

# The Buck Stops Here: Toxic Titles and Title Insurance

Molly Rose Goodman\*

**Abstract:** *By failing to properly transfer ownership of loans and mortgages, recording fraudulent documents, and performing unlawful foreclosures, financial institutions and law firms have generated property titles that range from defective to toxic. Those actions evince a systemic failure to comply with longstanding principles of real property law and regulations governing financial transactions. Title companies participated in title services and issued title insurance policies throughout the housing boom and although they did not directly cause toxic titles, many title insurers have ultimately assumed the risk for the bad practices that became the industry norms in the last decade. In this article, I will discuss how title insurers have exposed themselves to liability for toxic titles.*

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\*Molly Goodman, J.D. Candidate, 2013, Suffolk University Law School.

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Document fraud and robo­signing became commonly recognized phrases after the financial market collapsed in 2007. The rapid increase in foreclosure filings exposed documentation errors and deception that was commonplace in securitization and real estate transactions throughout the housing boom. The continuous appreciation of property values and the success of securitization diverted attention from the industry's systemic failure to comply with long-standing principles of property law.

Title companies participated in title services and issued title insurance policies throughout the housing boom. Although title insurers did not directly cause toxic titles, they have ultimately assumed the risk for the bad practices that became the industry norms in the last decade. In this article I will discuss why and how title insurers have exposed themselves to liability for toxic titles.

Following this introduction, the Article proceeds in eight parts. Part I gives a summary of real property principles and the state and local laws regulating real estate conveyancing and recording of land records. Part II discusses the emergence of title insurance and describes the title industry's role in property conveyancing and settlement services.

In part III, I describe the history of securitization and the conditions that spurred the housing boom. Part IV outlines the securitization process and introduces the MERS electronic registry, which the financial industry uses to track the ownership of mortgages. This section also enumerates the paperwork problems that stemmed from the use of MERS and the sloppy practices that became the industry norm for securitization transactions.

Part V introduces foreclosure mills and robo-signing and describes the title defects that were created by securitization errors and unlawful foreclosures. This part also discusses the parties who may be harmed by unlawful foreclosures, particularly third-party purchasers. Part VI examines how errors in the securitization process and unlawful foreclosures create liability for the party at the end of the line: the title insurance companies. This part also examines a title insurer's duties to its policyholders and how an insurer's actions can either mitigate or amplify its liability. In part VII, I discuss possible methods to fix the toxic titles clouded by securitization errors or unlawful foreclosures.

### **I. The Housing Market and State Property Laws**

The opportunity to own a house is a cornerstone of the American Dream. During the last century, national public policy encouraged the expansion of homeownership and the federal government initiated multiple programs to increase levels of homeownership for Americans of all economic classes.<sup>1</sup> Many studies have shown that homeownership provides social and financial benefits to individual homeowners and their families, and a stable housing market helps communities and strengthens the economy, as a whole.<sup>2</sup>

For many homeowners, the equity in their residence—the difference between the market value and all of the debt encumbering the property—represents a substantial portion of their savings and net worth. Furthermore, residential property has significance that exceeds its economic value. A house can be central to generations of family members; homes have a sentimental and emotional value that cannot be expressed in monetary terms.

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<sup>1</sup>President George W. Bush, A Home of Your Own: Expanding Opportunities for All Americans, June 2002; William J. Clinton, Remarks on the National Homeownership Strategy, June 5, 1995. Online by Gerhard Peters and John T. Woolley, The American Presidency Project. Available at <http://www.presidency.ucsb.edu/ws/?pid=51448>.

<sup>2</sup>Social Benefits of Homeownership and Stable Housing, National Association of Realtors, April 2012 at 2, available at

### **A. Real Property Law**

The right to own real property is a fundamental characteristic of citizenship in the United States, and the laws that protect an individual's right to use, occupy and sell that property are central to the American legal system. The housing market has always been a key component of the country's economy, making it critical to have a system that makes it possible to ascertain ownership of real property with legal certainty. The public recording of deeds, mortgages and other documents by which an interest in real estate is conveyed enables people to verify legal title by examining the instruments of conveyance showing an unbroken chain of transfers.<sup>3</sup> A reliable system that protects the transferability of land is a matter of the utmost importance; it concerns "the interests and life of every member of the community, for the use of land is essential to life."<sup>4</sup>

### **B. Interests in Real Property—Mortgages**

A landowner is rarely the only party with a legal interest in a parcel of land. For example, federal, state and local governments may have an interest in land located within their jurisdiction if they have liens for unpaid taxes or outstanding utility bills. The most common example of a third-party interest in real property is a mortgage; a landowner may grant a mortgage to an entity or individual to secure the repayment of a debt or the performance of some other obligation. The majority of residential homeowners finance the purchase of their homes by borrowing money from a financial institution. In order to purchase the property and pay the seller, the buyer borrows money from a lender and executes a promissory note, which is a promise to repay the loan. The note sets out the terms of the loan and requires monthly payments of principal and interest for a set term of years. To ensure that the borrowers perform obligations set forth in their notes, lenders require that borrowers grant a mortgage to them, which creates a security interest in the property and constitutes a conveyance of an interest in the land.<sup>5</sup>

Although the promissory note and mortgage are separate

<sup>3</sup>1 Joyce Palomar, Patton and Palomar on Land Titles, § 2 (3d ed. 2003).

<sup>4</sup>James R. Carret, Land Transfer.—A Reply to Criticisms of the Torrens System, 7 Harv. L. Rev. 24, 26 (1893).

<sup>5</sup>See Mass. Gen. Laws ch. 183, § 19 (2006) for a statutory description of mortgage covenants.

documents with very different legal substance, they are linked and one has little significance without the other. A promissory note is a legally binding contract detailing the terms and repayment schedule of a loan. The obligations within a note are binding, with or without a security interest in the obligor's property. A mortgage gives lenders a security interest, which will make it more likely that borrowers will repay. Without an underlying debt or obligation, the mortgage has nothing to secure and thus has no value.

### **1. Title Theory vs. Lien Theory**

Unlike secured interests in personal property, which are governed by the UCC and are nearly uniform throughout the country, the law of secured interests in real property varies from state to state. Each state's real property laws generally follow one of two underlying theories: lien theory or title theory.<sup>6</sup> In lien theory states, the borrower, or mortgagor, retains both legal and equitable ownership of the property. The mortgagor is the beneficial and legal owner of the premises and retains all rights of ownership and possession until foreclosure or sale. The mortgagee receives a security interest in the property and the mortgage represents a lien encumbering the title.<sup>7</sup> In a lien theory state, a mortgage is "merely a 'chase in action'-a secondary incident to the debt to secure its payment through a lien on specific property."<sup>8</sup>

Under title theory, a mortgage grants the legal title of the property to the mortgagee, defeasible upon the mortgagor's repayment of the underlying debt.<sup>9</sup> Although the mortgage conveys legal title to the mortgagee, the mortgagor retains the equitable title, known as the equitable right of redemption.<sup>10</sup> Generally, the right to the possession and use of the property is not altered as long as the mortgagor performs the obligations required by the promissory note, or any conditions enumerated in the mortgage document.<sup>11</sup> A mortgagee holds "bare" legal title, subject to the mortgagor's

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<sup>6</sup>5 Herbert T. Tiffany & Basil Jones, *Tiffany Real Prop.*, § 1380 (2012 ed.).

<sup>7</sup>Restatement (Third) of Property (Mortgages) § 4.1, comment (a)(1) (1997).

<sup>8</sup>*Burkhardt v. Bailey*, 260 Mich. App. 636, 680 N.W.2d 453, 462 (2004).

<sup>9</sup>*Perry v. Miller*, 330 Mass. 261, 112 N.E.2d 805, 806 (1953).

<sup>10</sup>*U.S. Bank Nat. Ass'n v. Ibanez*, 458 Mass. 637, 941 N.E.2d 40, 51 (2011).

<sup>11</sup>Mass. Gen. Laws ch. 183, § 26.

failure to repay the debt or to perform any other obligation required by the promissory note.<sup>12</sup> State property statutes and residential mortgages often preserve a mortgagor's right to possess the property absent a default.<sup>13</sup>

In a title theory state, once the mortgagor repays the debt or obligations evidenced by the note, the mortgagee's beneficial interest in the property comes to an end and the security interest in the property must be extinguished.<sup>14</sup> The landowner's legal title is cleared when the mortgagee executes the discharge or release of the mortgage and records it with the registry of deeds.<sup>15</sup> Repayment of the debt extinguishes the mortgagee's interest in the property; however, a valid discharge is mandatory to remove the cloud on the mortgagor's title.

## **2. Judicial and Non-Judicial Foreclosure**

Whether a state's law follows title theory or lien theory affects foreclosures. If mortgagors default on their obligations, judicial foreclosure is an available remedy to mortgagees in all jurisdictions, under both lien theory and title theory.<sup>16</sup> Some title theory states also permit non-judicial foreclosures, which authorize mortgagees to perform foreclosures under the power of sale. In practical terms, the difference between a "lien theory" and a "title theory" state is that in the latter title theory state, the mortgagee may enter into possession of the mortgaged premises upon default and before foreclosure, whereas under lien theory there is no right of posses-

<sup>12</sup>Negron v. Gordon, 373 Mass. 199, 366 N.E.2d 241, 244 (1977).

<sup>13</sup>2 Baxter Dunaway, L. Distressed Real Est., § 11:21 (2012 ed.).

Without an agreement or state law to the contrary, under title theory the mortgagee is entitled to possess the property or exercise the rights of an owner for the protection of his security. 5 Tiffany & Jones, supra note 7, § 1412; see also, Conference Center Ltd. v. TRC-The Research Corp. of New England, 189 Conn. 212, 455 A.2d 857, 860 (1983).

<sup>14</sup>Maglione v. BancBoston Mortg. Corp., 29 Mass. App. Ct. 88, 557 N.E.2d 756, 757 (1990).

<sup>15</sup>See Pineo v. White, 320 Mass. 487, 70 N.E.2d 294, 296 (1946) ("Upon the fulfillment of the conditions of the mortgage, the mortgagor is entitled to the note and a discharge of the mortgage in order to remove a cloud upon the record title to his premises.").

<sup>16</sup>Mortgage Servicing: An Examination of the Role of Federal Regulators in Settlement Negotiations and the Future of Mortgage Servicing Standards: Hearing Before the House Financial Services Subcommittee on Financial Institutions and Consumer Credit and Oversight and Investigations (2011) (testimony of David Stevens, President, Mortgage Bankers Association) ("Each of the 50 states and the District of Columbia has its own laws governing the foreclosure process.").

sion; the mortgagee must await sale of the mortgaged property at which point it obtains satisfaction of the mortgagor's debt from the proceeds of sale.<sup>17</sup>

Judicial foreclosure laws establish court oversight of the entire foreclosure process. The exact procedures vary by jurisdiction, but generally, a judicial foreclosure requires a mortgagee to file a suit in equity to sell the property and to end the borrower's right of redemption.<sup>18</sup> A court official or sheriff must conduct the sale of the property and manage the distribution of the proceeds.<sup>19</sup> Judicial foreclosures provide the finality of a court order. *Res judicata* will prevent subsequent litigation over the validity of the underlying note and mortgage, even if the foreclosure was based on a default judgment without the participation of the mortgagor.<sup>20</sup>

In contrast, a non-judicial foreclosure under the power of sale permits the mortgagee to conduct the sale through a public auction, in accordance with a statutory scheme and without participation or oversight from a judicial official.<sup>21</sup> Foreclosures under the power of sale are conducted as private conveyancing transactions between individuals.

### **C. Recording Statutes**

The current laws governing ownership and possession of real property developed from basic principles of property law seen under English common law; however, recordation of all instruments involving the conveyance of land or the transfer of interests in real property is unique to the United States.<sup>22</sup> The concept of tracking and documenting real estate conveyances evolved from recording statutes enacted by the first

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<sup>17</sup>Osborne, *Mortgages* §§ 13–16 (2d ed. 1970).

<sup>18</sup>5 Tiffany & Jones, *supra* note 7, § 1522.

<sup>19</sup>6 Dunaway, *supra* note 14, § 16:1.

<sup>20</sup>Stuart M. Saft, *Foreclosure, Commercial Real Estate Workouts*, § 11:11 (3d ed.) (“The result of the judgment of foreclosure and the subsequent sale is that the owner's and subordinate lienors' interests in the property are terminated.”).

<sup>21</sup>2 Real Est. L. Digest, § 21:63 (4th ed. 2012) (“Because of the substantial power that the statutory scheme affords to a mortgage holder to foreclose without immediate judicial oversight, the court observed, one who sells under a power of sale must follow strictly its terms, and if he fails to do so there is no valid execution of the power, and the sale is wholly void.”).

<sup>22</sup>1 Palomar, *supra* note 4, § 4.

