

# Alert To Problems Of Grossly Inaccurate Documents Used In The Land Title Underwriting For Commercial Real Estate Financing

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## I. Introduction:

The Commercial Mortgage Backed Securities (“CMBS”) market is bracing for record levels of defaults on commercial loans in 2012. According to Trepp, LLC, troubled commercial real-estate loans accounted for more than 65% of failed banks’ \$617 million in problem loans for the month of October 2011 alone.<sup>1</sup> Approximately \$1.4 trillion in commercial real estate loans will come due between now and 2014.<sup>2</sup> Most of these loans were made in 2006 and 2007, and the underlying collateral has lost as much as 40 percent of its value.<sup>3</sup> Nearly half of these loans are underwater and, consequently, borrowers and lenders are faced with an equity gap that some experts have estimated to be more than \$800 billion.<sup>4</sup>

- **What if there was a way out of these commercial loans so that owners, lenders and commercial mortgage backed security (“CMBS”) holders could recover 100% of their loan values rather than the 40% to 60% of purchase price that these commercial properties are currently worth in the marketplace?**
- **What if the way to recover 100% of a commercial property’s purchase price was through the property’s title insurance policy?**

Harbinger Analytics Group has discovered a widespread problem of inaccurate (and fraudulent) documents used in the land title underwriting for commercial real estate financing. This fraud is accomplished through inaccurate and incomplete filings of statutorily required records (commercial land title surveys detailing physical boundaries,

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<sup>1</sup> Jacqueline Palank, *Commercial Real Estate Continues to Weigh on Banks*, The Wall Street Journal (November 7, 2011).

<sup>2</sup> Richard Hollowell, *Guest Column: Commercial Real Estate, 2012*, Commercial Property Executive (December 9, 2011).

<http://www.cpexecutive.com/finance/guest-column-commercial-real-estate-2012-2/>

<sup>3</sup> *Id.*

<sup>4</sup> *Id.*

encumbrances, encroachments, etc.) on commercial properties in California, many other western states and possibly throughout most of the United States.<sup>5</sup>

Because title insurers performing land surveys in-house and independent land surveyors<sup>6</sup> (often hired by lenders, title insurers and/or national land survey brokerages claiming ownership of completed work product) have committed actual and/or constructive fraud by knowingly failing to conduct accurate boundary surveys and/or failing to file the statutorily required documentation in public records, owners, lenders or CMBS holders of these commercial properties may be able to recover 100% of their purchase price from their title insurers based on contract rescission claims.

Owners, lenders and CMBS holders may also be eligible for “put backs” of these afflicted properties if the loans were insured by the FDIC (for example, assets acquired, packaged and resold through bank closures or TALF via the PPIP program). Harbinger Analytics informed the FDIC (by detailed reports) about potential problems in the commercial real estate loans in July 2009. Harbinger Analytics also informed one of the four primary title insurer’s executives and general counsel (by detailed reports) of the failures, fraud and exposure to liability in their underwriting way back in early 2007.

- **Why wouldn’t a title insurer be concerned about underwriting poor quality ALTA land title surveys?**

Prior to the financial crisis of 2008, title insurance companies realized an average of 5% in loss/loss adjustments (compared to 70-85% in most other casualty insurance coverage).<sup>7</sup> Title insurers were able to outsource and reduce costs without realizing a loss/loss adjustment change. Presumably today, the title insurers have seen a spike in payable claims due to loss of priority (subordination), but they have not felt the effects of the flawed commercial loans to date.

In context, Mr. Woolley was offering to demonstrate fraud within the records maintained by one of the four main title insurer’s offices. These same records were relied upon for the underwriting of title insurance policies. Mr. Woolley believed, at the time he contacted this title insurer’s executives and general counsel in 2007, that this title insurer was unwittingly a victim of land surveying fraud. Later, it was discovered that this title insurer was inserting themselves into land surveying contracts by performing land title surveys in house and/or through their own network of subcontractors and then claiming the survey work product as their own via copyright protection. For example, First

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<sup>5</sup> Harbinger Analytics Group conducted a study of approximately 14,500 commercial loans initiated between 2005-2009 in California, with a minimum loan amount of \$3.5 million, and found compliance with relevant statutes in less than 10% of all cases.

<sup>6</sup> In California, most surveyors carry errors and omissions (E&O) policies which range from \$1-5 million dollars.

