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## **CLOSING PROTECTION LETTERS: IMPORTANT TOOLS FOR PROTECTING MORTGAGE-BACKED ASSETS**

*By August J. Matteis, Jr., William E. Copley, and Alyson A. Foster*

Anyone who has bought real estate is likely familiar with title insurance policies, which at a minimum protect buyers and lenders from title defects that exist as of the date of settlement. When a seller fails to disclose a prior existing lien on a property and the settlement agent fails to uncover the lien in his title search during a property purchase, both the buyer and the financial institution are protected by title insurance.

But what happens if the settlement agent fails to properly file a mortgage or deed of trust in the land records? Or if a settlement agent absconds with the settlement funds? Or if a settlement agent conspires with a local mortgage company to manufacture fraudulent loans and then sell those loans to national financial institutions in the secondary loan market? To address these kinds of scenarios, many lenders have begun to demand that title insurers supplement their title insurance policies with a closing protection letter (“CPL”). CPLs are indemnity agreements that expressly protect a lender — or a buyer — from defects to title caused by the fraud or negligence of the settlement agent. Most title insurers do not charge an additional premium for issuing a CPL. Moreover, many CPLs provide unlimited coverage up to the full amount of loss.

### **WHO IS PROTECTED BY CPLS?**

CPLs have been available since the 1960s and are available to buyers and lessees of real estate (both residential and commercial), as well as lenders — in other words, just about any party that acquires an interest in real estate and a title insurance policy. If you purchase an interest in land and receive a title policy, you should ensure that you also receive a CPL.

In particular, CPLs provide vital protection to financial institutions that purchase mortgages in the secondary loan

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market. Secondary lenders do not have agents at the closing table. They do not have an opportunity to oversee the closing process; nor is it practical for them to investigate the diligence and veracity of the closing agent involved in a real estate transaction. CPLs address this uncertainty by expressly protecting secondary lenders against losses caused by the negligence or defalcation of a settlement agent.

To maximize the CPLs' protection to financial institutions in the secondary loan market, the initial lender can demand that CPLs expressly identify the initial lender's successors and assigns. This is commonly done with the designation "ISAOA ATIMA," which signifies "Its Successors And/Or Assigns As Their Interests May Appear." This language benefits the initial lender and the secondary lender. The initial lender's loan is more marketable in the secondary loan market, and the secondary lender's loan is more fully (or at least more expressly) protected.

Although demanding that the title insurer include an "ISOA ATIMA" designation when identifying the insured in a CPL is generally the best practice, it may be unnecessary (depending upon state law and other factors) to extend the protections of a CPL to a financial institution that purchases a secured note in the secondary loan market. Courts have held that CPLs are not stand alone agreements but rather are part of the title insurance policy. The standard form title insurance policies used in most states expressly provide that the title insurance policy provides coverage to the initial lenders' successors and assigns.<sup>1</sup> As a result, depending on state law and other factors, secondary lenders may have a strong argument that they are covered even under a CPL that expressly lacks an "ISOA ATIMA" designation.

In addition, last year, the American Land Title Association ("ALTA") Forms Committee, which is responsible for creating the form title insurance documents often used in the title insurance industry, revised the standard CPL form and added two provisions that further clarify that CPLs protect a lender's assignees, and successors, such as warehouse lenders. The new standard form is available at the ALTA website at <http://www.alta.org/forms> under "Adopted or Revised Forms Effective 1/1/08" at "CPL – Closing Protection Letter (1-1-08)."

## **WHAT DO CPLS COVER?**

The typical CPL promises to reimburse the holder for loss associated with defects in the validity, enforceability, and priority of the title or lien at issue arising from a settlement agent's theft, fraud, negligence, or failure to comply with closing instructions. The typical CPL specifies that reimbursement applies in the following situations:

1. Failure of the Issuing Agent or Approved Attorney to comply with your written closing instructions to the extent that they relate to (a) the status of the title to that interest in land or the validity, enforceability and priority of the lien of the mortgage on that interest in land, including the

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<sup>1</sup> See American Land Title Association, <http://www.alta.org/forms> (scroll to "Basic Policies" at "ALTA Loan Policy (06-17-06)").

obtaining of documents and the disbursement of funds necessary to establish the status of title or lien, or (b) the obtaining of any other document, specifically required by you, but only to the extent the failure to obtain the other document affects the status of the title to that interest in land or the validity, enforceability and priority of the lien of the mortgage on that interest in land, and not to the extent that your instructions require a determination of the validity, enforceability or the effectiveness of the other document, or

2. Fraud, dishonesty or negligence of the Issuing Agent or Approved Attorney in handling your funds or documents in connection with the closings to the extent that fraud, dishonesty or negligence relates to the status of the title to that interest in land or to the validity, enforceability, and priority of the lien of the mortgage on that interest in land.<sup>2</sup>

The Issuing Agent or Approved Attorney typically is the settlement agent who handles the closing of a real estate transaction, and is named specifically in the CPL.

