E & O, Liability, and Title Policies

Real Estate Investment Trust Coverage

By Denae Hildebrand Budde

Insurers have numerous defenses to explore when evaluating claims resulting from issues related to REITs and mortgage-backed securities.

As property values decline, office buildings become vacant, foreclosures increase, and dividends for Real Estate Investment Trusts (REITs) decrease, resulting in increased scrutiny of the management of properties. As a result, management companies receive more claims related to their errors and omissions policies. Structural or physical problems with the real estate will increasingly occur in the future, which, in turn, will escalate claims to liability policies. As borrowers default on loans, priority and recording issues will lead to claims against the REITs' title policies.

Since 1992, REITs have grown dramatically in the investment industry marketplace. REITs can be privately held, publicly traded, or owned by foreign corporations. They can own and manage property across the country. The potential liability of a REIT trustee or manager creates a number of insurance coverage issues. In the wake of the real estate downturn and increasingly mismanaged trust funds, the potential demand for coverage is substantial. Now that trusts manage properties rather than simply collect income, construction defects and problems involving homeowner associations can further complicate liability issues, creating additional claims and coverage disputes.

Background

REITs stemmed from mid-century Massachusetts business trusts. Massachusetts law largely prohibited corporate ownership of real estate, which resulted in the formation of business trusts to hold real estate investments made by corporations. In the 1930s, the United States Supreme Court determined that the government should tax business trusts as corporations, which led to a significant decline in the use of business trusts. *Morrissey v. Comm'r of Internal Revenue*, 296 U.S. 344 (1935).

In 1960, Congress, with encouragement and prompting from the investment industry, created REITs to function as pass-through entities similar in some respects to mutual funds and Subchapter S corporations through the Real Estate Investment Trust Act.

A REIT is a corporate entity investing in real estate that owns real property and, in most cases, income-producing real estate, which has a tax designation designed to

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reduce or eliminate corporate taxes. In return, a REIT must distribute 90 percent of its taxable income to investors. The REIT structure was designed to provide a real estate investment structure similar to the structure that mutual funds provide for investment in stocks. *See* 26 U.S.C.A. §856.

There are three types of REITs: (1) equity REITs, which primarily own, or have an interest in, income-producing real estate; (2) mortgage REITs, which originate or acquire mortgage loans and other debt obligations that are secured by real property; and (3) hybrid REITs, which combine the equity REIT and mortgage REIT model and both owns commercial real estate and holds mortgages secured by commercial real estate. William A. Kelley, Jr., *Real Estate Investment Trusts Handbook* 8-11 (2d ed. 1998).

Before the Tax Reform Act of 1986 (1986 TRA), REITs were limited to the management services that they could provide and were viewed as fixed income investments and valued by their distributions. The 1986 TRA permitted a REIT to provide services directly to tenants rather than require that an independent contractor manage the REIT property.

Congress determined that taxing both the revenues earned and the distributions as dividends amounted to unfair double taxation because the investment entity was no more than a structural alter ego of the shareholders. REITs receive a pass-through status for tax purposes via a special "dividends-paid" deduction allowing them to deduct from their income the amount that they paid to the beneficiaries. *See* 26 U.S.C. §857(b)(2)(B). In addition to paying at least 90 percent of its taxable income annually in the form of shareholder dividends, to qualify for the pass-through entity advantages for the U.S. corporate income tax, a REIT must

- Be an entity that would be taxable as a corporation but for its REIT status;
- Be managed by a board of directors or trustees;
- Have shares that are fully transferable;
- Have a minimum of 100 shareholders after its first year as a REIT;
- Have no more than 50 percent of its shares held by 5 or fewer individuals during the last half of the taxable year;
- Invest at least 75 percent of its total assets in real estate assets and cash;
- Derive at least 75 percent of its gross income from real estate-related sources, including rents from real property and interest on mortgages financing real property;
- Derive at least 95 percent of its gross income from such real estate sources and dividends or interest from any source; and
- Have no more than 25 percent of its assets consist of non-qualifying securities or stock in taxable REIT subsidiaries.

U.S. Securities and Exchange Comm'n, Real Estate Investment Trusts (REITs), http://www.sec.gov/answers/reits.htm (last visited Mar. 6, 2012).

