Killian, Chris

From:Killian, Chris
Sent:24 Jul 2013 17:16:33 +0000
To:Pollard, Alfred
Subject:Fwd: KL Gates Blog Post on Eminent Domain and Title Issues
Hi Alfred,

Good to see you the other day and thanks for coming up to talk to our members. I hope it was useful for you; it was for us.

I wanted to make sure you saw the below piece from Larry at KL Gates.

-Chris

Christopher Killian
Managing Director
Securitization
o: (b)(6)
m

Begin forwarded message:

From: "Killian, Chris" <(b)(6)@sifma.org>

Subject: KL Gates Blog Post on Eminent Domain and Title Issues

Date: July 24, 2013 1:05:15 PM EDT

To: Eminent Domain Internal Workgroup <EminentDomainIntWrkgrp@sifma.org>

http://www.klgates.com/bibbidi-bobbidi-boo-eminent-domain-needs-more-than-a-magic-wand-to-overcome-title-defects-07-24-2013/

Consumer Financial Services Alert

Bibbidi Bobbidi Boo: Eminent Domain Needs More Than a Magic Wand to Overcome Title Defects

by Laurence E. Platt
July 24, 2013

Oh, if it only were that easy. A city seizes "underwater" residential mortgage loans through eminent domain, waves its magic wand, says Abracadabra or Bibbidi Bobbidi Boo, and then the mortgage lien of the prior loan

holder evaporates into thin air. The city is free to write down loan principal and, for a fee, arrange for private interests to refinance the no longer underwater loan for a grateful borrower. In this land of make believe, the prior holder accepts the city's offer of reasonable compensation without a fight. Yeah, right!

People disagree whether a local government's seizure of underwater residential mortgage loans through eminent domain is constitutional, sound public policy or otherwise lawful. One point appears to be beyond dispute, however—namely, that the holders of seized mortgages will not simply accept the governmental seizure of their loans without litigation. And that's where the practical problem of eminent domain arises.

Will the new loan that refinances the seized loan qualify for either sale to Fannie Mae, Freddie Mac or private investors, or insurance by the Federal Housing Administration ("FHA")or private mortgage insurers? The eligibility criteria for purchase or insurance may explicitly exclude loans that refinance seized mortgages. Even without such an exclusion, though, title issues that arise by virtue of the controversial use of eminent domain could impair the sale or insurance of such loans.

Clean title to the mortgaged property and priority of the lien are common eligibility criteria in both private and governmental mortgage loan transactions. Investors in part look to title policies to evidence good title and lien priority. Will title insurers be willing to give clean title opinions regarding the first lien status of the new mortgage or deed of trust on the property securing the refinancing of the seized mortgage, free of any claims or encumbrances?

Underlying any title insurance policy is a determination by the insurer that there are no claims to the mortgaged property that are superior or senior to the lien of the new security instrument. In this case, the only way that a new mortgage securing the refinancing constitutes a first lien is if the old mortgage has been released. The holder of the seized mortgage is not likely to execute a release of its security instrument on a voluntary basis if the holder challenges the amount of compensation offered by the governmental entity. Instead, one would have to rely on the extinguishment of the lien by operation of law following the exercise of eminent domain.

But assuming the lien holder is challenging the validity and implementation of eminent domain in court, there will be a serious legal question as to whether the prior lien has been extinguished. If the prior lien remains intact or in legal limbo pending the outcome of the litigation, the new lien may be unenforceable and/or not free and clear of other claims. So what would a title insurer do in that circumstance?

To issue the title policy, the title insurer would have to "insure around" the legal claims and take the risk that the eminent domain action ultimately will be upheld by a court in a final non-appealable judgment. If that risk backfires, the title insurer could be on the hook for all of the loans that it insured over the legal challenges. Such exposure could influence a title insurer's willingness to assume the risk of legal challenges to eminent domain.

A title insurer instead could elect not to take this legal risk and either not issue a title policy at all or seek to limit its exposure through an express exception for any defects in title that might arise as a result of such legal challenges to eminent domain. Either option may be problematic for lenders. Let's look, for example, at some common approaches to good title and lien priority to assess the likelihood that such an exception in a title policy or the absence of a title policy at all would play well in the marketplace.

Section B7-2-01 of the Fannie Mae Selling Guide (the "Selling Guide") requires that each first mortgage loan delivered to Fannie Mae have a title insurance policy in place that satisfies Fannie Mae's requirements and, by delivering a mortgage loan to Fannie Mae, the lender represents and warrants that the loan is covered by the required title policy issued by an acceptable insurer, including any required endorsements. Each title policy must be on one of the standard master forms promulgated by the American Land Title Association, in accordance with Section B7-2-03 of the Selling Guide. It further provides that the title insurance policy must ensure that the title is generally acceptable and that the mortgage constitutes a lien of the required priority on a fee simple or leasehold estate in the property.