Massachusetts colonies.<sup>23</sup> Recording entire conveyancing documents as public records allows land to be bought and sold as a commodity with security and efficacy, and accommodates the social and economic conditions of modern American society.<sup>24</sup> Each state has some form of a recording act and each county or jurisdiction within a state may adapt its recording procedures to accommodate the local practices and customs. Although there are variations from state to state, the general objective of recording statutes is to provide “transparency and clear priority in title.”<sup>25</sup> Public land records add stability to conveyancing transactions and assure landowners that “they will have the legal right to possess or use all of their interests in the subject real estate for their intended purposes.”<sup>26</sup>

Governmental entities are responsible for tracking conveyances and making the documents available to the public. Those entities do not, however, review the transactions involving the transfer of land between private parties. They simply set up the system and establish procedures for recording the transfers. A document in the public land records does not automatically have legal significance. Recording an instrument cannot create legitimacy for an unlawful conveyance; it is the validity of the document that controls its effectiveness.<sup>27</sup>

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<sup>23</sup>John H. Scheid, *Down Labyrinthine Ways: A Recording Acts Guide for First Year Law Students*, 80 U. Det. Mercy L. Rev. 91, 101 (2002).

<sup>24</sup>*Id.*

<sup>25</sup>Tanya Marsh, *Foreclosures and the Failure of the American Land Title Recording System*, 111 Colum. L. Rev. Sidebar 19, 20 (2011).

<sup>26</sup>John L. McCormack, *Torrens and Recording: Land Title Assurance in the Computer Age*, 18 Wm. Mitchell L. Rev. 61, 74–75 (1992). See also, C. Dent Bostick, *Land Title Registration: An English Solution to an American Problem*, 63 Ind. L.J. 55, 68 (1988) (“The extent to which the records bind, the modes of record keeping, and the overall quality of the system vary widely from jurisdiction to jurisdiction. As to the latter, even within the states themselves, variation occurs, especially from rural to urban areas. The systems, however, are similar in the following respects: most records are indexed on a name basis rather than a tract basis; all anticipate their use as the vehicle for establishing a ‘chain of title’ over some period of time; all purport to contain ‘evidence’ of title rather than title itself; and all in theory should contain within their bounds most of the ‘evidence’ of title needed to make a basic judgment as to the validity of the title.”).

<sup>27</sup>*Arnold v. Reed*, 162 Mass. 438, 38 N.E. 1132, 1133 (1894); *Bongaards v. Millen*, 440 Mass. 10, 793 N.E.2d 335, 339 (2003) (The court held that “a deed, clear on its face, validly may convey property not owned by the

Any person with an interest in real estate has an incentive to comply with local rules and customs and all recording requirements for the jurisdiction. When a party's interest in a parcel of land is absent from the public records, it may not be enforceable against third parties.<sup>28</sup> Publicly recorded documents protect landowners and lien holders and provide notice of their interests to anyone who might search the records. Moreover, the order of recorded documents is critical to determining the priority of any interests in the property.

Property law is one of the most complex and confusing areas of the American legal system, and the potential for missing or defective records adds even more complexity to transfers of real estate. Advances in technology and the Internet have improved the availability and accuracy of public land records, and have simplified the process of examining the documents relevant to a chain of title.<sup>29</sup> The increased reliability of public records has reduced some of the risks historically associated with real estate transactions, but errors can still impact the legitimacy of recorded documents. Documents are occasionally mislabeled or improperly indexed within recording systems and a simple typo or mistake in the drafting of a conveyancing document can create a flawed title.<sup>30</sup>

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grantor. Where, as here, the grantor has nothing to convey, a mutual intent to convey and receive title to the property is beside the point. The purported conveyance is a nullity, notwithstanding the parties' intent.")

<sup>28</sup>See 1 Grant S. Nelson & Dale A. Whitman, *REAL ESTATE FINANCE LAW*, § 5.34 (5th ed. 2007); Joel A. Stein, *RETITLE MA-CLE*, § 2-1 (2d ed. 2010) ("The title examination will not only determine that the seller owns the property, but it will also show what liens or encumbrances affect the title.")

<sup>29</sup>Emily Bayer-Pacht, *The Computerization of Land Records*, 32 *Cardozo L. Rev.* 337 (2010).

<sup>30</sup>Bostick, *supra* note 32, at 70 ("Other problems include unadministered estates or improperly administered estates; name changes through marriage, adoption, error and otherwise; possibilities of large numbers of tenants in common, especially in cases of large families with several generations of intestate deaths and unadministered estates; marital rights flowing from either common law or statute; incompetency of owners; and vague or difficult to manage conditions in wills that may shift estates on virtually as many contingencies as the mind can devise. The list of potential pitfalls continues with such matters as modern constitutional doubts about spousal prerogatives in dealing with realty held by husband and wife as tenants by the entirety. There is as well the entire range of

**D. Title Defects**

Some title defects can be easily fixed by recording a Scrivener's affidavit or some other corrective instrument.<sup>31</sup> When titles contain substantive errors or fraud, disputes are often costly for all parties involved. Because real estate is valuable, losses can be severe, so parties have every incentive to litigate most title issues that arise.

In order to ascertain or prove ownership of real property, as a matter of law, the owner must possess a clear title to the property. In conveyancing transactions, purchasers expect to receive a good title that is free from all encumbrances, "both in fact and of record."<sup>32</sup> A clear record title must be established by the public records, without reference to off-record evidence.<sup>33</sup> The four elements of good record title are considered to be: (1) the rightful ownership of the entire estate or interest contracted for, free from all fair and reasonable doubts; (2) the rightful possession thereof; (3) the appropriate record evidence of ownership; and (4) freedom of the title from liens, encumbrances or title defects (other than any provided for by the sale contract).<sup>34</sup> Purchasers receive good title with a valid and enforceable deed, conveyed by the previous owner, where all third-party liens or encumbrances were properly extinguished. They receive good record title when the county land records evidence the complete chain of conveyancing instruments.<sup>35</sup>

County land records impart constructive notice of the rights and interests evidenced in the recorded instruments,

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claims by third parties against owners. These claims include taxes, judgments and marital separation claims.").

<sup>31</sup>1 Palomar, supra note 4, § 79 ("A considerable number of statutes and state title examination standards now authorize their use for the purpose of establishing identity and marketable title."). See, e.g., Mass. Gen. Laws ch. 183, § 5B ("[A]n affidavit made by a person claiming to have personal knowledge of the facts therein stated and containing a certificate by an attorney at law that the facts stated in the affidavit are relevant to the title to certain land and will be of benefit and assistance in clarifying the chain of title may be filed for record and shall be recorded in the registry of deeds where the land or any part thereof lies.").

<sup>32</sup>1 Palomar, supra note 4.

<sup>33</sup>Sheila M. Hurley & Toni Mitchell, *Marketable Title*, RETITLE MA-CLE, § 16-1 (2d ed. 2010).

<sup>34</sup>*Id.*

<sup>35</sup>*Id.*, § 51.

which ensures they will be enforceable against third parties.<sup>36</sup> The fact that an instrument is recorded in a chain of title does not guarantee that it is legally valid or enforceable.<sup>37</sup>

There are times when titles are not perfect but are deemed marketable, meaning they can be conveyed. The term “marketable title” developed in the equity courts to address land titles with insignificant flaws that prevent the title from being “good,” but should not be classified as “bad” or “clouded.”<sup>38</sup>

## **II. Title Insurance and The Title Industry**

Real estate transactions carry considerable risks because of the complexity of property law and conveyancing customs.<sup>39</sup> Title defects expose landowners to considerable losses, including a diminution of the value of their investment. In response to these risks, the title insurance industry developed.<sup>40</sup>

Title insurance companies provide insurance policies to purchasers and lenders to cover the risks associated with conveyancing.<sup>41</sup> The American Land Title Association (ALTA), the national trade association for the title and abstracting industry, is responsible for creating and updating standard title insurance forms that serve as the model for title insurers across the country.<sup>42</sup> Today’s standard ALTA policies insure risks that exist as of the date of the policy and expressly “cover loss due to a document not being

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<sup>36</sup>Caryl A. Yzenbaard, *Residential Real Estate Transactions*, § 5:7 (2005).

<sup>37</sup>McCormack, *supra* note 26, at 69; 1 Palomar, *supra* note 4, § 62.

<sup>38</sup>Palomar, *supra* note 4, § 48.

<sup>39</sup>Quintin Johnstone, *Title Insurance*, 66 *Yale L.J.* 492 (1957).

<sup>40</sup>McCormack, *supra* note 26, at 78. See also, *Lawyers Title Ins. Corp. v. D.S.C. of Newark Enterprises, Inc.*, 544 So. 2d 1070, 1072 (Fla. 4th DCA 1989) (“Examination of record title or an abstract of the record title of real property is both an esoteric and a painstaking process. Evaluation of the status of title requires considerable expertise.”).

<sup>41</sup>Johnstone, *supra* note 45, at 492.

<sup>42</sup>On its website ALTA writes that’s its “members advocate safe and efficient transfer of real estate and insist on high standards when searching land title records and preparing insurance documents. The industry seeks to eliminate risk before insuring, which provides the insured with the best possible chance of avoiding land title problems. But, title difficulties can and do occur, and members offer both owner’s and lender’s title insurance as effective safeguards.” <http://www.alta.org/about/index.cfm>; See also, *ALTA Standards & Forms*, available at <http://www.alta.org/standards/index.cfm> (last visited Nov. 30, 2012).

properly created, recorded, or indexed electronically.”<sup>43</sup> Coverage includes settlement procedures and recorded closing documents.<sup>44</sup> Insurers indemnify policyholders from damages in the event that some defect in the chain of title is discovered after the issuance of the policy.<sup>45</sup> Title insurers also help identify potential flaws before the conveyance occurs and the policy is issued.<sup>46</sup>

When evaluating an owner’s title prior to the issuance of a new policy, employees or agents of the title insurance company must examine the instruments in the chain of title and identify potential problems. A title insurer will sometimes issue an insurance binder or preliminary title commitment to a party to a real estate sales transaction in order to enable the transaction to proceed, even though the final title insurance policy is not to be issued until the closing or after.<sup>47</sup> Depending on the jurisdiction, title examiners or abstractors, attorneys, or title company employees perform the preliminary title examination and identify any liens or encumbrances that must be removed before the land can be conveyed at the closing. Attorneys will often serve as agents on behalf title insurance companies and perform title services for a real estate conveyance, in addition to their role representing a lender or purchaser.<sup>48</sup>

The insurance underwriter has an incentive to thoroughly examine the title to detect potential flaws or encumbrances affecting the property. If the defects cannot be removed from the title, the insurer will exclude the existing encumbrances from the coverage of the policy. The schedule of excluded

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<sup>43</sup>Id.

<sup>44</sup>Joyce Palomar, *The 2006 ALTA Title Policies: What New Protections Do They Give?* 42 *Real Prop. Prob. & Tr. J.* 1, 3 (2007).

<sup>45</sup>Ward P. Graham, *Title Insurance, RETITLE MA-CLE*, § 4.1.3(c) (2d ed. 2010) (“Because the basic tenet of title insurance is still ‘risk elimination’ and ‘retrospective coverage,’ the premium for title insurance is a one-time premium, whereas the premiums paid for all other forms of insurance are based on an ongoing annual premium structure.”).

<sup>46</sup>Palomar, *supra* note 50, at 2; *Trenton Potteries Co. v. Title Guarantee & Trust Co.*, 176 N.Y. 65, 68 N.E. 132, 134 (1903). See also, *Foehrenbach v. German-American Title & Trust Co.*, 217 Pa. 331, 66 A. 561 (1907).

<sup>47</sup>See *First American Title Ins. Co. v. Seaboard Sav. and Loan Ass’n*, 227 Va. 379, 315 S.E.2d 842 (1984).

<sup>48</sup>*Howland v. First American Title Ins. Co.*, 672 F.3d 525, 526 (7th Cir. 2012).

claims severely reduces the insurer's exposure to liability under the policy.

Title insurance transfers the risk of loss from the insured to the insurer in exchange for the onetime payment of a premium.<sup>49</sup> The policy protects against defects that exist (undetected) at the time the policy was issued, and not against issues arising after the policy's effective date.<sup>50</sup> When policyholders experience a loss due to title defects or encumbrances that existed at the time the policy was issued, they have a contractual claim against the insurer to recover any losses, up to the face value of the policy.<sup>51</sup> The mere existence of a defect covered by the policy, in and of itself, is not sufficient to justify recovery; the loss must be actual in order to recover.<sup>52</sup> Under an owner's policy, "the owner is entitled to the full market value of the property and that value is immediately reduced by outstanding title defects and liens."<sup>53</sup>

Although serious title defects are rare, title insurance is an imperative investment for property owners and lenders. When errors occur and cause a title to be defective, the losses can be exorbitant. Furthermore, in the event that a convey-

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<sup>49</sup>Insurance premiums are directly linked to the market value of the property, which is determined by a third-party appraiser. The premium of a lender's policy increases in relation to the size of the mortgage, while the premium of an owner's policy is calculated by the market value of the property at the time the policy is issued. See also, Birny Birnbaum, *An Analysis of Competition in the California Title Insurance and Escrow Industry*, Report to the California Insurance Commissioner, Dec. 2005, at 15; Rona Fischman, *Title Insurance Demystified: Do Homeowners Really Need it?* Boston Globe, Aug. 12, 2009.

<sup>50</sup>46 Eric M. Larsson, *Causes of Action*, § 605 (2 ed. 2010).

<sup>51</sup>Graham, *supra* note 50, § 4.12.

<sup>52</sup>See, *Falmouth Nat. Bank v. Ticor Title Ins. Co.*, 920 F.2d 1058, 1062-63 (1st Cir. 1990) ("This distinction relates to the definition and measurement of the loss. More specifically, an owner-insured is entitled to the full market value of the property, a value that is immediately diminished by the presence of title defects.").