Exclusions Under Errors and Omissions Policies

Claims involving REITs' liability policies will often implicate wrongdoing on behalf of the manager of the asset. The REIT will turn to its insurance carrier to provide coverage for the underlying claims, and an insurer may be required to defend the REIT depending on the allegations in the underlying complaint. In reviewing a claim, the carrier can limit its liability and exposure for matters that may already be percolating before the issuance of a "claims made" errors and omissions policy based on the limitations of its front-end exposure date in the policy and by examining the exclusions such as the one for work that an officer does while not acting on behalf of the officer's company. Each exclusion and underlying action must be evaluated with great caution to determine if the action falls within the grant of coverage.

Although an insured may have an errors or omissions policy that covers its work, the policy may not cover the insured for acting outside the specifications of the insuring clause. When an attorney acts as a trustee for a testamentary trust and invests in a REIT or manages a REIT, his or her malpractice insurance probably will not cover him for that work if it contains language such as "is insured when acting in his capacity as a lawyer." *See Cohen v. Employers Reinsurance Corp.*, 117 A.D.2d 435 (N.Y. App. Div. 1986). Likewise, other errors and omissions (E & O) policies may not afford coverage if an officer or a director acted on behalf of another entity when the negligent act for which the policyholder seeks coverage occurred.

To illustrate, in *Gulf Ins. Corp. v. Cont'l Co.*, 464 So. 2d 207 (Fla. Dist. Ct. App. 1985), when an attorney handled the administration of a REIT, his professional liability insurance was implicated, and

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the insurance didn't limit coverage based on the nature of the work he performed. After the court entered a judgment in the underlying matter, the plaintiff sought contribution from the other malpractice carriers that had insured the attorney during the relevant time that he mismanaged the trust. The plaintiff argued that all the carriers ought to pay liability based on a per diem basis, which was not supported by the applicable language of the insurance policies related to "other insurance." The court held that the language in both policies prorating the payment according to the policy limits was the proper method of determining the liability of the insurer.

Another exclusion that may limit the exposure under an errors and omissions policy is the prior litigation exclusion. The Eleventh Circuit dealt with this when it granted a summary judgment in favor of the insurer based on prior litigation exclusion and held that the denial of coverage for the second action was proper due to the related pending lawsuit. *HR Acquisition 1 Corp. v. Twin City Fire Ins. Co.*, 547 F.3d 1309 (11th Cir. 2008). The case involved a shareholder derivative action claiming accounting fraud by selling property and leasing it back at artificially inflated prices. The second lawsuit in which the insured tendered its defense involved a false claims action regarding reimbursement through Medicare. HR Acquisition 1 Corp. purchased a "claims made" errors and omissions policy from Twin City that included a non-securities claim liability insuring agreement. The prior litigation exclusion excluded coverage for actions that were pending or existed prior to the litigation date listed in the policy. The court found the action for which the insured sought coverage sufficiently related to another case that was pending before the date specified in the policy.

Depending on the specificity of the allegations and the language contained in the exclusions, a carrier can avoid mortgaged-backed securities exposure.

Coverage Considerations Under Liability Policies

The litigation of coverage issues may occur simultaneously with a liability lawsuit. In *Del-Val Financial Corp. v. Federal Insurance Co.*, 193 A.D.2d 544 (N.Y. App. Div. 1993), Del-Val Financial Corp. REIT sought coverage for indemnification under its E & O, commercial general liability, and excess policies from Federal Insurance in a number of securities lawsuits commenced in various jurisdictions against the trust and its officers and directors. Del-Val distributed monthly dividends for years and then ceased to make payments and was sued for breach of fiduciary duty, negligence, and violation of securities laws. The insurer denied coverage, and the action ensued, which the plaintiff sought to stay due to other pending matters. Under New York law the court would not stay the coverage action brought by the insured because there was not a complete identity of parties, causes of action, or relief sought.

The party or parties to a coverage dispute will depend on the type of policy at issue and the jurisdiction in which the action is filed. A REIT's liability policy is often effectuated through a separate endorsement for full entity coverage and problems with the property that typically carves out trust contribution claims and management claims including illegal profits and deliberate acts. Depending on the type of property held by a REIT, the REIT may desire to obtain a pollution coverage policy. Pollution legal liability real estate coverage provides coverage for commercial property owners, managers, and developers for pollution conditions that could impede a property's operation. Coverage of the managers of the trust typically necessitates the purchase and implication of E & O coverage or a fidelity bond. If the allegations involve securities violations or securities fraud, they will often be excluded under E & O policies.

