Winning The Next War: Title Insurers Can Expect a New Set of Challenges in the Coming Years

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> *"Generals always fight the last war, especially if they have won it."*
> *Anthony Kemp (1988) The Maginot Line: Myth and Reality*

The nation's title insurers are emerging from a tumultuous decade. When the technology stock bubble burst in 2000, investors shifted their focus to real estate. The Fed's low interest rates intensified that trend. So did relaxed lending standards that began with federal regulators and soon spread throughout the lending industry. At the same time, the securitization of mortgages and the development of insurance products designed to hedge the risk of mortgage backed securities spurred unprecedented demand for newly originated mortgages. As a result, investment in residential real estate increased more than 37 percent from 2000 to 2005, from roughly $450 billion to almost $600 billion. In an ominous sign that this was an unsustainable bubble, real home prices increased even faster, doubling between 1996 and 2006, according to the Bureau of Labor Statistics Report. Title insurers scrambled to keep up with the demand to close the rapidly increasing numbers of purchase and refinance transactions caused by this frenzy of activity. From 2001 to 2005, industry-wide title premiums shot up from $8.9 billion to $16.5 billion. Since title claims and claims expenses tend to trail premium receipts by a number of years, this period looked very healthy for the title insurance industry, with industry-wide net operating gains in the same period increasing from $242 million in 2001 to $787 million in 2005, according to data from ALTA. In these market conditions, title insurers found themselves under intense pressure to sign up more issuing agents who could close more deals and issue more policies. Many of these new agents lacked the training and experience of those who had been in the industry for years before the boom. Some of these new agencies were little more than side businesses of developers, brokers and real estate lawyers who saw opening a title agency as a potential lucrative offshoot of their main business. Some lacked the expertise, time, resources or skill to avoid writing over dangerous title defects or becoming entangled in transactions that lenders and law enforcement agencies would later say were fraudulent. The FBI reported active fraud investigations tripled between 2003 and

2007 to 1,204. This unprecedented growth also strained underwriter resources in across-the-agency services, training, and audit functions, threatening to exacerbate many potential problems with both newer and long-standing agents. In 2006, deal volume began to decline at the same time that claims associated with the beginning of the boom began to emerge, driving claims expenses up. By 2009, the real estate bubble had burst, the astounding volume of real estate transactions had dried up, and a series of title agent defalcations rocked the ledgers of the title insurers. From the 2005 peak, premiums dropped sharply to $10.2 billion in 2008 to a low of $9.32 billion in 2010. The net gains of the boom era evaporated, replaced by industry-wide net operating losses every year from 2007 to 2011, peaking at over $711 million in losses in 2008. By 2014, however, title insurers had heavily trimmed their rosters of issuing agents, shaking loose many of the bad apples who had caused those losses. Title insurers have also digested most of the glut of title claims that emerged from the foreclosure crisis. This was no easy task, since the sharp decline in real property values that came with the bursting bubble often made title claims more difficult to resolve and increased the amount of alleged loss associated with each claim. Now, in some sectors, title insurers are beginning to see deal volume pick back up, as well as a fairly strong and steady decline in claim volume. In parallel with the economic challenges associated with the real estate bubble, title insurers also found themselves the new favorite target of plaintiffs' class action lawyers. In March 2002, plaintiffs filed the first of a new breed of "reissue rate" class actions cases in Ohio. Just three months later, copycat cases appeared in New York against virtually every underwriter in the state. In these cases, plaintiffs alleged that title insurers had concealed from borrowers the availability of discounted "reissue" or "refinance" rates. They alleged, contrary to many states' rate filings, that title insurers should have automatically given these discounts without adequate proof of a prior title insurance policy, which was typically required for the lower rate. Courts in Minnesota and New York quickly certified classes in these cases, with little analysis of whether plaintiffs could actually prove any violation of the rate rules—let alone a uniform class-wide violation. Title insurers initially responded by trying to buy peace, settling a number of these cases despite their dubious merit. In 2004, for example, several underwriters jointly entered into a $26.5 million dollar settlement of the New York cases. But they were disappointed to find that the settlement served as little more than chum in the water, attracting more and bigger lawsuits. New copycat cases were filed in Florida in 2004, Pennsylvania in 2005, and Texas in 2006. Eventually, literally dozens of classes were certified by state and federal courts from Arizona to Ohio to Maine. But title insurers had learned important lessons from the early cases. They changed tack, vigorously contesting the cases. They challenged class certification with well-developed factual records. They moved to decertify previously certified classes by developing new evidence to undercut plaintiffs' theories about how often prior policies would actually be found. And they challenged plaintiffs on the merits, even against large certified classes. The title insurers scored a critical series of victories in these battles, beginning in 2009 in Ohio and Washington, and continuing on to Michigan, Texas, Kentucky, Maine, Maryland, Arizona, Pennsylvania and Florida. While a few cases linger on, by 2014, it has become increasingly clear that the title insurers have turned the tide against these cases and stemmed the flow of new filings. We should congratulate title insurers for their fortitude and hard work in these battles, and through the terrible economic strains of the Great Recession. But they should also be cautious not to keep their eyes fixed on the last war, as new trouble spots may be poised to flare up. In particular, title insurers should be vigilant and proactive on five fronts in the coming decade: **Mineral Rights Claims**