<sup>53</sup>*CMEI, Inc. v. American Title Ins. Co.*, 447 So. 2d 427, 428 (Fla. 5th DCA 1984). It is often difficult for owners to show an actual loss until they try to sell the property. A mortgagee will not experience a loss covered by a lender's policy while the borrower continues to make its scheduled mortgage payments; the loss will not become recoverable unless the property provides inadequate security for the repayment of the debt. See also, *Purcell v. Commonwealth Land Title Ins. Co.*, 19 A.D.3d 469, 799 N.Y.S.2d 218 (2d Dep't 2005) (insureds suffered a loss of the market value of the premises within the meaning of the policy and the market value policy rider).

ance was based on fraud or some fatal title defect was missed, it is difficult and can be extremely costly for the injured party to recover losses from a seller or closing attorney. In contrast, to recover under a title insurance policy, the insured need only prove that a defect exists, it affects the title's marketability and caused a financial loss, and that the defect falls within the coverage provided by the policy; there is no need to show fraud or misrepresentation to receive the benefits of the policy.<sup>54</sup>

### **A. Real Estate Conveyancing**

A seller's ability to convey marketable title is often a prerequisite for real estate sales and a standard purchase and sale agreement obligates the purchaser to accept the property if the seller is able to deliver marketable title.<sup>55</sup>

Multiple industries work together to coordinate the financial and real property components of a conveyancing transaction, and to ensure that the entire transaction complies with the relevant laws. A number of companies operate on a national scale and offer multiple settlement services to oversee real estate transactions from start to finish. Real estate brokers, attorneys and lenders work with title companies to coordinate property conveyances with loan transactions.<sup>56</sup> Generally, borrowers/purchasers (the consumers) pay for the title and settlement services performed in connection with their closing.

Companies that provide closing and settlement services on a national scale are less inclined than local firms to learn the intricate conveyancing customs of each county, or even of each state. National companies strive to cut costs and speed up transactions, and often rely on software to offer automated services. Uniform procedures are beneficial for lending

<sup>54</sup>46 Larsson, *supra* note 50.

<sup>55</sup>See Johnstone, *supra* note 45, at 494 ("In many contracts of sale the buyer agrees to buy only if the seller's title is one that a named title insurance company will insure subject to no more than the standard exceptions. Or contract purchasers may have agreed to buy only if the title is marketable, depending on the title insurance examination report for this determination; and if the title is not marketable, the seller will want to know what defects must be cleared to make it so.")

<sup>56</sup>Jack Guttentag, *Real Estate Settlement Services Take Bite Out of Borrowers*, *Inman News*, Sep. 6, 2005 ("Third parties involved in the lending process include title insurance companies, mortgage insurance companies, appraisers, credit-reporting agencies, flood insurance companies and escrow companies. Their costs are generally higher than they would be if they were purchased in a normally competitive market.")

transactions that must comply with federal law, but they can overlook the various systems of state conveyancing practices.

### **III. The Housing Boom**

During the 20th century, the federal government focused on public policy that would boost levels of homeownership and increase the availability of mortgage-credit.<sup>57</sup> The opportunity to work hard and become a homeowner became a part of the American Dream and the government actively promoted programs to increase the availability of investment capital for the financing of residential mortgage loans.<sup>58</sup>

The first step was taken shortly after the Great Depression, with the formation of the Federal Housing Administration (FHA), which provides government insurance to certain residential mortgage loans.<sup>59</sup> The Federal National Mortgage Association (Fannie Mae) was later formed to purchase FHA loans, which gave banks and thrifts an opportunity to sell loans that they previously held in their mortgage portfolios.<sup>60</sup>

In 1968, the government created the Government National Mortgage Association (“Ginnie Mae”) to take over purchasing FHA and VA insured mortgages, and turned Fannie Mae into a government-sponsored enterprise (GSE).<sup>61</sup> Fannie Mae began purchasing non-insured, conventional, residential mortgages from private banks and thrifts. In 1970, the

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<sup>57</sup>Kate Pickert, A Brief History of Fannie Mae and Freddie Mac, *Time Magazine*, July 14, 2008.

<sup>58</sup>12 U.S.C. § 1716; See also, Joseph C. Shenker & Anthony J. Colletta, *Asset Securitization: Evolution, Current Issues and New Frontiers*, 69 *Tex. L. Rev.* 1369, 1374–75 (1991) (“We will define ‘securitization’ for our analysis as the sale of equity or debt instruments, representing ownership interests in, or secured by, a segregated, income producing asset or pool of assets, in a transaction structured to reduce or reallocate certain risks inherent in owning or lending against the underlying assets and to ensure that such interests are more readily marketable and, thus, more liquid than ownership interests in and loans against the underlying assets. A securitized transaction will take advantage of a broader capital market and will result in a more efficient movement of capital and, therefore, reduce the cost of the equity or debt financing.”).

<sup>59</sup>Shenker & Colletta, *Id.*, at 1383 (The Veterans’ Administration is a similar program that was established to increase mortgage credit to veterans.); Charles M. Sivesind, *Mortgage-Backed Securities: The Revolution in Real Estate Finance*, *Fed. Res. Bank N.Y. Q. Rev.*, Autumn 1979, at 1.

<sup>60</sup>Shenker & Colletta, *Id.* at 1372.

<sup>61</sup>Christopher L. Peterson, *Predatory Structured Finance*, 28 *Cardozo L. Rev.* 2185, 2198 (2007).

government introduced another GSE, the Federal Home Loan Mortgage Corporation (“Freddie Mac”) to stimulate competition and increase available capital for the loans.

The GSEs offered private lenders an opportunity to sell their loans and replenish their funds for lending.<sup>62</sup> These programs also allowed banks to offload the risks of borrower default.<sup>63</sup> The GSEs were the dominant purchasers of loans and, in that capacity, were able to standardize procedures and industry forms for promissory notes, mortgages and deeds of trust.

Fannie Mae, Freddie Mac and Ginnie Mae paved the way to securitization with the introduction of pass-through securities, specifically Collateralized Mortgage Obligations (CMO). The GSEs created bonds called Residential Mortgage-Backed Securities (RMBS) by bundling loans and transferring them into special purpose vehicles (SPV) and pooling the cash flow from debtors’ monthly payments. Investors who purchase these securities receive revenue from the monthly principal and interest payments from the underlying pool of mortgages.<sup>64</sup>

The introduction of Real Estate Mortgage Investment Conduit (REMIC) programs within the Internal Revenue Code made RMBS a safe and attractive product for investors.<sup>65</sup> During the 1990’s, securitization of residential mortgages really took off when private financial institutions began bundling residential loans and issuing pass-through securities known as “private label” RMBS.<sup>66</sup>

Pass-through securities created opportunities to invest in U.S. real estate indirectly, and they attracted a variety of

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<sup>62</sup>Shenker & Colletta, *supra* note 77, at 1372; Kathleen C. Engel and Patricia A. McCoy, *The Subprime Virus: Reckless Credit, Regulatory Failure, and the Next Steps*, Oxford University Press 2011 at p. 18 [hereinafter, Engel and McCoy 2011].

<sup>63</sup>Sivesind, *supra* note 78, at 1.

<sup>64</sup>*Id.*, at 2.

<sup>65</sup>Product Overview: REMIC Program, Freddie Mac <http://www.freddiemac.com/mbs/html/product/remics.html> (“A REMIC is a multiclass, mortgage-backed security in which cash flows from the underlying assets are allocated to individual bonds, called tranches, of varying maturities, coupons and payment priorities.”).

<sup>66</sup>Housing Finance and Securitization Resource Center, SIMFA available at <http://www.sifma.org/issues/capital-markets/securitization/housing-finance-and-securitization/overview/> (last visited Nov. 29, 2012).

investors from all over the world.<sup>67</sup> The influx of investments from a diverse pool of investors led to an integrated, national mortgage market. New and inexperienced borrowers became eligible for credit, and “geographically [or] economically constrained areas had the benefit of receiving money for lending from across the U.S.”<sup>68</sup> A pension fund in California could invest in a residential mortgage in the middle of North Dakota.<sup>69</sup>

Securitization led to dramatic changes in mortgage financing and completely revolutionized the entire real estate industry.<sup>70</sup> Historically, neighborhood banks and local thrifts funded residential real estate transactions. Mortgages remained in their portfolios and the same entity collected payments from the borrower for the life of the loan.<sup>71</sup> Lenders maintained relationships with their borrowers and there was an element of personal contact and customer service that is rare in the banking industry today. A borrower’s default would directly affect the lender, so there was an incentive to lend money to creditworthy and responsible consumers. This mutually beneficial relationship likely kept risky mortgage credit products in check prior to securitization.

#### **A. Risky Lending**

Prior to the 1990’s, prime borrowers made the majority of residential real estate purchases and lenders used conventional underwriting standards to evaluate the risk of default

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<sup>67</sup>Id.

<sup>68</sup>Patrick Pulatit, MERS and Recording—Past, Present and Future, Part 2: Securitization, ml-explode.com, available at <http://ml-explode.com/2011/11/mers-and-recording-%E2%80%93-past-present-and-future-pt-2-securitization/> (last visited Nov. 11 2012).

<sup>69</sup>Id.

<sup>70</sup>See Sivesind, *supra* note 78, at 4. (“Pass-throughs are considered eligible real estate investments by most agencies that regulate commercial banks and thrift institutions, and for purposes of determining the tax status of thrift institutions. The securities provide a safe, easily marketable investment with an attractive long-term yield and a high cash flow each month resulting from interest and principal repayment.”)

<sup>71</sup>Henry M. Paulson, Jr., U.S. Sec’y of the Treasury, Remarks on Current Housing and Mortgage Market Developments at the Georgetown University Law Center (Oct. 16, 2007), available at <http://www.treasury.gov/press/releases/hp612.htm> (“A mortgage loan is likely to be originated, serviced, and owned by three different entities. Originators often sell mortgages to securitizers who package them into mortgage-backed securities, which are then divided and sold again to a global network of investors.”).

before approving loans.<sup>72</sup> Lenders analyzed many factors to predict whether a borrower would be able to repay the loan, and whether the property had adequate value to secure the lender's investment in the case of default.<sup>73</sup> Buyers were required to make down payments of 20% of the purchase price, which meant the loan could not exceed 80% of the property's value; this ratio is known as the loan-to-value (LTV) ratio.<sup>74</sup> A low LTV increases the likelihood that borrowers will be able to refinance or sell the property if they run into problems down the line and can no longer make their mortgage payments.

Securitization led to increased homeownership by making more capital available for home loans and also created massive profits for Wall Street institutions and investors. In order to cater to Wall Street's increasing demand for residential loans, originators drastically relaxed their approval criteria and underwriting standards in order to extend credit to greater numbers of borrowers.<sup>75</sup> As subprime lending became an accepted business practice in the lending industry, originators and brokers flooded the market looking to cash in on the profits available through securitization.<sup>76</sup> The government's housing policies, together with securitization,

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<sup>72</sup>Geetesh Bhardwaj & Rajdeep Sengupta, *Where's the Smoking Gun? A Study of Underwriting Standards for US Subprime Mortgages*, Fed. Res. Bank of St. Louis Working Paper Series, Working Paper No. 2008-036A, 7 (2008) available at <http://ssrn.com/abstract=1286106>.

<sup>73</sup>Kurt Eggert, *The Great Collapse: How Securitization Caused the Subprime Meltdown*, 41 Conn. L. Rev. 1257, 1267 (2009) (Soft mortgage underwriting focuses on more subjective factors, while hard mortgage underwriting can be automated and save both time and money for lenders.).

<sup>74</sup>George Lefcoe, *Real Estate Transactions* 217 (5th ed. 2005) ("The LTV is "the ratio of the unpaid principal balance of the loan to the lesser of the appraised value or sales price of the property."); Oren Bar-Gill, *The Law, Economics and Psychology of Subprime Mortgage Contracts*, 94 Cornell L. Rev. 1073, 1076 (2009).

<sup>75</sup>See Matt Taibbi, *Invasion of the Home Snatchers*, Rolling Stone, Nov. 25, 2010 ("In their extreme haste to get thousands and thousands of mortgages they could resell to the banks, the lenders committed an astonishing variety of fraud, from falsifying income statements to making grossly inflated appraisals to misrepresenting properties to home buyers.").

<sup>76</sup>See Kathleen C. Engel & Patricia A. McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending*, 80 Tex. L. Rev. 1255 (2002). See also, Eggert, *supra* note 93, at 1267 ("In the early 1990s, there were few subprime mortgage originations, but with securitization, subprime boomed, and subprime origination topped \$625 billion dollars by 2005.").

encouraged lenders to extend credit to borrowers who would have been denied access to credit in the past;<sup>77</sup> this expansion of risky lending allowed Wall Street to tap into a population of borrowers that were previously ineligible for mortgages, and thus precluded from purchasing real estate. Unfortunately, many subprime lenders targeted these inexperienced borrowers and used unfair and deceptive tactics to push loans with higher fees and interest rates.<sup>78</sup>

The desire for short-term profits created incentives for lenders to fund loans as quickly as possible. Emphasis was placed on the quantity of the loans produced, rather than on their value or risk. Furthermore, the opportunity to sell those loans and transfer the risks off of their balance sheets led to a substantial decline in the quality of loans.<sup>79</sup>

The decline in underwriting standards worsened with the introduction of new types of loan products that required less documentation. In the last years of the housing boom, there was an increase in mortgage fraud and lax underwriting. Risky lending practices were encouraged by a widespread belief that housing prices would never decline.<sup>80</sup> At the beginning of the millennium, high property values and a healthy economy encouraged lenders and Wall Street firms to make risky loans and reckless business decisions.<sup>81</sup> They assumed that defaulting borrowers would always be able to sell their homes to avoid foreclosure.