In certain jurisdictions, the liability policies require inclusion of the underlying plaintiffs in the coverage matter. Under Illinois law a claimant must be included in the coverage matter because the claimant is affected by the determination of whether or not coverage is available, unless the REIT has substantial financial wherewithal and the position to cover the potential loss in a property damage case, giving rise to the alleged suitability and warranty violations. In determining venue for the litigation, if a claimant is considered a necessary party to the coverage action, the coverage action will be litigated in the plaintiff's state of residence. The rationale in Illinois for including the underlying plaintiff is that a declaration of non-coverage would eliminate a source of funds in most instances. *Flashner Med. P'ship v. Mktg. Mgmt. Inc.*, 545 N.E.2d 177 (Ill. App. Ct. 1989); *Bituminous Cas. Corp. v. Gust K. Newburg Constr. Co.*, 578 N.E.2d 1003 (Ill. App. Ct. 1991) (not requiring the plaintiff to be a party in this construction defect coverage matter as the underlying plaintiff was not a necessary party and the issue of joinder was not raised).

Coverage Under Title Policies

Title claims arise due to priority issues when a lender or an owner moves to foreclose. The coverage issues include damages following foreclosure, failing to record a lien, and improper applications of loan funds.

Generally, a foreclosure sale needs to takes place before a lender can determine whether it has sustained an insured loss under a title insurance policy. Unlike an owner's policy, a lender's policy of title insurance only insures the extent to which the lender's debt is secured by the real property. It is not "mortgage insurance" in that it does not insure full payment of a loan or against default. It also does not guarantee against market fluctuations in the collateral. An insured lender is only insured up to the value of the property, and depreciation in the property is not a risk borne by the title insurer. Generally a lender's loss is measured by the extent to which the insured debt is not repaid because the value of the security property is diminished or impaired by outstanding lien encumbrances or title defects that are covered by the title insurance policy. Superior liens or title defects may exist that reduce the market value of the security property to the owner yet result in no loss or damage to the insured lender.

When a REIT forecloses and credit bids the full amount of the loan and property, and the property is worth more than the amount due on the loan, there is no loss under the title policy and there can be no claim against the title insurer. *First Commerce Realty Investors v. Peninsular Title Ins. Co.*, 355 So. 2d 510 (Fla. Dist. Ct. App. 1978).

In *Chicago Title Ins. Co. v. CV REIT, Inc.*, 588 So. 2d 1075 (Fla. Dist. Ct. App. 1991), CV REIT Inc. brought a declaratory judgment action seeking a defense under the title policy issued by Chicago Title, but CV REIT could not establish that the allegations of the underlying complaint fell within the coverage grant of the title insurance policy. The underlying lawsuit constituted a collection of claims requesting money damages for breach of various agreements surrounding the real estate development claiming that CV REIT was a codeveloper and did not properly apply the benefit of the funds to the homeowners and the homeowners' association. CV REIT, Inc. was the mortgage holder and none of the claims challenged the status of the mortgage or lien priority insured by Chicago Title. The court determined that whether or not a duty to defend exists arises from the allegations of the complaint itself, not from some conclusions drawn by the insured based on a theory of liability that has not been pleaded. *Id.* (citing *Auto-Owners Ins. Co. v. Jones*, 397 So. 2d 317, 320 (Fla. Dist. Ct. App. 1981)); *cf. Aetna Ins. Co. v. Waco Scaffold & Shoring Co.*, 370 So. 2d 1149 (Fla. Dist. Ct. App. 1978).

In another case a mortgagee sued its title insurer seeking, among other things, a declaration that the defendant had been negligent in failing to record a building loan contract and was therefore liable for the costs of disposing of certain mechanics' liens that had apparent priority over the plaintiff's mortgage lien. In *Diversified Mortgage Investors v. U. S. Life Title Ins. Co. of New York*, 544 F. 2d 571 (2d Cir. 1976), the plaintiff, Diversified Mortgage Investors (DMI), was a real estate investment trust and the defendant-appellant, U. S. Life Title Insurance Company of New York (USL), was a title insurance company with a branch office in Albany. Beginning in 1971, DMI made a number of mortgage loans to Sleepy Hollow Lake, Inc. for the development of a recreational housing community in Greene County, New York, totaling $21-Million. The court determined there was insufficient evidence of irreparable harm and overturned the grant of a preliminary injunction.