<sup>7</sup> United States Government Accountability Office, *TITLE INSURANCE Actions Needed to Improve Oversight of the Title Industry and Better Protect Consumers* (April 2007) GAO-07-401.

American also created eAppraiseIT that was subsequently sued by the FDIC in *FDIC v. Corelogic Valuation Services, LLC*.<sup>8</sup> Although several causes of action were subsequently dismissed from this complaint, appraisal services are much more subjective than land surveying.<sup>9</sup> After being warned about these fraudulent activities, this major title insurer apparently never changed their business model and/or demanded statutorily required records of survey in California.

## II. Title Insurance, Insurers and Land Surveyors:

Title insurance is a form of indemnity insurance predominantly found in the United States that insures against financial loss from defects in title to real property and from the invalidity or unenforceability of mortgage liens. There are basically only four (4) U.S. national families of title insurers which underwrite approximately 92% of the title insurance market.<sup>10</sup> Most states are dominated by a group of two or three title insurers, sometimes including a regional title insurer.<sup>11</sup>

Land surveyors and land title insurers play a crucial role in buying and selling commercial properties. Most mortgage lenders require an American Land Title Association (“ALTA”) land title survey for properties to evaluate and define the property’s boundaries, site improvements, easements and encroachments as a condition of obtaining title insurance (required for mortgage financing by lenders). The insurance policies generated by title companies are called ALTA Owner’s and Loan Policies. An ALTA policy insures against off-record defects.<sup>12</sup> The ALTA policy also provides “covered risk” for “unmarketable title” and “fraud”. The title insurer and lender each understand a title defect will tie up a property for years and can cost hundreds of thousands of dollars to remedy, therefore, they require that a property is surveyed as a matter of due diligence prior to funding. This need for title information is further evidenced by an inherently frugal lender’s willingness to spend \$5,000 - \$50,000 per land title survey.

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<sup>8</sup> *FDIC v. Corelogic Valuation Services, LLC f/k/a eAppraiseIT, LLC, et al* (CD Cal. May 9, 2011) Case No. SA CV 11-0704 DOC (ANx).

<sup>9</sup> *FDIC v. Corelogic Valuation Services, LLC f/k/a, LLC, et al* (CD Cal. November 14, 2011) Case No. SA CV 11-0704 DOC (ANx), Order Granting In Part and Denying In Part Defendants’ Motion To Dismiss.

<sup>10</sup> [http://en.wikipedia.org/wiki/Title\\_insurance\\_in\\_the\\_United\\_States](http://en.wikipedia.org/wiki/Title_insurance_in_the_United_States) (citing American Land Title Association, *2007 Market Share by Family and State – Distribution*, found at <http://www.alta.org/industry/financial/cfm>); See also United States Government Accounting Office, *TITLE INSURANCE Actions Needed to Improve Oversight of the Title Industry and Better Protect Consumers* (April 2007) GAO-07-401.

<sup>11</sup> *Id.* For example, in 2005 in California, about 66% of the market share was split between the two largest insurers – First American and Fidelity.

<sup>12</sup> *Lick Mill Creek Apartments v. Chicago Title Insur. Co.* (1991) 231 Cal. App. 3d 1654, 1659.

Prior to conducting an actual survey, the land surveyor receives a “preliminary title report” from the title insurer describing what that title insurance company is willing to insure. The land surveyor<sup>13</sup> takes the preliminary title report’s property description and compares it to the actual condition of the property on-site.<sup>14</sup> The surveyor researches public records looking for previously discovered defects or discrepancies in title. The land title surveyor is tasked with identifying and documenting these material defects in title as a part of the surveyor’s due diligence.

Because land title surveyors are often hired directly by title insurers, lenders, attorneys or national land surveying brokerages, various parties may claim ownership of the surveyors’ work product. Foolishly, outside parties will occasionally insert themselves into the land surveyor’s contract to realize additional fees through mark-up costs. Some title insurers even insert themselves into the land surveying contract and/or offer land title surveying services by way of their employees or vendor subcontractors. They further insert themselves by specifying the format of the information displayed and claiming a copyright to the information. The contracting parties realize larger profits by selecting lowest bidding surveyors (who then cut corners by failing to properly research properties and failing to complete statutory filings). In comparison, it is very unlikely the contracting parties select their professionals, such as counsel, by the same low bid process.