Many of the loans originated during the housing boom enticed borrowers with teaser rates that applied to the

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<sup>77</sup>Benjamin Howell, *Exploiting Race and Space: Concentrated Subprime Lending As Housing Discrimination*, 94 Cal. L. Rev. 101, 102 (2006) (“Subprime lending, the extension of loans to those with less-than-perfect credit at higher rates, has developed almost overnight into a multibillion dollar industry.”).

<sup>78</sup> “[S]ince the 1990’s there has been a growing concern about predatory lending in the subprime mortgage market. These types of loans target low income, high-risk consumers who own some equity in their homes.” Dee Pridgen and Richard M. Alderman, *Consumer Credit and the Law*, § 9:1 (Nov. 2012).

<sup>79</sup>Eggert, *supra* note 93, at 1259 (“[S]ubprime lenders could quickly unload much of the risk of the subprime loans as well as recoup the money lent and relend it to new subprime borrowers.”).

<sup>80</sup>The global housing boom. *Economist*, June 16, 2005 (last visited Nov. 15, 2012) available at [http://www.economist.com/node/4079027?story\\_id=4079027](http://www.economist.com/node/4079027?story_id=4079027) [hereinafter “The Global Housing Boom”].

<sup>81</sup>Michael, Simkovic, *Competition and Crisis in Mortgage Securitization*, 88 Ind. L. J., 2013 (2011).

introductory period, but not for the entire life of the loan.<sup>82</sup> Lenders and brokers provided borrowers with opaque information, such as hidden fees, confusing variable interest rates, and other predatory terms.<sup>83</sup> Many of the loans bundled into RMBS were subprime and had multiple characteristics that made borrower defaults inevitable. Furthermore, many of the down payment and LTV requirements were relaxed or even abandoned by lenders, which diminished the equity owners had in their properties. Borrowers could get loans for 105% of a property's value.<sup>84</sup> When the housing bubble burst and real estate values plummeted, properties with high LTVs became underwater and the borrowers were left without any equity in their property. When teaser rates for many of the worst subprime loans reset, the required payments increased substantially, but negative equity left many borrowers without options to sell or refinance.<sup>85</sup>

#### **IV. Securitization, Residential Settlement Services and The Title Industry**

##### **A. Securitization Process**

The process of bundling loans into REMICs and issuing mortgage-backed securities requires strict compliance with a series of complex regulations. The special-purpose vehicles (SPVs) used in securitization are bankruptcy remote entities and exempt from double taxation, but only if they are structured properly and meet the standards set forth by the

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<sup>82</sup>Com. v. Fremont Investment & Loan, 452 Mass. 733, 897 N.E.2d 548, 554 (2008) (“The judge reasoned that Fremont as a lender should have recognized that loans . . . were “doomed to foreclosure” unless the borrower could refinance the loan at or near the end of the introductory rate period, and obtain in the process a new and low introductory rate.”).

<sup>83</sup>Eggert, *supra* note 93 (“[T]hrough the wonders of securitization, the interests in the defaulting loans had been sliced and diced, tranced and sold, then often res securitized, re tranced and resold, perhaps several times over. The risk of default was no longer concentrated in the lenders responsible for the loans, but instead was distributed in a complex and opaque way throughout the financial industry and among a multitude of investors, some completely unaware that their investments ultimately depended on the stability of the subprime market.”).

<sup>84</sup>The global housing boom, *supra* note 99 (“Indeed, homebuyers can get 105% loans to cover buying costs. And, increasingly, little or no documentation of a borrower’s assets, employment and income is required for a loan.”).

<sup>85</sup>Gil Sandler, *Aggressive Mortgage Lending and the Housing Market: The Economic Impact of Minor Miscalculations*, 24 Real Estate Fin. 3 (2007).

Internal Revenue Code.<sup>86</sup> The issuers of RMBS have a duty to make sure the SPV is the legal owner of each loan in the underlying pool of assets to protect the investors and ensure they receive the payments to which they are entitled.

Securitization adds a level of complexity to settlement services for typical real estate transactions because the lender or originator sells its loans on the secondary market after the borrower's closing. Lenders must execute instruments to sell the loans, which involves creating separate instruments to assign the mortgages and transfer the right to receive repayment of the debt enumerated in the promissory notes.<sup>87</sup> When selling loans through securitization there are complicated procedures, including transfers between multiple entities, that have to occur so as "to ensure that the transactions [are] bankruptcy remote, REMIC acceptable and [meet] securities law and IRS regulations."<sup>88</sup> Furthermore, RMBS contain bundles of loans from all over the country and the endorsement of each note and assignment of each mortgage must comply with the state laws and local recording requirements of the jurisdiction in which the mortgaged property is located. The ability to accurately document loan transfers and streamline account information throughout these complicated procedures is essential.

The Mortgage Electronic Registration System (MERS) is an electronic database that tracks the ownership of mortgages for its member companies and helps facilitate the transfer of mortgages throughout the securitization process.<sup>89</sup> It was developed through a collaboration of dominant industry players and trade associations in the mortgage and title industries who wanted to speed up the securitization

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<sup>86</sup>26 U.S.C. § 860 (1996). See, generally, Gelpert & Levitin, *supra* note 67 (discussing RMBS and explaining the creation of SPVs).

<sup>87</sup>Alan M. White, *Losing the Paper—Mortgage Assignments, Note Transfers and Consumer Protection*, 24 *Loy. Consumer L. Rev.* 468, 471 (2012).

<sup>88</sup>Pulatie, *supra* note 88.

<sup>89</sup>Floyd Norris, *Some Sand in the Gears of Securitizing*, *N.Y. Times*, Oct. 19, 2007 at B1 ("The Mortgage Electronic Registration Systems, which was created to smooth the securitization process and, in the process, to allow lenders to avoid paying registration fees to counties each time the mortgage changed hands."); Phyllis K. Slesinger & Daniel McLaughlin, *Mortgage Electronic Registration System*, 31 *Idaho L. Rev.* 805, 807 (1995).

process and reduce costs.<sup>90</sup> Founders of MERS claimed that the real property principles and procedures for transferring mortgage rights were “cumbersome, paper-intensive, error-prone,” and not suited to twentieth century mortgage finance transactions; they created the MERS registry to eliminate the need for paper mortgage assignments and to bypass the state and municipal registries responsible for tracking public land records and interests in real property.<sup>91</sup>

MERS provides access to its system to lenders and other financial firms, and also to servicers, investors and other participants in the secondary market. The system allows members to avoid paying multiple recording fees by having MERS named as the mortgagee in the public land records.<sup>92</sup> When MERS is named as the mortgagee of record, it acts as the nominee or agent for the owner of the note. Any loan “registered on the MERS System is inoculated against future assignments because MERS remains the mortgagee” no matter how many times the loan changes hands.<sup>93</sup> The company slogan is “Process Loans, Not Paperwork,”<sup>94</sup> and according to the Florida Bankers Assn., in many cases “the physical document was deliberately eliminated to avoid confusion im-

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<sup>90</sup>Christopher L. Peterson, *Two Faces: Demystifying the Mortgage Electronic Registration System’s Land Title Theory*, 53 *Wm. & Mary L. Rev.* 111, 116 (2011). See also, Michael Powell & Gretchen Morgenson, *MERS? It May Have Swallowed Your Loan*, *N.Y. Times*, Mar. 6, 2011, at BU1 (“Participants in the MERS initiative are the Mortgage Bankers Association of America (MBA), the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac), the Government National Mortgage Association (Ginnie Mae), the Federal Housing Administration (FHA), and the Department of Veterans Affairs (VA), which comprise the MERS Steering Committee. Representatives of related trade groups, such as America’s Community Bankers, the American Bankers Association, the American Land Title Association, the American Bar Association, the American Escrow Association, and others also have engaged in the planning process.”). See also, Chris Bruce, *New York Attorney General Sues Banks, Says MERS Led to Deceptive Foreclosures*, *BNA’s Bankruptcy L. Reporter*, Feb. 9, 2012 (“The banks created the MERS system as an end-run around the property recording system, to facilitate the rapid securitization and sale of mortgages.”).

<sup>91</sup>Slesinger & McLaughlin, *supra* note 109, at 807.

<sup>92</sup>Howard Schneider, *MERS Aids Electronic Mortgage Program*, *MORTGAGE BANKING*, Jan. 1997 at 42.

<sup>93</sup>See, *About Us, MERS*, <http://www.mersinc.org/about-us/about-us> (last visited Nov. 25, 2012).

<sup>94</sup>Norris, *supra* note 109.

mediately upon its conversion to an electronic file.”<sup>95</sup> Members can orchestrate electronic transfers of their beneficial ownership interests or servicing rights within the system, without executing physical instruments to document the transactions.

In the public land records, MERS purports to hold legal title to properties, acting as an agent on behalf of lenders or securitization trusts; however, the ownership of the note, and thus the beneficial interest in the property covered by the mortgage, is continuously changing hands behind the scenes. The registries of public land records were established in accordance with their state property laws and they rely on the paper instruments to keep an accurate record of property interests in their jurisdiction. “No matter how many times a mortgage is bundled, sliced up or resold, the public record often begins and ends with MERS,”<sup>96</sup> which prevents transparency “in a historically transparent legal regime.”<sup>97</sup>

Throughout the housing boom, the lending and financial services industries pushed for the increased use of electronic record keeping to speed up transactions and cut costs. Companies such as National Real Estate Information Services (NREIS) and Legal Processing Services (LPS) developed a suite of services and software to assist with all aspects of mortgage lending and securitization, starting with origination, settlement and title services through securitization and transfers, servicing and, if necessary, default management and foreclosure.<sup>98</sup> These programs help to integrate real property conveyances and loan closings with subsequent transactions. In addition, “when homeowners fall behind,

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<sup>95</sup>Chad Terhune, Paul M. Barrett, and Peter Coy, *Mortgage Mess: Shredding the Dream*, *Bloomberg Businessweek Magazine*, Oct. 21, 2010.

<sup>96</sup>Mike McIntire, *Tracking Loans Through a Firm That Holds Millions*, *N.Y. Times*, April 23, 2009.

<sup>97</sup>David P. Weber, *The Magic of the Mortgage Electronic Registration System: It Is and It Isn't*, 85 *Am. Bankr. L.J.* 239, 240 (2011); Robert E. Dordan, *Mortgage Electronic Registration Systems (Mers), Its Recent Legal Battles, and the Chance for A Peaceful Existence*, 12 *Loy. J. Pub. Int. L* 177, 178 (2010).

<sup>98</sup>LPS Solutions, *Lender Processing Services*, <http://www.lpsvcs.com/Pages/LPSSolutions.aspx> (last visited Nov. 29, 2012) (“LPS customizes the closing and escrow process to meet each client’s own unique needs. Services delivered to mortgage lenders include: payoff management, title clearance, scheduling and closing execution and funding activities centralized through one convenient point of contact for both the lender and borrower.”).

LPS helps assemble the information needed to foreclose.”<sup>99</sup> The software also streamlines electronic communication between LPS and its users, which further reduces the time and paperwork required for each transaction.<sup>100</sup>

Companies like LPS and NREIS are particularly attractive to national financial institutions and firms involved in securitization because they provide services to multiple industries in the securitization process. They are involved with real property and title-related services, as well as financial services and the lending industry. Although these national companies can provide cheaper and quicker services, they are often unable to integrate the complex and varied state and local regulations controlling real estate transactions with their uniform services offered throughout the country.

### **1. Securitization and Title Flaws**

Historic principles of property law require physical instruments to document transfers that involve interests in real property, but “as the volume of mortgage transfers and foreclosures exploded, the mortgage industry was either unwilling or unable to follow the old paper-based rules.”<sup>101</sup> At the height of securitization, promissory notes were traded like playing cards and bundled into RMBS. The securities were sold to investors and money was changing hands, but shoddy and missing paperwork throughout the securitization process meant the transactions did not comply with state property laws.<sup>102</sup>

The inadequate record keeping during the chaos of

<sup>99</sup>See Terhune, Barrett, and Coy, *supra* note 115.

<sup>100</sup>Mortgage Paperwork Mess: Next Housing Shock? CBS 60 Minutes, April 1, 2011 [hereinafter Mortgage Paperwork Mess] (“[A] company called LPS, a \$2 billion firm . . . calls itself the nation’s leading provider of mortgage processing services.”).

<sup>101</sup>See White, *supra* note 107, at 475. [“Much anecdotal evidence suggests that servicers of private-label securitized mortgages either delivered original notes without endorsements to document custodians for the trust, routinely prepared lost note affidavits in lieu of delivering notes to foreclosure attorneys and trustees, routinely destroyed original notes, and/or obtained or forged necessary endorsements long after the transfers were supposed to have taken place.”]

<sup>102</sup>Gretchen Morgenson, *If Lenders Say “The Dog Ate Your Mortgage,”* NY Times, Oct. 25, 2009 (“Securitizations allowed for large pools of bank loans to be bundled and sold to legions of investors, but some of the nuts and bolts of the mortgage game—notes, for example—were never adequately tracked or recorded during the boom. In some cases, that means nobody truly knows who owns what.”).