Mortgaged-Backed Securities

Mortgaged-backed securities are a slight variation of REITs in which the pooled mortgages are securitized, packaged, and sold to investors. Specifically, with mortgaged-backed securities

- Mortgage loans (mortgage notes) are purchased from banks and other lenders and assigned to a trust;
- The trust assembles these loans into collections, or "pools" by a governmental, quasi-governmental, or private entity; and
- The entity issues securities that represent claims on the principal and interest payments made by borrowers on the loans in the pool, a process known as securitization.

U.S. Securities and Exchange Commission, Mortgaged-Backed Securities, http://www.sec.gov/answers/mortgagesecurities.htm (last visited Mar. 6, 2012).

These securitization trusts include government-sponsored enterprises and private entities that may offer credit enhancement features to mitigate the risk of prepayment and default associated with these mortgages. Since residential mortgages in the United States have the option to pay more than the required monthly payment, referred to as curtailment, or to pay off the loan in its entirety, referred to as prepayment, the monthly cash flow of mortgaged-backed securities is not known in advance and, therefore, presents risk to mortgaged-backed securities investors. As a result, financial guaranty insurance is often purchased.

The main coverage issues with mortgaged-backed securities under financial guaranty insurance occur when a financial institution is sued for return of their investment that was lost, stolen, or mismanaged. The cases regularly involve class action matters claiming mismanagement of funds and are typically litigated in federal courts either by direct filing or removal. Depending on the specificity of the allegations and the language contained in the exclusions, a carrier can avoid mortgaged-backed securities exposure. Pleading deficiencies typically include failure to allege the specific act or omission and failure to allege causation sufficiently. Obtaining copies of the prospectus and pooling and servicing agreement may prove beneficial for insurers that can make a claim of fraudulent inducement in providing the financial guaranty insurance policy based on breach of contractual representations and warranties. Specific aspects of the representations and warranties that should be examined are statements regarding the accuracy of information compliance with securities laws and warranties regarding the transaction documents. Often an insurer will guaranty the accuracy of the information in the prospectus.

In evaluating indemnity issues, an insurer should consider the representations made in the pooling and servicing agreement and whether the representations would prevent or create indemnity to a third party. Many insurance agreements include language incorporating contracts in which the insured may be liable to a third person, so when the insured violates provisions of the contract and its obligations to a third person, the insurer may likewise be in a position to claim a violation of the obligations under the insurance contract.

As insurance companies have invested in mortgaged-backed securities or residential mortgaged-backed securities, as with other investors, they have attempted to sue the financial institutions handling the mortgaged-backed securities or residential mortgaged-backed securities for misrepresentations regarding the quality of the portfolios.

In *In re Security Capital Assurance, Ltd.*, 729 F. Supp. 2d 569 (S.D.N.Y. 2010), a putative class action for fraud, the plaintiffs failed to allege sufficient claims, and the court granted the motion to dismiss, although it granted the plaintiffs an opportunity to replead their case. The plaintiffs failed to allege sufficient facts to explain the officers' and directors' deliberate illegal behavior and, in evaluating recklessness, indicated that the knowledge of general economic trends does not create a mental state of deception. The plaintiffs attempted to further claim a number of misrepresentations based on press releases, and the court indicated that hindsight knowledge cannot be a basis for fraud. The material misrepresentation must be known to be false at the time it is made and mere mismanagement is not sufficient for a securities fraud claim.

Bad Faith

As with other types of insurance claims, parties typically litigate bad faith issues against a REIT or mortgaged-backed securities insurer after the determination of coverage, and courts will bifurcate the litigation from the coverage determination. Florida requires courts to determine coverage before resolving a bad faith claim. *One Beacon Ins. Co. v. Delta Fire Sprinklers, Inc.*, 898 So. 2d 113, 115 (Fla. Dist. Ct. App. 2005). The Florida Supreme Court has indicated that courts should employ tools such as abatement of actions and in-camera inspection to ensure full and fair discovery without prejudicing an insurer. *Allstate Indem. Co. v. Ruiz*, 899 So. 2d 1121, 1130 (Fla. 2005).

Conclusion

REITs and mortgaged-backed securities create a number of coverage issues depending on the jurisdiction and the type of insurance, and insurers have numerous defenses to explore when evaluating claims, both to limit and to share the exposure.