Increasing energy prices, together with the fracking boom and other advances in drilling technology have driven a wave of acquisition and trading of mineral rights. Many of these acquisitions have been speculative and have not yet been put into production. This means that there is often no visible evidence of any severance of mineral rights, and many purchasers may be unaware that someone else holds mineral rights to their land. Unfortunately, many of these interests have been missed and insured over. Owners of these mineral interests can often "hold up" the insured surface owner's development plans, just as the prospective profit in development begins to return. If the price of energy drops, if production projections turn out to have been overblown, or if environmental regulations reduce the upside of production, then "selling" the mineral rights back to the owner or to a title insurer facing a claim, can become more appealing than trying to use them for their intended purposes. This is a recipe for tricky and potentially expensive title claims. **Title Agent Defalcations**

Increasing deal volume will once again pump up the flow of funds through title agents' escrow accounts. The more robust the economic recovery and the higher the deal volume, the more likely that new and untested agents will once again start up. As a result, the temptation to divert escrow funds may rear its ugly head again. So long as deal volume continues to increase, many defalcations can remain difficult to detect. This is particularly true with large, multi-location agencies that maintain a number of intricately related separate escrow and wire accounts. Market interruptions like a natural disaster or another sharp downturn in the housing market could cause these escrow thefts to come quickly to light, sometimes with disastrous consequences. Detecting defalcations in progress, before they grow in financial magnitude, should be a key goal for title insurers. Robust audit programs, and new and creative theft detection strategies employing cutting-edge data analytics should be the order of the day. **"Regulator Chaser" Class Actions**

If regulators drove ambulances, plaintiffs' class action lawyers would trail them in traffic. Nothing generates new class actions like the "gotcha" law of a new set of regulators. The Consumer Financial Protection Bureau continues its roll-out of massively complex new rules, effectively reconfiguring the entire settlement service industry. At the same time, the deep budget cuts of the Great Recession have forced state and federal regulators to continue to fund their own enforcement efforts with fines, settlements, and insurer-paid audits. Title insurers can expect plaintiffs to follow hard on the heels of these regulators. Copycat class actions can drag on for years at staggering expense, even when their merits seem far-fetched. **Data Breach Claims**

Hardly a week goes by without news of another data breach suffered by a well-known institution. Even the largest and most sophisticated companies are no longer immune to cyber-attackers who constantly probe their defenses from offshore havens like Russia, China and Africa. Title insurers wind up in possession of confidential customer information and sensitive financial information in any number of ways—through their direct operations, through services provided to their agents or indirectly through affiliates offering a broad range of financial services, either directly to individuals or to financial institutions. Federal regulators have been increasingly aggressive in their approach to data breaches. States are increasingly adding their own, sometimes even more onerous, statutory and regulatory requirements. And, once again, private plaintiffs are never far behind, pursuing every type of theory from class actions to multi-district panel litigation to shareholder derivative suits, in order to take advantage of any security breach. Investing in data security can be expensive, and keeping up-to-date can seem a never-ending problem, but this battle must be fought. **Unreleased HELOCs**

Throughout the boom, untold thousands of HELOCs taken out by sellers or refinancing borrowers were paid down to a zero balance, but without actually obtaining a release of the accompanying lien. When the HELOC borrowers realized that the credit line remained open, they often drew new funds. This spawns priority disputes and policy claims. This is not a new problem, and the post-boom wave of foreclosures exposed and led to the resolution of many of these claims. But, as the interest rates on these HELOCs reset, and possibly rise steeply in light of Fed policy changes and a strengthening economy, many more of these problems will likely come to light in the next several years. From 2004 to 2014, title insurers proved strong through unprecedented crisis. From 2014 to 2024, title insurers may well be called upon to fight again on new fronts. *Originally published in Title News: Official Publication of the American Land Title Association (January 2015).*

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