## THE BUCK STOPS HERE: TOXIC TITLES AND TITLE INSURANCE

securitization had devastating consequences that continue to surface. The lack of compliance with state property laws plagues land records and individual property titles. Although paperwork may seem like a mere formality, “the rules of the game with securitization, as with real property law and secured credit are, and always have been, that dotting ‘i’s’ and crossing ‘t’s’ matter, in part to ensure the fairness of the system and avoid confusions about conflicting claims to property.”<sup>103</sup>

Flawed paperwork has also impacted investors. Pooling and Servicing Agreements (PSA) set forth the obligations of RMBS issuers and the servicers that manage the day-to-day operations of the trusts. The PSAs require all of the pooled loans to be explicitly identified and properly transferred into the trust within a specific timeframe.<sup>104</sup> Investors, and the trustee/servicers that represent them, rely on accurate chains of assignments to efficiently manage the assets of the trust. Without valid assignments of loans, a servicer has no right to enforce the loans and, consequently, the trust doesn’t have the collateral it claimed to have when it sold RMBS to investors.<sup>105</sup>

Mortgagors rely on accurate chains of assignments to preserve the integrity of their land titles. In addition, as a matter of public policy, as borrowers they have a right to know who holds their promissory notes and owns their debt, mainly because only that person or entity is legally entitled to collect money from them or potentially foreclose on their property.

MERS has added another layer of title issues because it claims that it eliminates the need to record mortgage assign-

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<sup>103</sup>Robo-Signing, Chain of Title, Loss Mitigation, and Other Issues in Mortgage Servicing: Hearing Before the Subcomm. on Hous. and Comty. Opportunity of the H. Fin. Servs. Comm., 111th Cong. 2d Sess. (2010) [hereinafter “Levitin testimony”] (testimony of Adam J. Levitin, Associate Professor of Law, Georgetown University Law Center), available at <http://financialservices.house.gov/Media/file/hearings/111/Levitin111810.pdf>.

<sup>104</sup>See White, *supra* note 107.

<sup>105</sup>Michael Olenick, How Banks and Their Lawyers Win at the Expense of Investors and Homeowners, *Naked Capitalism*, June 6, 2012, available at <http://www.nakedcapitalism.com/2012/06/michael-olenick-how-banks-and-their-lawyers-win-at-the-expense-of-investors-and-homeowners.html> (last visited June 9, 2012).

ments with land registries;<sup>106</sup> however, it does not explain how its business model conforms to real property laws that govern the transfer of equitable and legal rights in mortgages.<sup>107</sup> MERS is named as both the lender's nominee and the mortgagee in millions of mortgages, which creates ambiguity about its legal authority to act on behalf of its members. A slew of cases throughout the country have held that MERS cannot represent the interests of its members in real property transactions in which it has no beneficial interest.<sup>108</sup> As a result, when MERS is listed in a chain of title, there may be reasonable doubts as to the validity of documents and the authority of signatories.

The problems with MERS are not limited to its presence in the chain of title. MERS relies on an honor system and its members are responsible for registering their own transactions within the system. Members are supposed to keep all ownership information accurate and up-to-date. In reality, members often failed to enter loan transfers into the system, particularly in situations where loans were sold to non-members.<sup>109</sup> The MERS system is riddled with errors and has created confusion for its members as well as borrowers and professionals who rely on the transparency and accuracy of ownership records. Today, it is often difficult to use MERS to determine who owns what.<sup>110</sup>

## **V. Servicing, Default Management and Foreclosure**

In 2007, the housing bubble burst and real estate values plummeted. The rise in unemployment and the overall

<sup>106</sup>See White, *supra* note 107, at 486. (“MERS was created in order to eliminate the need to record each mortgage assignment in county property records. Participating member mortgage lenders and servicers agree to record mortgages in county property records showing MERS as the proxy mortgagee. MERS purports to be a national database of mortgage ownership and ownership changes.”).

<sup>107</sup>Christopher L. Peterson, *Losing Our Homes, Losing Our Way, or Both? Foreclosure, County Property Records, and the Mortgage Electronic Registration System*, 40 *Cap. U. L. Rev.* 821, 830 (2012).

<sup>108</sup>Kate Berry, *Foreclosures Turn Up Heat on MERS*, *Am. Banker*, July 10, 2007, at 1.

<sup>109</sup>See White, *supra* note 107, at 486 (“[P]rior to 2011 MERS was not regulated by any state or federal agency, and its database was not regularly audited. Because MERS relied on its mortgage industry members—banks and servicing companies—to voluntarily report loan ownership transfers, the MERS database was not a reliable record of those transfers.”).

<sup>110</sup>Marsh, *supra* note 26, at 24.

downturn in the global economy caused borrowers to default on their mortgage payments. The crash in housing prices left an overwhelming number of homeowners with their properties underwater and by the middle of 2011, 10.7 million, or 22.1%, of all residential properties with a mortgage had negative equity.<sup>111</sup> Underwater mortgagors couldn't afford to make their mortgage payments and were stuck with houses they could not sell. The delinquency rate for all residential mortgage loans peaked at over 10% in 2009.<sup>112</sup>

Borrowers defaulted on conventional loans as well as the risky, subprime loans, and foreclosure filings skyrocketed throughout the country. Toward the end of 2009, the combined percentage of delinquent loans and loans in foreclosure was 14.41%.<sup>113</sup> The financial industry was unprepared for the rise in foreclosures when the housing market collapsed.

#### **A. Wrongful Foreclosure**

The servicers responsible for the day-to-day management of individual accounts quickly discovered that gaps in the transfers of mortgages meant they were missing the required paperwork needed to initiate foreclosure proceedings. An entity wishing to foreclose on a mortgage must be able to prove that it has legal standing to do so. For the majority of securitized loans, MERS remained the mortgagee of record throughout the securitization pipeline, even after the loan was sold and transferred into a trust. There was no chain of title recorded in the public land records from the time of the transfers, but banks still needed to make their records and paperwork comply with the legal requirements.

The complexity of securitization, and the use of electronic systems like MERS, wreaked havoc on the paper records of loans and mortgages. Loans were missing endorsements, hadn't been assigned to the new owners or the original paperwork had gone missing. Shortcuts used during securitization of loans and the failure to comply with state convey-

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<sup>111</sup>Corelogic Third Quarter 2011 Negative Equity Data Shows Slight Decline But Remains Elevated. Nov. 29, 2011.

<sup>112</sup>Mortgage Bankers Association, National Delinquency Survey Q3 2009.

<sup>113</sup>Mortgage Bankers Association, Delinquencies Continue to Climb in Latest MBA National Delinquency Survey, November 19, 2009.

ancing laws corrupted countless titles.<sup>114</sup> To compound the situation, banks did not always keep their internal records up to date and often lost track of which loans they owned and which accounts were current or in default. Bankruptcies of lenders and mergers of firms also contributed to confusion over the ownership and servicing rights of individual loans. As a result, banks wrongfully foreclosed on countless homeowners. There are examples of banks foreclosing on mortgagors who were current on their loan payments. Sometimes banks foreclosed on the wrong property altogether.<sup>115</sup> There are also examples of banks foreclosing on homes even though they didn't have standing.<sup>116</sup>

### **1. Robosigning**

Before the financial crisis hit, Fannie Mae and Freddie Mac set up a network of law firms and servicers to perform foreclosures on their behalf.<sup>117</sup> The attorneys authorized to foreclose on behalf of the GSEs were known as the retained attorney network and each of the firms "agreed to a flat-rate fee structure and pricing model based on the volume of foreclosures they completed."<sup>118</sup> The LPS software, LPS Desktop, connects network attorneys and servicers for the purpose of foreclosures. LPS Desktop allows servicers to use the LPS Desktop platform to request legal services and provide information about account records and the necessary paperwork for delinquent mortgages, all through digital cod-

<sup>114</sup>Matt Stoller, *Treat Foreclosure as a Crime Scene*, Politico, Dec. 15, 2011.

<sup>115</sup>J. Scott Trubey, *Botched Transfer Leads to Foreclosure Nightmare*, Atlantic Journal-Constitution, July 6, 2012 available at <http://www.ajc.com/news/business/botched-transfer-leads-to-foreclosure-nightmare/nQW4f/> (last visited July 9, 2012); Matt Taibbi, *supra* note 1.

<sup>116</sup>Consumer Law-Mortgage Foreclosure-Massachusetts Supreme Judicial Court Unanimously Voids Foreclosure Sales Because Securitization Trusts Could Not Demonstrate Clear Chains of Title to Mortgages.—U.S. Bank National Ass'n, 125 Harv. L. Rev. 827, 833 (2012).

<sup>117</sup>Gretchen Morgenson, *Fannie Mae Knew Early of Abuses*, Report Says, N.Y. Times, October 3, 2011 ("The new report from the inspector general tracks Fannie Mae's dealings with the law firms handling its foreclosures from 1997, when the company created its so-called retained attorney network. At the time, Fannie Mae was a highly profitable and powerful institution, and it devised the legal network to ensure that borrower defaults would be resolved with efficiency and speed.")

<sup>118</sup>*Id.*

ing, not oral communication.<sup>119</sup> Furthermore, LPS Desktop allows servicers and LPS employees to “rate” the participating law firms based on “their ability to meet . . . time parameters.”<sup>120</sup> Many of these law firms became known as “foreclosure mills” based on the sheer number of foreclosures they processed, both through the courts and non-judicially.

Gaps in the chain of ownership of loans made it difficult for the mortgagees to prove they had the legal right to foreclose on the underlying property. Many of the servicers managing defaults and foreclosure services were subsidiaries or affiliates of the financial institutions responsible for the securitization or origination of the same loans.<sup>121</sup> They could not expose the issues with missing documentation without triggering buyback provisions or exposing their firms and the entire financial industry to investor lawsuits.

Rather than admit that fatal mistakes had been made during securitization, banks started creating mortgage assignments long after the securitization transactions were completed.<sup>122</sup> Hundreds of thousands of mortgages needed assignments so servicers and foreclosing attorneys outsourced execution of assignments to third party vendors.<sup>123</sup> To makeup for the missing instruments in earlier transactions, companies like LPS and its subsidiary Doc X provided services to fabricate and execute assignments of mortgages, affidavits, powers of attorney or “whatever other paperwork [was] determined to be needed to provide a legal basis for

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<sup>119</sup>Paul Jackson, *Foreclosure Mess Exposes the Rot from Within*, *HousingWire*, Oct. 11, 2010, available at <http://www.housingwire.com/reviewed/foreclosure-mess-exposes-rot-within> (last visited July 11, 2012); Abigail Field, *When Banks Outsource Foreclosures, Nothing Good Happens*, *Daily Finance*, Feb. 11, 2011 available at <http://www.dailyfinance.com/2011/02/11/when-banks-outsource-foreclosures-nothing-good-happens/> (last visited Nov. 12, 2012).

<sup>120</sup>Yves Smith, *Multi-Billion-Dollar Class Action Suits Filed Against Lender Processing Services for Illegal Fee Sharing, Document Fabrication; Prommis Solutions Also Targeted*, *Naked Capitalism*, Oct. 5, 2010 available at <http://www.nakedcapitalism.com/2010/10/multi-billion-dollar-class-action-suits-filed-against-lender-processing-services-for-illegal-fee-sharing-document-fabrication-prommis-solutions-also-targeted.html> (last visited Nov. 12, 2012).

<sup>121</sup>Olga Kogan, *Infinite Loop: Robo-Signers and Ethics in Bankruptcy Mortgage Cases*, 25 *Geo. J. Legal Ethics* 645, 648 (2012).

<sup>122</sup>By 2009, MERS was named as the mortgagee of record for over sixty million mortgages. See McIntire, *supra* note 108.

<sup>123</sup>Smith, *supra* note 141.

foreclosure.”<sup>124</sup> LPS eventually closed Doc X after a “document production price sheet” was discovered and the company’s practices were subjected to intense media scrutiny.<sup>125</sup>

Investigations of Doc X and similar foreclosure outsourcing vendors showed that employees working in a “sweatshop for forged mortgage documents” spent all day creating paperwork and signing it, without ever verifying its contents or reviewing the underlying information.<sup>126</sup> Many employees of servicers, documentation vendors and foreclosure mills admitted to participating in unlawful industry practices including forged signatures, backdated documents, robo-signing, and passing around notary stamps.<sup>127</sup> Although the legality of this paperwork is questionable at best, the documents are recorded in public land records throughout the country and were used in countless foreclosure proceedings in state and federal courts over the past few years.<sup>128</sup>

The rise in delinquencies and foreclosures has been extremely profitable for companies like LPS. The default management branch of LPS contributed 48% of the compa-

<sup>124</sup>Robo-Signing, Chain of Title, Loss Mitigation, and Other Issues in Mortgage Servicing: Hearing Before the Subcomm. on Hous. and Comty. Opportunity of the H. Fin. Servs. Comm., 111th Cong. 2d Sess. (2010) [hereinafter “Levitin testimony”] (testimony of Adam J. Levitin, Associate Professor of Law, Georgetown University Law Center), available at <http://financialservices.house.gov/Media/file/hearings/111/Levitin111810.pdf>.

