics and materialmens liens. Title insurance traditionally has been limited to insuring the condition of the title to land against defects arising before the policy was issued.

Demand Grows

Affirmative mechanics lien coverage, however, has the effect of extending protection forward in time. More and more frequently this additional protection for the lender is being required of the developer regardless of the priorities set forth in the mechanics lien statute of any particular state.

[The author, C. Daniel Clemente, is an attorney in Washington, D. C., and is active in real estate and financing affairs.]

As lenders experience losses, the demand for such coverage will grow to nationwide proportions.

How does the sub-contractor benefit from this coverage? He is not a direct beneficiary under the policy because the sub-contractor is not a named insured. The lending institution is in fact the only insured party. But consider the effect of such insurance on the sub-contractor. In the typical situation the lender holds a policy and is named as the insured. The job experiences difficulty and the developer or builder defaults on his loan. The lender either begins foreclosure proceedings or takes in the property. In either event liens are filed.

The lender calls upon the title insurance company to fulfill its obligation under the policy, that is, have the liens removed. This forces the title insurance company to enter into negotiations with the sub-contractor to secure a release.

In effect, because the lender has insisted on mechanics lien coverage in its title insurance policy, the sub-contractor is dealing with a solvent title insurance company instead of a defunct building company. Many times the sub-contractor is unaware of this opportunity to deal with a solvent party.

In other cases the title insurance company wishing to stay out of the picture will seek to handle the release through the defaulting contractor, thus the sub-contractor will be willing to compromise his claim unnecessarily.

Sub Settles Cheap

Thus, while the local courts may be friendly to the local tradesman and supplier, all too often the sub-contractor cannot afford the legal expenses and delay involved in enforcing a lien for work being since finished. He will settle his claim directly with the builder for

Continued on page 17

CASH

Continued from page 12

Expense to Sales Ratio — net sales divided into the amount of each type of expense.

Working Capital Ratio — current, liabilities divided into current, assets.

Inventory Turnover Ratio — average inventory divided into cost of sales for the year.

Accounts Receivable Turnover Ratio — net credit sales for the year

divided into trade receivables at the end of the year times 365.

Net Worth to Total Debt Ratio — total liabilities divided into net worth.

Because the information desired by the lender depends on the kind of loan and the type of collateral being used, a contractor seeking a loan should also be prepared, if requested, to provide accurate information on some of the following items:

1. Inventory: What is the condition and age of existing inventory? How much is on hand . . . unusable? How much money is tied up in inventory . . . too much . . . too little?

2. Assets: What is the value, type, age, and condition of equipment, and building? What is the company depreciation policy . . . details on any mortgages or conditional sales contracts?

Continued on page 22

TITLE INSURANCE

Continued from page 13

pennies on the dollar in the belief that the builder will be out of business shortly and not knowing that a healthy title insurance company is obligated to see that his lien is removed.

In most situations where such coverage has been granted the title insurance company has secured a personal indemnity from the builder. Thus it is in the best interest of the builder to cooperate with the insurance company and settle claims for as small a figure as possible. This goal is best accomplished by concealing the insurance company's involvement, and feigning bankruptcy.

The sub-contractor's attorney must appraise himself of the policy protection afforded the construction lender before entering into any negotiations for settlement.

Perhaps a more direct approach would be to explore with the title insurance companies the possibilities of a form of coverage for the sub-contractors. On the surface it would appear that the construction

lender, the sub-contractor and the title insurance company granting affirmative mechanics and materialmen's coverage have a common goal . . . to see that the construction monies advanced are spent only on the job in question.

The construction lender wants the job completed, the title insurance company wants all funds disbursed to be spent on the job insured and the sub-contractor wants to be paid for work he performs. With so many common interests, a system could be developed whereby the title

insurance companies could directly insure the sub-contractor he would be paid in return for sub-contractor certifications that he has been paid.

The high rate of defaults across the country is evidence of the fact that some changes in the system are necessary. In times of skyrocketing costs everyone needs to be assured that funds will be disbursed in a timely fashion. This would seem to be the proper time to institute changes in the system that will benefit all parties in interest now and in the better days ahead.