In California and in many western states, if the land title surveyor finds any material discrepancies between the property description supplied by the title insurer and the actual condition or location of the land and, if no Record of Survey has been previously filed to document these discrepancies, the surveyor must submit a proper Record of Survey within 90 days, to the County Surveyor’s Office (subject to third party review and approval) pursuant to California Business & Professions Code §§ 8762, 8766, et seq.<sup>15</sup> Once reviewed for procedures, statutory compliance and accepted by the County, this document becomes available to the general public.

Despite these explicit requirements, surveyors are **not** performing the required ALTA land title surveys, pursuant to adopted written standards, are **not** conducting thorough due diligence (i.e. proper research, evidence collection/evaluation in relation to the insured deed), are **not** filing Records of Survey and are **not** providing accurate boundary and chain of title information to title insurance underwriters. These repeated statutory violations go beyond mere negligence and constitute constructive fraud and/or

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<sup>13</sup> Oftentimes, the surveyor is hired by attorneys, national brokerages or title insurers (with in-house surveying capacities or offering vendor contracting involved in the sale).

<sup>14</sup> Beginning in the early 1800s, Government Land Office (“GLO”) surveyors were tasked with subdividing land into one square mile sections – each containing 640 acres. In reality, no two (2) sections are exactly the same when measured on the ground for any number of reasons, (e.g. instrumentation of the era, rough terrain, and, sometimes, the surveyors’ failure to survey at all). These subdivided 640 acre varied from a few inches to several hundred feet and many of discrepancies remain today and can manifest on the micro-level (subdivision, city block etc.).

<sup>15</sup> The failure to submit the Record of Survey is considered negligence per se in California.

actual fraud. The breach of statutory laws constitutes negligence per se and negligence (violation of a standard of care) is then presumed. Therefore, title insurance policies are based upon fraudulent and/or (at least) negligently prepared survey documents.

This isn't the last of the bad news - additional claims may exist from third parties when a boundary line is common between adjacent owners.

### **III. Claims Against Title Insurers and Land Surveyors:**

- **What if the ALTA land title survey is fraudulent?**
- **Who is liable? The title insurance company? The land title surveyor?**

There is an opportunity for owners, lenders and CMBS holders to recoup losses incurred by decreased property values by filing contract rescission claims based on unmarketable title, fraud<sup>16</sup>, constructive fraud<sup>17</sup> and/or negligence<sup>18</sup> and/or negligence per se<sup>19</sup> against the property's title insurer and land surveyor. Although a representation of opinion is ordinarily not actionable, misrepresentations of opinion are actionable where the defendant holds himself out to be specially qualified.<sup>20</sup> The surveyor's work is often

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<sup>16</sup> The elements of fraud, which give rise to the tort action for deceit, are:

- (1) misrepresentation (false representation, concealment or nondisclosure);
- (2) knowledge of falsity;
- (3) intent to defraud, i.e., to induce reliance;
- (4) justifiable reliance;
- (5) resulting damage

Witkin, *5 Summary of California Law, Torts* (9<sup>th</sup> ed. 1987) § 676, pg. 778. A document posted on Fannie Mae's website states that fraud is "a misstatement, misrepresentation or omission that cannot be corrected and that was relied upon by Fannie Mae to purchase the mortgage being refinanced." A scheme or pattern involves "two or more mortgages and two or more perpetrators acting in common effort." Fannie Mae, *Home Affordable Finance FAQ* (November 15, 2011) <https://www.efanniemae.com/sf/mha/mharefi/pdf/refinancefaqs.pdf>

<sup>17</sup> Constructive fraud is defined as any act, omission, or concealment involving a breach of a legal or equitable duty, trust, or confidence that results in damage to another even if the conduct is not otherwise fraudulent. CEB, *California Real Property Remedies and Damages I* (2<sup>nd</sup> ed. 2005) § 3.27, pp. 128-131. See also California Civil Code § 1573.

<sup>18</sup> The elements of negligence are "duty, breach, causation and damages." *Phinney v. Casale*, (1996) 40 Conn. App. 495, 500, 671 A.2d 851. Professional negligence or malpractice is defined as "the failure of one rendering professional services to exercise that degree of skill and learning commonly applied under all the circumstances in the community by the average prudent, reputable member of the profession with the result of injury, of loss, or damage to the recipient of those services." *Vona v. Lerner* (2002) 72 Conn. App. 179, 187, 804 A.2d 1018.

<sup>19</sup> Failure to conduct an accurate survey constitutes negligence per se by the licensed surveyor. As stated in the California Code of Regulations, Title 16, Division 5, § 419 (e) (C) (2), "Negligence in the practice of professional engineering and/or land surveying: (4) Failure to file a Record of Survey and/or corner record in the practice of professional land surveying. Noncompliance constitutes negligence per se."