<sup>125</sup>Yves Smith, 4ClosureFraud Posts Lender Processing Services Mortgage Document Fabrication Price Sheet, Naked Capitalism, Oct. 3, 2010 available at <http://www.nakedcapitalism.com/2010/10/4closurefraud-posts-docx-mortgage-document-fabrication-price-sheet.html> (last visited Nov. 12, 2012).

<sup>126</sup>Gretchen Morgenson, Flawed Paperwork Aggravates a Foreclosure Crisis, NY Times, Oct. 3, 2010 (“In some cases, documents have been signed by employees who say they have not verified crucial information like amounts owed by borrowers.”). Mortgage Paperwork Mess, *supra* note 112.

<sup>127</sup>Kerry Curry and Sarah Mueller, Ex-paralegal tells Florida AG of questionable practices at foreclosure law firm, HousingWire, Oct. 11, 2010 available at <http://www.housingwire.com/news/ex-paralegal-tells-florida-a-g-questionable-practices-foreclosure-law-firm> (last visited July 9, 2012).

<sup>128</sup>See, *S & H Petroleum Corp., Inc. v. Register of Deeds for County of Bristol*, 46 Mass. App. Ct. 535, 707 N.E.2d 843, 845 (1999) (“The function of a registry of deeds is to record documents. It is essentially a ministerial function, and the personnel of registries cannot be expected to-and are not required to-dispense legal advice.”).

ny's total revenues in 2009,<sup>129</sup> and according to SEC filings, the "foreclosure-related revenue was \$1.1 billion [in 2009] compared with \$473 million in 2007."<sup>130</sup>

## **2. The Impact on Property Titles**

In many title theory states that permit nonjudicial foreclosure, a standard residential mortgage permits mortgagees to foreclose under the power of sale when mortgagors default on their obligations.<sup>131</sup> Foreclosure under the power of sale means a mortgagee has the right to extinguish the mortgagor's interests in the underlying property and sell it at a public auction to satisfy the borrower's debt.<sup>132</sup>

Before initiating a foreclosure, the mortgagee must verify that the homeowner defaulted on his or her obligations in the promissory note. Delinquent account information is often evidenced by affidavits, which "lay the legal foundation for a foreclosure by attesting that the borrower is delinquent and that the lender is entitled to seize the home."<sup>133</sup> LPS employees commonly signed affidavits without having the requisite legal authority or when they had no knowledge or understanding of what they were signing.<sup>134</sup>

Although the mortgage represents a contract between private parties, the requirements for power of sale are defined by statute. Mortgagees with the authority to foreclose under the power of sale must adhere to law and the terms of the mortgage to legally sell a mortgagor's land. Property sold at a foreclosure sale is conveyed free and clear of all liens, even if the sale proceeds are insufficient to repay all of the liens encumbering the property. The foreclosure

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<sup>129</sup>Smith, *supra* note 141.

<sup>130</sup>*Id.*

<sup>131</sup>5 Tiffany & Jones, *supra* note 7, §§ 1518–1527.

<sup>132</sup>Mass. Gen. Laws ch. 183, § 21.

<sup>133</sup>Lorraine Woellert and Dakin Campbell, JPMorgan Based Foreclosures on Faulty Documents, Lawyers Claim, Bloomberg, Sep. 27, 2010 available at <http://www.bloomberg.com/news/2010-09-27/jpmorgan-based-home-foreclosures-on-faulty-court-documents-lawyers-claim.html>.

<sup>134</sup>In September 2010, GMAC said it was halting foreclosure proceedings in 23 states because of problems with its legal practices. The move by GMAC followed testimony by an employee who signed affidavits for the lender; he said that he executed 400 of them each day without reading them or verifying that the information in them was correct. See Morgenson, *supra* note 149.

extinguishes the mortgagor's equitable right of redemption as well as the rights of any junior lien holders.<sup>135</sup>

The ramifications of a wrongful foreclosure are severe, and in many cases the transaction cannot be easily undone or reversed. More importantly, when a party initiates a foreclosure sale in violation of state property law, there is no valid execution of legal rights, and the sale is wholly void.<sup>136</sup> If the mortgagee fails to comply with the requisite procedures, there is no authority to sell the property and nothing is conveyed by the subsequent foreclosure deed.

Judicial foreclosures based on flawed evidence do not create the same title flaws because court orders are final and have the effect of extinguishing the mortgagor's equitable right of redemption and the rights of junior lien holders. Most judicial foreclosure states require mortgagees to prove they are a person entitled to enforce the note before filing a foreclosure action. Many courts have discovered problems with documentation and dismissed those foreclosure actions on the grounds of lack of standing.<sup>137</sup>

### **B. Massachusetts Courts and Their Scrutiny of Bad Foreclosure Practices**

Throughout the country, consumer advocates, legislators, attorneys general and federal and state banking regulators have highlighted flaws in the documentation supporting foreclosures. In many respects, the Massachusetts courts have been at the vanguard in addressing the title issues that arise from missing or fraudulent securitization documents, and the effect these defects have on legal title to real property.

In 2011, the Massachusetts Supreme Judicial Court (SJC) affirmed a Land Court decision that invalidated the non-judicial foreclosures of two securitized mortgages.<sup>138</sup> US Bank and Wells Fargo, acting as trustees on behalf of mortgage-

<sup>135</sup>6 Dunaway, *supra* note 14, § 69:28 ("Where a foreclosure sale occurs in the absence of authority, there is no valid execution of the power, and the sale is wholly void.")

<sup>136</sup>Moore v. Dick, 187 Mass. 207, 72 N.E. 967 (1905).

<sup>137</sup>See, e.g., *In re Foreclosure Cases*, 521 F. Supp. 2d 650 (S.D. Ohio 2007); *Riggs v. Aurora Loan Services, LLC*, 36 So. 3d 932, 933, 72 U.C.C. Rep. Serv. 2d 888 (Fla. 4th DCA 2010), review denied, 53 So. 3d 1022 (Fla. 2011); *Bank of New York v. Silverberg*, 86 A.D.3d 274, 926 N.Y.S.2d 532 (2d Dep't 2011).

<sup>138</sup>*U.S. Bank Nat. Ass'n v. Ibanez*, 458 Mass. 637, 941 N.E.2d 40 (2011) [hereafter *Ibanez*].

backed securitization trusts, foreclosed on properties without having legally valid assignments of the mortgages at the time they initiated foreclosure proceedings.<sup>139</sup> The assignments were executed and recorded months after the properties were sold at foreclosure auctions. As owners, they were unable to procure title insurance policies because of questions about their compliance with notice requirements. Each bank filed a quiet title action in the Land Court seeking to remove a “cloud” from the title of the property in question and requesting that the court adjudge and decree the mortgagor’s right, title and interest in the property was extinguished by the foreclosure sale.<sup>140</sup>

The banks argued that securitization documents, specifically the loan schedule or the agreement to purchase mortgages that were part of the securities deal, sufficiently assigned the mortgages to the securitization trust. The SJC did not reject the banks’ argument; however, the court held that the securitization agreement—the Pooling and Servicing Agreement (PSA)—could only suffice as a valid assignment of a mortgage if the PSA was properly executed and the schedule of loans sufficiently identified the mortgage in question.<sup>141</sup> Neither US Bank nor Wells Fargo could provide an executed PSA with a schedule of loans that contained information to sufficiently identify the mortgages in question.

The trustee banks raised multiple supplementary arguments in support of their contention that the foreclosures were valid. For example, they argued that an assignment ex-

<sup>139</sup>Land Court Justice Keith C. Long issued a ruling that invalidated two separate foreclosure sales. *U.S. Bank Nat. Ass’n v. Ibanez*, 2009 WL 795201 (Mass. Land Ct. 2009), judgment entered, 2009 WL 795204 (Mass. Land Ct. 2009), judgment aff’d, 458 Mass. 637, 941 N.E.2d 40 (2011); Judge Long’s decision in *Ibanez* was a consolidation of two cases, *U.S. Bank National Association, as trustee for the Structured Asset Securities Corporation Mortgage Pass-Through Certificates, Series 2006-Z v. Antonio Ibanez*, Misc. Case No. 08-384283 (KCL) and *Wells Fargo Bank, N.A., as trustee for ABFC 2005-OPT1 Trust, ABFC Asset Backed Certificates Series 2005-OPT1 v. Mark Larace and Tammy Larace*, Misc. Case No. 08-386755 (KCL).

<sup>140</sup>*U.S. Bank Nat. Ass’n v. Ibanez*, 2009 WL 795201 (Mass. Land Ct. 2009), judgment entered, 2009 WL 795204 (Mass. Land Ct. 2009), judgment aff’d, 458 Mass. 637, 941 N.E.2d 40 (2011).

<sup>141</sup>Adam Levitin, *Ibanez and Securitization Fail, Credit Slips*, Jan. 10, 2011 available at <http://www.creditslips.org/creditslips/2011/01/ibanez.html> (last visited Nov. 29, 2012).

ecuted in blank was sufficient to legally convey a mortgage.<sup>142</sup> The court rejected this argument explaining that an assignment of a mortgage that does not identify the assignee does not constitute a valid assignment.<sup>143</sup>

The banks also claimed that once a promissory note is transferred, the mortgage automatically follows the note.<sup>144</sup> The court rejected their position that a mortgage follows the note under Massachusetts's law. This analysis is particularly relevant in title theory states where a mortgage constitutes a conveyance of title to real property, and the transfer of an interest in real property must follow strict legal procedures to be valid and enforceable; "a mortgage or deed of trust alone is theoretically worthless as it is only a tool by which a creditor seeks repayment of an obligation. Logically, therefore, an assignment of nothing cannot turn into an assignment of something."<sup>145</sup>

The banks alternatively claimed that the backdated, post-foreclosure assignments, which were executed and recorded months after the foreclosure sale, were sufficient to validate the foreclosures after the fact as confirmatory assignments. The court held that a confirmatory assignment could only be valid if it is indeed confirming a previous assignment that legitimately transferred the mortgage to the assignee.<sup>146</sup> A backdated assignment cannot retroactively authenticate a foreclosure that already happened, and recording a "confirmatory assignment" without first creating the assignment is a confirmation of nothing.<sup>147</sup>

Ultimately, the court made clear that to meet its burden under Massachusetts's foreclosure law, the mortgagee must provide written documentation of a pre-foreclosure assign-

<sup>142</sup>Ibanez, *supra* note 162, at 51.

<sup>143</sup>Christopher J. DeCosta, *US Bank v. Ibanez: The Mortgage Industry's Documentation Practices in Focus*, 55 *Boston B. J.* 23 (2011).

<sup>144</sup>*Id.* at 24.

<sup>145</sup>David P. Weber, *The Magic of the Mortgage Electronic Registration System: It Is and It Isn't*, 85 *Am. Bankr. L.J.* 239, 241 (2011).

<sup>146</sup>Ibanez, *supra* note 162, at 55.

<sup>147</sup>The SJC also rejected arguments asserted by the appellant banks that the flaws were minor paperwork errors and substantial compliance with the state law was sufficient to satisfy their burden of proof.

ment to the foreclosing party.<sup>148</sup> Foreclosures stemming from securitization transactions cannot be based on supplemental instruments that attempt to fix or cover up the gaps in the chain of title.

Critics of the decision argued that the SJC retroactively changed accepted procedures, however, the court did not change the underlying law or its interpretation. The problem was that the financial industry implemented its own customs and procedures for use in day-to-day business practices, but failed to ensure that those customs complied with the longstanding rule of law. The SJC simply affirmed the existing state law protecting fundamental individual property rights.<sup>149</sup>

Although the *Ibanez* decision is only mandatory authority for foreclosures in Massachusetts, it received national attention because it emphasized that sloppy and careless securitization procedures could create gaps in chains of ownership and cause title defects.<sup>150</sup> In the context of foreclosures, these title issues have the potential to inflict serious consequences in all title theory states.<sup>151</sup> Since the beginning of 2007 there have been over 54,000 residential foreclosures in Massachusetts.<sup>152</sup> In a Moody's study of post-2005 first-lien loans that were in private-label RMBS, approximately 31,500 Massachusetts loans went through, or were in the midst of, foreclosure by January of 2011. Of the foreclosed loans, "third-party purchasers own approximately seventy percent of the properties that backed these loans."<sup>153</sup> All of these properties potentially have clouded titles.

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<sup>148</sup>Tracy Alloway, *The Full Story of the Ibanez Case*, Financial Times Alphaville, Jan. 18, 2011, available at <http://ftalphaville.ft.com/2011/01/18/455331/the-full-story-of-the-ibanez-case/> (last visited July 27, 2012).

<sup>149</sup>Jennifer B. McKim, *Judge Reaffirms Crucial Foreclosure Sale Ruling*, Boston Globe, Oct. 14, 2009.

<sup>150</sup>See Peter Pitegoff & Laura Underkuffler, *An Evolving Foreclosure Landscape: The Ibanez Case and Beyond*, American Constitution Society, Oct. 13, 2011.

<sup>151</sup>See Elizabeth A. Renuart, *Property Title Trouble in Non-Judicial Foreclosure States: The Ibanez Time Bomb?* (February 21, 2012). Albany Law School Research Paper No. 38 of 2011–2012. Available at SSRN: <http://ssrn.com/abstract=1968504>.

<sup>152</sup>Paul McMorrow, *Making Banks Justify Foreclosures*, Boston Globe June 26, 2012 at A11.