Fannie Mae will not purchase or securitize a mortgage secured by property that has an unacceptable title impediment, according to Section B7-2-05 of the Selling Guide. If a title insurer provides an exception to its coverage

for legal challenge to the validity of the extinguishment of a prior recorded lien through eminent domain, query whether such an exception will rise to the level of an unacceptable title impediment. Section A2.01-06 of the Selling Guide seems to answer that question, noting that any defect shown on the title policy would not be considered to be an acceptable minor impediment if there was additional cost or delay involved in curing such defect. Would legal challenges based on the jurisdiction of a city over an out of state loan holder, or a constitutional challenge to the validity of eminent domain or a pure valuation fight over reasonable compensation add additional cost or delays?

Irrespective of the presence of a clean title policy, the selling lender bears the risk to Fannie Mae that the mortgage lien creates good title and appropriate lien priority. Section A2-2.1-06 of the Selling Guide makes clear that the lender is responsible for representations and warranties for the life of the loan that pertain to clear title and first-lien enforceability. A mortgage loan must:

- be sold by a lender that was the sole owner and holder of the mortgage loan and had the full right and authority to sell and assign it, or a participation interest therein, to Fannie Mae. The lender's right to sell or assign the mortgage loan cannot be subject to any other party's interest or to an agreement with any other party;
- be a valid and subsisting first lien enforceable in accordance with its terms (with no pending condemnation or other legal proceedings) and that otherwise meets Fannie Mae's requirements for loan documents;
- have a mortgagee policy of title insurance meeting Fannie Mae's requirements, or other title evidence acceptable to Fannie Mae. Lenders continue to be responsible for all warranties related to title, marketability, and lien position, regardless of whether included or excluded by coverage under a mortgagee policy of title insurance. Any defect shown on the title policy would not be considered to be an acceptable minor impediment if there was additional cost or delay involved in curing such defect;
- permit foreclosure or other enforcement of the note holder's rights under the loan documents and acquisition of good and marketable title to the underlying security property without incurring any expenses or delays as a result of any matters affecting title to the property, including legal or land use restrictions or other defects relating to the land or location of the improvements.

Freddie Mac has substantially similar requirements regarding the requirement for a title policy and the lender's representations and warranties regarding clean title, in Chapter 39 and Section 22.5, respectively, of the Freddie Mac Single-Family Seller/Servicer Guide. For example, sellers represent and warrant that: "The Mortgaged Premises must be free and clear of all prior liens and encumbrances and no rights or condition may exist that could give rise to such liens." Will pending court challenges to the legality of eminent domain constitute such a prior lien or encumbrance and who will take the risk that the answer may be yes?

While the FHA does not require lenders to obtain an acceptable title insurance policy as a condition to a loan's eligibility for insurance, nevertheless clean title is required at the time of loan closing. Section 202.32(a) of Volume 24 of the Code of Federal Regulations provides that:

> "Except as otherwise provided in this section, a mortgagor must establish that, after the mortgage offered for insurance has been recorded, the mortgaged property will be free and clear of all liens other than such mortgage, and that there will not be outstanding any other unpaid obligations contracted in connection with the mortgage transaction or the purchase of the mortgaged property, except obligations that are secured by property or collateral owned by the mortgagor independently of the mortgaged property."

This is written in terms of a mortgagor's obligation, but other HUD requirements impose this obligation squarely on the mortgagee. Section 6.a.1.h of HUD Handbook 4155.2, Lender's Guide to Single Family Mortgage Insurance Processing, makes clear that the lender is responsible for ensuring that the mortgaged property has good and clean title at the time of loan closing. Indeed, the lender states to HUD on the Lender's Certificate on page 4 of form HUD-92900-A, Addendum to the Uniform Residential Loan Application, that "the security instrument has been recorded, and is a good and valid first lien on the property." Would a lender make this certification in the face of legal challenges to the validity of the eminent domain action and the extinguishment of the prior lien on the same mortgaged property?

So here is a little discussed aspect of the eminent domain controversy. Courts ultimately will resolve the legality of eminent domain. While those challenges are pending, however, there may be serious questions whether the refinancing lender has clean title to the mortgaged property with appropriate lien priority. Even a collective chant of Bibbidi Bobbidi Boo by participating cities may not eliminate the title defects that such legal challenges may present. And lenders will need more than magic wands if they are called upon to defend title defect claims by mortgage investors and insurers arising out of such legal challenges.

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