<sup>20</sup> Witkin, *5 Summary of California Law, Torts* (9<sup>th</sup> ed. 1987) § 678, pg. 779. § 680, pg. 781-782.

viewed as an expression of professional opinion and may be considered as representations of fact. It only takes one false representation of a material fact [encroachment] to create a case for fraud.<sup>21</sup>

“Unmarketable title” is defined in Section 1(k) of the ALTA Owner’s Policy and Section 1(m) of the ALTA Loan Policy as:

“title affected by an alleged or apparent matter that would permit a prospective purchaser or lessee of the title or lender on the title to be released from the obligation to purchase, lease, or lend if there is a contractual condition requiring delivery of marketable title.”

Conversely, “marketable title” is defined as:

“such a title free from reasonable doubt, and such that a reasonably prudent person, with full knowledge of the facts and their legal bearings, willing and anxious to perform his contract, would, in the exercise of that prudence which business men ordinarily bring to bear upon such transactions, be willing to accept and ought to accept. Title must be so far free from defects as to enable the holder, not only to retain the land, but possess it in peace, and, if he wishes to sell it, to be reasonably sure that no flaw or doubt will arise to disturb its market value.”<sup>22</sup>

A title insurance policy promises that, if the state of the title is other than as represented on the face of the policy, and if the insured suffers loss as a result of the difference, the insurer will reimburse the insured for that loss and any related legal expenses, up to the face amount of the policy.<sup>23</sup> From the information supplied by the surveyor, the title insurance company writes the actual title insurance policy including any defects found by the surveyor and specifically excludes those defects from title insurance coverage unless a specific endorsement is written.

**A. Title Insurer:**

An inaccurate ALTA land title survey gives rise to an unmarketable title claim by an owner, lender or CMBS holder against the title insurer for the value of the property at

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<sup>21</sup> As to matters of boundaries. *Cory v Villa Props.* (1986) 180 Cal. App. 3d 592, 597 (size and length of lot); *Sodeling v Tomlin* (1959) 170 CA2d 169 (location of boundaries); *Edwards v Sergi* (1934) 137 Cal. App. 369 (boundary lines).

<sup>22</sup> *Lick Mill Creek Apartments v. Chicago Title Insur. Co.* (1991) 231 Cal. App. 3d 1654, 1660-1661 (citing *Mertens v. Berendsen* (1931) 213 Cal. 111, 112).

<sup>23</sup> *Id.* at 1658. See also California Insurance Code § 12340.1.

the time it was insured. A property may be deemed unmarketable if material flaws in an ALTA land title survey are discovered. In fact, no “adverse claimant” need be present for an owner or lender to raise an unmarketable title or fraud claim under their title insurance policy. The possibility of a “cloud” on title is enough to trigger title insurance coverage through the title insurer.

If owners, lenders and CMBS holders of commercial properties (with these fraudulent survey documents) have title insurance with specific endorsements covering unmarketable title, fraud and negligence claims, these groups may be entitled to damages including contract rescission for the full balance of loan amounts (plus attorney’s fees and costs) against their title insurer based unmarketable title, fraud, constructive fraud (requiring less intent), negligent misrepresentation and negligence theories. Title insurance companies may be liable for a failure to defend if they deny title insurance coverage.

**B. Surveyors:**

Surveyors providing inaccurate surveys and/or failing to file records of survey are in violation of various California statutes including California Business & Professions Code §8762 et. seq., California Business & Professions Code § 17200, et seq. Surveyors may also be liable to owners, lenders and CMBS holders based on the theory of negligence per se for violation of California Code of Regulations, Title 16, Division 5, § 419 (e) (C) (2) and California Business & Professions Code §§ 8762, et seq. Most western states have statutes similar to those cited for California. Nevada (whose commercial real estate has been particularly hard hit), recently enacted A.B.284, which states fraudulent documents used in a financial transaction are a Category C Felony. Nevada land surveyors should quickly order a recent edition of *Incarceration 101* or *Behind Bars* now, before they are sold out to recently indicted California title officers. These owners (and possibly adjacent owners), lenders and CMBS holders may also have claims of fraud, constructive fraud, negligent misrepresentation and negligence against the licensed land surveyor (who typically carries a large errors and omissions policy ranging from \$1-5 million).

**END OF ARTICLE.**