<sup>153</sup>Scott D. Samlin & Rinaldo Martinez, *Case Note: Massachusetts Supreme Judicial Court Decision in Bevilacqua v. Rodriguez*, 460 Mass. 762, 955 N.E.2d 884, 65 Consumer Fin. L.Q. Rep. 349, 351 (2011).

### **1. Effects of Unlawful Foreclosures on Third-Party Purchasers**

The logical question that followed the *Ibanez* ruling was whether a third-party purchaser of a foreclosed property could obtain clear title from a foreclosure deed, the validity of which rests on an unlawful foreclosure. In *Bevilacqua v. Rodriguez*, a third-party purchaser brought an “action to try title” in the Massachusetts Land Court to establish the validity of his title.<sup>154</sup> Essentially, a “try title” action compels parties with an interest in the subject property to appear in court and defend that interest in the land. If a party with an adverse claim fails to appear, then the court may bar the adverse party’s claim and quiet the title of the petitioner.

In this case, the adverse party was Rodriguez, the owner of the property at the time of the foreclosure. Rodriguez did not appear to assert his rights, but the Land Court dismissed Bevilacqua’s action and the SJC affirmed the decision. The court held that Bevilacqua did not possess record title to the property and, thus, did not have standing.<sup>155</sup>

In order to have standing to bring a “try title” action, a petitioner must have possession of the disputed property and hold “record title.”<sup>156</sup> Bevilacqua claimed that he possessed record title by virtue of the recorded quitclaim deed granted to him by US Bank. The foreclosure sale in Bevilacqua’s chain of title was *void ab initio*, or void from the beginning.<sup>157</sup> Under Massachusetts law, a void contract, such as a conveyancing instrument, cannot be enforced.<sup>158</sup> As the court noted, “there is nothing magical in the act of recording an instrument with the registry that invests an otherwise meaningless document with legal effect . . . [and] recording

<sup>154</sup>*Bevilacqua v. Rodriguez*, 460 Mass. 762, 955 N.E.2d 884, 892 (2011) [hereinafter *Bevilacqua*]. Owners of real property in Massachusetts may bring an action to try title in the Land Court if their record title is clouded by an adverse claim, or the possibility thereof. Mass. Gen. Laws ch. 240, §§ 1 to 5.

<sup>155</sup>On a side note, the petitioner in this case, Bevilacqua, had an owner’s title insurance policy on the property in question. The efforts to “try title” were in fact, the efforts by the title insurance company and its counsel of choice, to establish the title as insured. *Id.*, at 888–889.

<sup>156</sup>*Id.*, at 889.

<sup>157</sup>*Ibanez*, *supra* note 162, at 49–50 (“The SJC held that foreclosure under the power of sale requires strict compliance with all statutory requirements and an attempt to foreclose by a party lacking jurisdiction and authority is wholly void.”).

<sup>158</sup>*Id.*

is not sufficient in and of itself . . . to render an invalid document legally significant.”<sup>159</sup> The validity of the quitclaim deed is the relevant factor that determines the legitimacy of the “record title.” A grantor cannot transfer an interest without first having rightful ownership of that interest.<sup>160</sup> When Bevilacqua admitted that US Bank had no interest in the mortgage at the time it foreclosed, he effectively demonstrated the foreclosure sale was void and that his grantor’s title was invalid.<sup>161</sup>

Bevilacqua also argued that he had standing to try title because he was a bona fide purchaser for value and could not have known about the defective title.<sup>162</sup> Some title industry representatives also claim that third-party purchasers are protected as bona fide purchasers. For example, an ALTA official claimed the title industry was not worried about its liability for chain of title issues because “folks who buy (property) and have no knowledge that there may be some defect in the chain of title are protected very strongly by state law . . . . Every state provides protection to bona fide purchasers of real property for value.”<sup>163</sup>

The SJC disagreed and held that Bevilacqua was not entitled to such protection.<sup>164</sup> Although the exact dates were not mentioned, the court concluded that at the time the property was under agreement to be purchased from US Bank, the registry’s records would have shown that the bank was either a complete stranger to title or a mere assignee of the mortgage, not the owner of record. Alternatively, the registry’s records would have shown that US Bank conducted the foreclosure sale before receiving assignment of the

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<sup>159</sup>Bevilacqua, *supra* note 179, at 892.

<sup>160</sup>See *In re Grimes*, 147 B.R. 307 (Bankr. E.D. N.Y. 1992) (stating that a forged deed is a void instrument and transfers no title to property). See also, *Lloyd v. Chicago Title Ins. Co.*, 576 So. 2d 310, 311 (Fla. 3d DCA 1990) (“Controlling here is the general principle that the recording of a void or forged instrument cannot create legal title or protect those who may claim under it.”); *McCoy v. Love*, 382 So. 2d 647 (Fla. 1979); *Reed v. Fain*, 145 So. 2d 858 (Fla. 1961); *Farmers & Ginners Cotton Oil Co. v. Hogan*, 267 Ala. 248, 100 So. 2d 761 (1957).

<sup>161</sup>Bevilacqua, *supra* note 179, at 893.

<sup>162</sup>*Id.*

<sup>163</sup>Carolyn Said, *Robosigning Focuses Attention on Title Companies*, SF Gate, Mar. 3, 2012 available at <http://www.sfgate.com/business/article/Robosigning-focuses-attention-on-title-companies-3378567.php>.

<sup>164</sup>See Bevilacqua, *supra* note 179.

mortgage.<sup>165</sup> The court concluded that based on the publicly available information, the circumstances could not show that Bevilacqua was “a bona fide purchaser for value and without notice that U.S. Bank’s title was doubtful.”<sup>166</sup>

## **2. The Effect of Paperwork Flaws on Mortgage Discharges**

It is critical to note that the defective assignments and other invalid or forged documents recorded in a chain of title can have an impact on all titles’ marketability, not only those with foreclosures in their history. Without a valid chain of assignments showing the transfer of a mortgage, a discharge of a mortgage may be insufficient to prevent it from clouding the title.<sup>167</sup> Given the many errors that occurred in securitization transactions, the secrecy of the MERS registry and its internal transfers between members, and the fact that many MERS members and lending entities no longer exist, there may be more questions about the ownership of real property interests than answers.

Unraveling complex securitization transactions to rectify title issues may seem like an extreme inconvenience, but there should not be a margin of error when it comes to seizing a family’s home. Landowners were not a party to securitization transactions, but they will experience the consequences through adverse claims and uncertain titles. In *Bank of New York v. Silverberg*, the presiding judge admonished the use of MERS and said, “The law must not yield to expediency and the convenience of lending institutions. Proper procedures must be followed to ensure the reliability of the claim of ownership, to secure the dependable transfer of property, and to assure the enforcement of the rules that govern real property.”<sup>168</sup>

## **VI. Liability of Title Insurers for Title Defects**

Title insurance companies did not directly cause defective titles; however, by issuing title insurance policies, they as-

<sup>165</sup>Id., at 897.

<sup>166</sup>Id.

<sup>167</sup>Deborah L. Thorne & Ethel Hong Badawi, Does “The Mortgage Follow the Note”? Lessons Learned, Best Practices for Assignment of A Note and Mortgage, *Am. Bankr. Inst. J.*, May 2011, at 54, 84 (“There is no substitute for a formal assignment of the mortgage. All assignments should be dated, identify the assignor and assignee, and be recorded. Blank assignments may not be sufficient and may be void.”).

<sup>168</sup>*Bank of New York v. Silverberg*, 86 A.D.3d 274, 283, 926 N.Y.S.2d 532 (2d Dep’t 2011).

sumed the risk of title flaws caused by the unlawful actions of lenders, servicers, foreclosure law firms and other entities involved in the securitization of residential mortgages and their foreclosure.

Title companies market their products touting extensive experience examining property titles.<sup>169</sup> The issuance of a policy is “predicated upon a careful examination of the muniments of title, an exhaustive study of the applicable law and the exercise of expert contract draftsmanship.”<sup>170</sup> When consumers purchase title insurance, they expect to obtain a “professional title search [and] legal opinion as to the condition of title, and a guarantee.”<sup>171</sup> There is no expectation that a consumer involved in a conveyancing transaction will have the knowledge or ability to identify title issues or understand their significance. There is an inherent asymmetry of information and understanding between title insurers and their consumers—especially when dealing with homeowners.

A title that contains an invalid foreclosure sale is not objectively marketable, and will potentially harm the many parties associated with the property—the original owner, the third-party purchaser, the entity that loaned money to the third-party purchaser and the title insurer. In most foreclosures, the mortgagors were delinquent and it was inevitable that they would not be able to keep their homes. The new owners legitimately purchased the property and believed they were receiving clear title. Yet, if the foreclosing entity was not the holder of the mortgage at the time the foreclosure was initiated, the foreclosure sale could be void and the people who paid for the property may not own it. The third-party purchaser would then need to establish marketable title. A void foreclosure sale means the former owner’s equitable right of redemption is still legally intact, and all junior liens that existed before the sale continue to encumber the property.<sup>172</sup> All of these legal and equitable interests would

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<sup>169</sup>L. Smirlock Realty Corp. v. Title Guarantee Co., 52 N.Y.2d 179, 437 N.Y.S.2d 57, 418 N.E.2d 650, 654, 17 A.L.R.4th 1067 (1981).

<sup>170</sup>U.S. v. City of Flint, Genesee County, State of Mich., 346 F. Supp. 1282, 1285 (E.D. Mich. 1972).

<sup>171</sup>Lawyers Title Ins. Corp. v. Research Loan & Inv. Corp., 361 F.2d 764 (8th Cir. 1966).

<sup>172</sup>See e.g., Hartman v. Shambaugh, 96 N.M. 359, 630 P.2d 758 (1981). See also, Black v. Pioneer Nat. Title Ins. Co., 138 Ga. App. 138, 225 S.E.2d 689 (1976) (Defendant was liable under policy which insured plaintiff’s title to property subject to third person’s easement for right of way where

likely fall within the scope of a title insurance policy issued when the property was purchased at foreclosure.

A prima facie case in an action to recover benefits under a title insurance policy includes five essential elements.<sup>173</sup> The insured plaintiff must prove that: (1) the insurer issued a title insurance policy covering the plaintiff's property or property interest and designating the plaintiff or the person through whom the plaintiff is claiming benefits as the named beneficiary; (2) the plaintiff's title proved to be defective, encumbered, or unmarketable; (3) the defect, encumbrance, or other matter affecting the plaintiff's interest was within the scope of coverage of the title insurance policy; (4) the plaintiff sustained an actual loss resulting from the defect, encumbrance, or other matter; and (5) the plaintiff complied with the insurer's notice of claim and proof of loss requirements or duly filed a claim for title insurance benefits and the claim was denied.<sup>174</sup>

#### **A. Insured Seeks Remedy**

Upon discovery of a title defect or a claim by someone asserting an adverse interest in the property, the insured must provide notice of the claim to the insurer and may also have to provide proof of loss information to recover benefits under the policy.<sup>175</sup> Upon receipt of a claim, the insurer will first consider whether the claim falls within the scope of the policy's coverage. An insurer has no obligation to the insured unless it has sufficient knowledge of the claim and the opportunity to carry out its contractual obligations set out in the title insurance policy.<sup>176</sup>

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third person proved to have fee simple interest in right of way and not mere easement.).

<sup>173</sup>46 Larsson, supra note 51.

<sup>174</sup>Id.

<sup>175</sup>See Barlow Burke, *Law of Title Ins.*, § 6.02 (2010) ("The purpose of notice provisions is to allow the insurer to form an intelligent estimate of its rights and liabilities, to afford it an opportunity for investigation, and to prevent fraud and imposition upon it.").

<sup>176</sup>See, *Lawyers Title Ins. Corp. v. D.S.C. of Newark Enterprises, Inc.*, 544 So. 2d 1070, 1072 (Fla. 4th DCA 1989) ("Given the foregoing it follows that the title insurance company does not and should not avoid liability when a defective condition of title not excepted from coverage subsequently causes a loss to the insured even though the insured knew or should have known of the particular defect.").

If the title defect is covered under the policy, the insurer must decide on a course of action.<sup>177</sup> Standard ALTA policies give insurers some leeway; they can choose to settle a claim by paying the full amount of the policy, defend the title in litigation, or take some affirmative action to clear the defect and establish the title as insured.<sup>178</sup> If the insurer fulfills its contractual obligations under the policy, then it will not be liable for the insured's losses or damages.<sup>179</sup>

Even if an insured is seeking damages, the insurer can opt for the alternative route of clearing title in lieu of paying the insured's claim. For example, in *Elliot v. Chicago Title Ins. Co.*, the court held that a title insurer "is entitled by policy conditions to pursue an action to quiet title . . . before the insured may bring any action to force indemnification under the policy."<sup>180</sup> If an insurer decides to restore the marketability of the title rather than pay for the insured's loss, there is an obligation to act in good faith, a duty that is implied in every contract as a matter of law. Furthermore, based on court interpretations of standard policy clauses, the insurer has a contractual duty to take action within a reasonable time or to act with reasonable diligence.<sup>181</sup> If the insurer fails to honor its contractual obligations, the insured has a cause of action for breach of contract and the insured can "recover not only the amount due under the policy, but also consequential, incidental, and punitive damages."<sup>182</sup>

<sup>177</sup>See, *Horn v. Lawyers Title Ins. Corp.*, 89 N.M. 709, 711, 557 P.2d 206, 208, 94 A.L.R.3d 1182 (1976) ("The rights and duties of the parties are fixed by the contract of title insurance.").

