

Arizona Supreme Court Decision Could Affect Lending Practices

by Isaac M. Gabriel and Madison Burr

Construction lenders beware – a recent Arizona Supreme Court decision interpreting Exclusion 3(a) of standard-form title-insurance policies could mean lenders are not insured against a senior mechanics' lien if the lender's ceasing funding is what caused the mechanics' lien to arise. In *Fidelity National Title Insurance Co. v. Osborn III Partners LLC*, et al., the Arizona Supreme Court "consider[ed] the meaning and application of Exclusion 3(a) - a standard title insurance policy exclusion designed to cover any defects, encumbrances, or adverse claims "created" or "suffered" by the insured—in the context of construction lending." *Fid. Nat'l Title Ins. Co. v. Osborn III Partners LLC*, No. CV-21-0086-PR, 2023 WL 2291996 at *1 (Ariz. Mar. 1, 2023).

In *Fidelity*, the construction lender, Mortgages Limited ("ML"), entered into a loan agreement with Osborn III Partners, LLC ("Developer") to secure financing for the construction of a condominium project. ML thereafter sought title coverage for its deed of trust from the predecessor to Fidelity National Title Insurance Company ("Fidelity"). The policy explicitly protected the priority of ML's deed of trust against mechanics' liens arising from work related to the project that commenced before the policy date. Importantly, ML's protection under the policy was subject to Exclusion 3(a) which barred coverage for any "[d]effects, liens, encumbrances, adverse claims or other matters... **created, suffered assumed or agreed to by the insured claimant.**" *Id.* at 2 (emphasis added).

During the construction, ML stopped funding the loan based on defaults by Developer, as contemplated under ML's loan documents. As a result, Developer failed to pay one of its subcontractors, Summit Builders ("Summit"). Summit then filed a mechanics' lien, which had statutory priority over ML's lien because its work on the project had commenced prior to ML recording its deed of trust. Summit sued to enforce its mechanics' lien rights, and later settled with ML for \$1,750,000.00 to resolve the lien foreclosure action. ML then sought to recover that amount from Fidelity under the title insurance policy. Fidelity denied coverage citing Exclusion 3(a) and claimed ML's cessation in funding of the construction loan "caused" or "created" Summit's mechanics' lien, which gave rise to

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ML's alleged coverage.

After nearly a decade of litigation and conflicting rulings at the trial and appellate court levels, the Arizona Supreme Court was faced with the question of whether ML's actions "caused" Summit's mechanics' liens. The Supreme Court found the language of the policy was unambiguous and ML's claim should be denied if it ultimately was found to have caused or created Summit's lien. However, the Supreme Court found the record was not sufficiently developed as to this question, and that factual issues existed and needed to be further evaluated by the trial court to determine whether ML or Developer "caused" the lien. Two of the critical questions to be determined by the trial court on remand were: (i) "whether the Developer failed to pay Summit because ML withheld remaining funding, or whether the Developer's failure to pay Summit preceded ML's withholding of funds", and (ii) "whether the work Summit performed that resulted in mechanics' liens occurred before or after ML withheld funds, at least in part, and whether ML notified Summit that funding would cease." The Court reasoned that "Exclusion 3(a) will only apply if ML's actions caused Summit's mechanics' liens." *Id.* at 8.

Given the nature of construction lending, *Fidelity* could stand to bar construction lender's coverage under a title policy if the lender's cease in funding is what ultimately "caused" a mechanics lien to exist (assuming the 3(a), or similar policy exclusion is in the policy). This is especially true since construction work is likely to be performed before a lender ceases funding, given the work is typically performed, and then billed and applied for in a pay application. On the other hand, a Developer may also fail to pay its subcontractors specifically because a lender withheld the remaining funding (assuming the loan was intended to cover the full construction cost of the project). The *Fidelity* opinion does not state which of these factors would control. Nevertheless, construction lenders should be aware of the risks in ceasing funding of a project, and consider the impact this cessation could have on their lien priority under a title insurance policy.