This protection is important because the many roles played by a settlement agent in a real estate closing create opportunities for both unintentional mistakes and intentional frauds or thefts. In general, the settlement agent coordinates the administrative and clerical functions associated with closing a real estate transaction. The settlement agent prepares, collects, and records documents, including the title abstract. The settlement agent also receives, holds, and disburses settlement funds. He or she also is an authorized agent for the title insurance company with authority to issue title insurance binders, commitments, policies, and CPLs in the name of the insurance company. At the same time, the settlement agent acts as an agent for the lender, buyer, and/or seller acting pursuant to their individualized instructions. At any given point in a real estate transaction, the settlement agent is wearing some or all of the following titles — settlement agent, insurance agent, closing officer, escrow officer, settlement officer, closing agent, closing attorney, settlement attorney.<sup>3</sup> In short, the settlement agent has responsibility for overseeing and executing every facet of the real estate transaction, and in most cases, no one is in a position to oversee the manner in which the settlement agent fulfills these responsibilities.

Because of the trust and responsibility placed in settlement agents, states have subjected settlement agents to strict regulation. For example, the Virginia Consumer Real Estate Settlement Protection Act (“CRESPA”) imposes numerous requirements upon settlement agents with the goal of protecting buyers, sellers, and lenders involved in real estate transactions. Va. Code §§ 6.1-2.19 - 6.1-2.29. CRESPA requires a settlement agent to maintain up to three forms of protection against loss: an errors and omissions or malpractice insurance policy with a minimum of \$250,000 coverage per claim; a blanket fidelity bond of employee dishonesty policy with a minimum of \$100,000 coverage; and a surety bond of at least \$200,000. *Id.* § 6.1-2.21. Given the high cost of real estate in many areas of the country, these protections can be grossly inadequate to

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<sup>2</sup> *Id.*

<sup>3</sup> See 1031 Exchange Glossary, <http://www.1031exchangemadesimple.com/glossary.html>.

protect buyers, sellers, and lenders from the negligence or defalcations of settlement agents. CPLs, on the other hand, provide the necessary and additional full protection.

For example, the court in *American Title Insurance Co. v. Variable Annuity Life Insurance Co.* held a title insurer liable under the terms of a CPL for the full amount of a secondary lender's loss.<sup>4</sup> The secondary lender's loss arose from a settlement agent's failure to disburse settlement funds to satisfy a prior-existing lien. The court held that the secondary lender was entitled to recover its full losses, even though the prior existing lien that the settlement agent failed to satisfy was of an amount significantly less than the full amount of the secondary lender's loss.

CPLs also provide valuable protection against a particularly damaging form of real estate fraud that involves a conspiracy between a settlement agent and a mortgage broker. Settlement agents frequently work closely with mortgage brokers. As a result, mortgage brokers and settlement agents could work together to perpetrate mortgage fraud. Indeed, because of their unique power to handle funds, the settlement agent is an indispensable part of any effective conspiracy to defraud buyers or lenders.

#### **GETTING INSURERS TO PAY UNDER CPLS**

Despite the fact that CPLs were designed by the title insurance industry to provide protection against the negligence and defalcations of settlement agents, many title insurers have made it a practice regularly to deny coverage under CPLs. In denying coverage, title insurers have relied upon one or more of the following arguments:

- the settlement agent acted outside his or her scope of authority;
- the settlement agent acted fraudulently but only in his role as the settlement agent for the buyer, not as the agent of the title insurer;
- the CPL does not specifically designate successors and assigns as insureds, and therefore the CPL supposedly provides no coverage to financial institutions who purchase a secured note in the secondary loan market;
- the fraud was caused by another party, such as the mortgage broker; or
- the settlement agent is not required to report suspected

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<sup>4</sup> 1996 WL 544431 (Tex. App. 1996).

Much of case law interpreting and giving effect to CPLs is still evolving. In general, courts have been willing to enforce CPLs in spite of such arguments by title insurers. Of the jurisdictions that have considered the effect of CPLs, courts generally have held title insurers liable under CPLs for the fraud or defalcation of a settlement agent. For example, in *Sears Mortgage Corporation v. Rose*, the Supreme Court of New Jersey held that a settlement agent who had handled all the closing functions and had defalcated the settlement funds was the agent of the title insurance company.<sup>5</sup> The Court explained that “[t]itle-insurance carriers specifically protect . . . institutional lenders against the risk of defalcation by the buyer’s attorney handling the closing . . . through a ‘closing protection letter’ that insurers issue to the lender.”<sup>6</sup>

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In sum, CPLs can provide important protection to buyers and lenders in real estate transactions because they expressly provide coverage for the negligence and defalcations of title agents. However, CPLs will only provide this coverage if they are properly crafted and, unfortunately in many cases, if buyers and lenders are willing to fight for the coverage promised by the title insurer in the CPL. Accordingly, one should be very hesitant to accept a title insurer’s initial denial of coverage under a CPL.

Given the evolving nature of the law in this area, buyers, lenders, and financial institutions harmed by a settlement agent’s negligence or fraud are well advised to seek the advice of counsel with experience in dealing with the principles of law that govern real estate closings and the issuance of title insurance.

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<sup>5</sup> 134 N.J. 326, 634 A.2d 74 (1993).

<sup>6</sup> *Id.* at 85.