<sup>178</sup>1 Palomar, supra note 64, § 10:5 (insurer has a choice of whether to settle an adverse claim, pay its insured the policy limits, or defend the title in litigation).

<sup>179</sup>*Elliott v. Chicago Title Ins. Co.*, 123 Ill. App. 3d 226, 78 Ill. Dec. 521, 462 N.E.2d 640, 644 (1st Dist. 1984) ("[S]o long as the title insurer responds to the insured's claim within a reasonable time, the insured will not be entitled to damages caused by unmarketability of the title during the pendency of litigation to defend or clear it.").

<sup>180</sup>*Elliott v. Chicago Title Ins. Co.*, 123 Ill. App. 3d 226, 78 Ill. Dec. 521, 462 N.E.2d 640 (1st Dist. 1984).

<sup>181</sup>See generally, *Hatch v. First American Title Ins. Co.*, 895 F. Supp. 10 (D. Mass. 1995) (holding that whether an insurer's actions to cure a title defect were reasonable was a question of fact).

<sup>182</sup>*Palomar*, supra note 169, § 10:2; *Dreibelbiss Title Co., Inc. v. MorEquity, Inc.*, 861 N.E.2d 1218 (Ind. Ct. App. 2007) (holding that the policy limits restrict the amount the insurer has to pay in performing its contract, not damages recoverable for breach of contract).

### **B. Defense Against Adverse Claim**

In addition to indemnifying the insured from financial loss caused by a title defect, a standard title insurance policy requires the insurer to defend the title against adverse claims covered by the policy. The duty to defend the insured's title is extremely broad and is triggered when a cause of action against the property includes at least one claim that is covered by the policy.<sup>183</sup> The claims alleged in the pleadings determine an insurer's duty to defend rather than the ultimate outcome of the litigation.

After receiving the insured's notification of an adverse claim, the insurer must proceed within a reasonable time. Once insurers are made aware of title defects, they have a reasonable opportunity to investigate the circumstances and "facts affecting their liability [and] to determine the existence and extent of that liability."<sup>184</sup>

The duty to defend is determined by comparing the facts alleged in the complaint or petition with coverage provided by the terms of the policy. This rule is often called the "eight corners rule."<sup>185</sup> If the insurer's duty to defend is clear from the facts alleged and it fails to defend the insured within a reasonable time, it may be liable for insured's accrued damages during any delay.<sup>186</sup>

Deciding whether an insurer's actions were reasonable is a

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<sup>183</sup>See *United Bank v. Chicago Title Ins. Co.*, 168 F.3d 37 (1st Cir. 1999); *Associated Bank, N.A. v. Stewart Title Guar. Co.*, 881 F. Supp. 2d 1058 (D. Minn. 2012); *Fleishour v. Stewart Title Guar. Co.*, 743 F. Supp. 2d 1060 (E.D. Mo. 2010); *Chicago Title Ins. Co. v. Kent School Corp.*, 361 F. Supp. 2d 4, 16 A.L.R.6th 913 (D. Conn. 2005) ("if an allegation of the complaint falls even possibly within the coverage, then the insurance company must defend the insured").

<sup>184</sup>See, *Boel v. Stewart Title Guar. Co.*, 137 Idaho 9, 43 P.3d 768 (2002). See also, *Zions First Nat. Bank, N.A. v. National American Title Ins. Co.*, 749 P.2d 651 (Utah 1988).

<sup>185</sup>Douglas R. Richmond, *Reimbursing Insurers' Defense Costs: Restitution and Mixed Actions*, 35 San Diego L. Rev. 457, 460-61 (1998).

<sup>186</sup>See, *Premier Tierra Holdings, Inc. v. Ticor Title Ins. Co. of Florida, Inc.*, 2011 WL 2313206, \*9 (S.D. Tex. 2011) ("A title insurer who has materially breached its covenant to act with reasonable diligence in curing title defects cannot require its insured to comply with other contract terms, such as policy loss limitations when the insurer is paying the claim according to the policy's terms."). See also, *Nebo, Inc. v. Transamerica Title Ins. Co.*, 21 Cal. App. 3d 222, 98 Cal. Rptr. 237 (4th Dist. 1971) (failure to remove title defect within reasonable time after notice thereof made insurer liable for the insured's damages accruing during the insurer's attempts).

question of fact based on the particular situation. Generally, a court will consider two factors when determining an insurer's liability: "(a) whether both the length of and reasons for the insurer's delay were reasonable, and (b) whether the insurer's delay significantly disadvantaged its insured."<sup>187</sup>

### **C. Title Insurers' Liability for Breach of Contract**

The terms of a standard title policy preclude recovery for losses incurred during pending litigation; however, limitations on losses do not apply to damages arising from, or caused by, the insured's breach of contract or breach of the covenant to act diligently. An insurer can limit its liability and avoid paying claims by complying with its contractual duties and diligently clearing any title defects; however, if an insurer decides to engage in protected litigation it can expose itself to damages beyond the terms of the policy. In *Cocoa Properties, Inc. v. Commonwealth Land Title Insurance Co.*, a mortgagee filed an action to foreclose a mortgage on the insured property.<sup>188</sup> The mortgage was a valid lien on the property, but it was not listed as an exception on the policy, therefore, it clearly fell within the scope of the title policy's coverage. The insurer unsuccessfully defended the insured in the foreclosure action, but later purchased the mortgage and discharged the lien to clear the title.<sup>189</sup> The court held that the insurer "gambled on litigation, and after losing in the trial court, finally cleared the title through a purchase."<sup>190</sup> The litigation did not successfully clear the title, so the policy did not prevent the insurer from having liability for the insured's losses. The court remanded the case for the trial court to determine whether the insurer acted within a reasonable time.

Similarly, in *Premier Tierra Holdings, Inc. v. Ticor Title Ins. Co. of Florida, Inc.*, the court found that policy limits on liability were not applicable to damages arising from an

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<sup>187</sup>Joyce Palomar, *supra* note 169, § 11:3.

<sup>188</sup>*Cocoa Properties, Inc. v. Commonwealth Land Title Ins. Co.*, 590 So. 2d 989 (Fla. 2d DCA 1991).

<sup>189</sup>*Id.*

<sup>190</sup>Mark A. Brown & Christopher W. Smart, *Are Consequential Damages Recoverable Under A Title Insurance Policy for the Time It Takes to Attempt to Cure A Title Defect?*, Fla. B.J., (July/August 2012) at 47, 49.

insurer's breach of a material term of the insurance policy.<sup>191</sup> The insured alleged that Ticor had breached its duty of reasonable diligence and "sought damages in the amount of the decrease in fair market value that resulted from Ticor's delay in curing the title defects for nearly a year after discovery of the defects."<sup>192</sup> The insurer argued that recovering damages for a defective title was expressly limited by the terms of the policy, but the court held that the insured could recover for breach of contract and the insurer's failure to perform its contractual obligations with reasonable diligence and in good faith. The Court further stated that the "damages for breach of the covenant to defend are separate and distinct from damages for a defect in title."<sup>193</sup>

Homeowners are not the only policyholders to whom title insurers owe a duty. When people finance purchases of property, the lenders require them to buy lenders title insurance. When title defects surface, lenders also have claims. For example, in *Bank of Sacramento v. Stewart Title Guar. Co.*, the Ninth Circuit recognized that an insured lender's claim for damages, arising from an insurer's failure to pursue litigation in a reasonably diligent manner, was sufficient to survive the insurer's motion to dismiss.<sup>194</sup> The Bank sought to recover losses resulting from its "increased carrying costs for any additional time title was unmarketable due to the alleged lack of reasonable diligence."<sup>195</sup> The court also found that the Bank alleged sufficient facts to support its claim for breach of the implied covenant of good faith and fair dealing.<sup>196</sup> Under the policy, the insurer had an obligation to clear title in a reasonably diligent manner and failure to act

<sup>191</sup>2011 WL 2313206, \*9 (S.D. Tex. 2011) [hereinafter *Tierra Holdings*].

<sup>192</sup>Jerel J. Hill, Karen C. Ahearn, Steven R. Parker, Recent Developments in Title Insurance Litigation, 47 *Tort Trial & Ins. Prac. L.J.* 501, 510 (2011).

<sup>193</sup>60 V. Woerner, A.L.R.2d 972, § 8 (1958).

<sup>194</sup>*Bank of Sacramento v. Stewart Title Guar. Co.*, 462 Fed. Appx. 766, 767 (9th Cir. 2011).

<sup>195</sup>*Id.* at 766.

<sup>196</sup>*Id.* at 767. ("To properly allege a breach of the covenant of good faith and fair dealing, the Bank must show that (1) benefits due under the policy have been withheld; and (2) the reason for withholding benefits must have been unreasonable or without proper cause.") (citing *Love v. Fire Ins. Exchange*, 221 Cal. App. 3d 1136, 1151, 271 Cal. Rptr. 246 (4th Dist. 1990)).

in a reasonably diligent manner is by definition unreasonable.<sup>197</sup>

The extent of securitization related title issues is still unknown and the applicable case law is continuing to develop. It is difficult to predict the full amount of the damage because title defects commonly remain unnoticed until the property is put on the market or refinanced. Regardless of the confusion surrounding the developing case law, title insurers still have contractual obligations to clear titles or pay claims for securitization-related title defects, even without having definitive answers to all of the legal issues. Moreover, the complexity of the problems creates increased asymmetry between insurers and consumers.

### **VII. Methods for Clearing Title**

Fixing the marketability of land titles brings up two essential questions: how to fix the damage inflicted by invalid conveyancing documents recorded in public land records and who should pay for it. Title insurance companies will be liable on many of the policies they issued. In a statement he may later regret, a representative of ALTA said “title insurers are prepared to step up when issues arise . . . if a homeowner has purchased a title insurance policy and a defect in the foreclosure comes up after the fact, we will stand there and protect them.”<sup>198</sup>

In the past, the SJC has held that “it is possible for a foreclosure deed, ineffective due to noncompliance with the power of sale, to nevertheless operate as an assignment of the mortgage itself.”<sup>199</sup> The court stated that a party in Bevilacqua’s position might be considered an assignee of the mortgage, but only if there was a valid chain of assignments leading back to the original mortgagee. Based on the chain of title documentation that is common in securitization, that is a big “If!”

If a third-party purchaser can show that he is the assignee of an invalidly foreclosed mortgage, he could likely re-foreclose on the mortgage. This requires the foreclosure process to be restarted from the beginning. All of the interests

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<sup>197</sup>The same facts that give rise to breach of contract claims could also support state law unfair and deceptive practices (UDAP) claims, which could subject insurers to up to treble damages.

<sup>198</sup>Said, *supra* note 188.

<sup>199</sup>See, *Holmes v. Turner’s Falls Co.*, 142 Mass. 590, 8 N.E. 646 (1886); *Dearnaley v. Chase*, 136 Mass. 288, 290, 1884 WL 10448 (1884); *Brown v. Smith*, 116 Mass. 108, 1874 WL 9659 (1874).

in the property at the time of the invalid foreclosure continue to encumber the property, along with the original mortgage. All junior lien holders and any party with an interest in the property must be notified before a foreclosure sale can proceed. Reforeclosure carries the risk that a third party will out bid the holder of the mortgage at the foreclosure auction. This would divest the third-party purchaser of his or her property and all rights and interests in the title. In the event that a third-party purchaser ends up without any valid interest in the property, his insurer will likely have to pay all the costs associated with the foreclosure process, including attorneys' fees.

Alternatively, an insurer could establish the insured's title by removing all adverse claims encumbering the property.<sup>200</sup> Because the foreclosure was invalid, the former owner and any other parties with an interest in the property, including second mortgage holders, must willingly release all of their rights, title and interests, which could make this method of clearing title particularly difficult and expensive.

#### **A. Subrogation and Assignability of the Insured's Claims**

Once an insurer performs its obligations under the policy, the standard ALTA owner's policy requires the insured to assign all "rights and remedies . . . against any person or property related to the claim"<sup>201</sup> to the insurer "to prevent [a] wrongdoer from avoiding the consequences of its acts and to prevent the insured from being unjustly enriched by recovery from the insurer as well as the wrongdoer."<sup>202</sup> The insurer can then pursue any of the available rights or claims in the insured's name. In theory, this provision allows a title insurance company to bring an action against an individual or entity that caused or created title defects.

Title insurance companies are liable for the cost of establishing marketable title on countless properties; however, it is not clear they have to foot the bill on their own. If title insurers are facing extensive liability, we may well see attempts to recover against attorneys and firms like LPS that were in a position to prevent unlawful foreclosures,

<sup>200</sup>2 Palomar, supra note 63, at Appendix B2 (ALTA Owner's Policy (June 17, 2006)).

<sup>201</sup>American Land Title Ass'n, 2006 Owner's Policy, Introduction, available at <http://www.alta.org/forms> (last visited Dec. 1, 2012).

<sup>202</sup>Palomar, supra note 169, § 8:10.

but instead contributed to the problems and reaped the profits.

**VIII. Conclusions**

Failing to properly transfer ownership of loans and mortgages, recording fraudulent documents and performing unlawful foreclosures are some of the actions that created title defects. Those actions evince a systemic failure to comply with longstanding principles of real property law and regulations governing financial transactions. At the end of the day it will be the title insurers who will have to resolve the resulting plague of toxic titles.