



# Claims Awareness Express

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## Federal Tax Liens and the Hidden Seller

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Barring the application of certain statutory exceptions or legal defenses, the interest of a subsequent purchaser or encumbrancer of real property is acquired subject to all *known* existing interests or liens. The legal concepts of actual and constructive knowledge dictate whether the prior interest or lien was *known* to the party/entity acquiring the subsequent interest. It is only when that party/entity first records their interest, having no actual or constructive knowledge of the prior interest or lien in question, *at the time of recordation*, that that subsequent party/entity who pays value for its interest will be afforded the status of *bona fide* purchaser or encumbrancer; a preferred status, wherein the interest or lien is acquired free and clear of all unknown prior interests.

From the standpoint of a title search, the focus is on constructive knowledge since it is rooted in the California recording statutes, which impute knowledge of a *properly recorded* document to the subsequent interest holder, regardless of whether the existence of the document was actually known. Thus, a proper search of the public record is the critical starting point in determining whether insured buyers or lenders will be afforded bona fide status.

When dealing with Federal tax liens, our industry searching practices are generally sufficient to locate outstanding liens, such that they will be appropriately dealt with in the transaction at hand. Federal tax liens in particular, however, present an additional hidden risk, in that these liens are recorded and indexed under the name of the taxpayer, e.g. *Bobbie Morgan*, which may sometimes differ from the way in which record title is held, e.g. *Bobbie Morgan Lane*. Therefore, a search under the name Bobbie Morgan Lane will not necessarily disclose the existence of a Federal tax lien recorded against Bobbie Morgan. Of course, a properly completed Statement of Information would remedy the problem presented by one's use of an alternative name, but the use of an alternate name is not always adequately disclosed prior to a title search, irrespective of whether the omission is intentional or mere oversight on the part of the seller or refinance borrower.

One might be quick to argue that there is no constructive notice of a Federal tax lien recorded and indexed against only the taxpayer, and not the holder of record title, since the lien cannot be located through a proper search of the grantor/grantee index, thereby taking the Federal tax lien outside the chain of

title. Generally speaking, this conclusion is often correct. However, federal tax liens, are as stated by one court, "wholly a creature of federal statute," and therefore, governed by federal law. Thus, we must look to the operative federal statute, as interpreted by applicable case law, to determine whether knowledge of the lien is present, affecting the ultimate priority of the lien.

In *TKB International v. United States of America* (9th Cir. 1993) 995 F.2d 1460, the Ninth Circuit Court of Appeals held that a subsequent purchaser's *actual knowledge* of a Federal tax lien is immaterial if the lien is not properly recorded in the direct chain of title pursuant to 26 U.S.C. section 6323(f)(4). Thus, contrary to California law, which holds that actual knowledge of a prior interest serves to defeat one's status as a bona fide purchaser/encumbrancer, the Federal statutory scheme makes this form of knowledge inconsequential. Section 6323(f)(4) is, more or less, the Federal equivalent of the constructive knowledge concept, requiring that the lien can be located through the grantor/grantee index. However, this subsection also further modifies the index searching process, stating that if the lien cannot be located through a *reasonable inspection* of the index, then that lien shall be validly enforceable as against any purchaser or holder of a security interest. While California law arguably requires a similar investigation of the public record when ambiguities in the chain of title would otherwise prompt a reasonable person to make further inquiry, the Federal statutory scheme, as interpreted by federal case law, leaves no doubt that there is an affirmative obligation to reasonably inspect indexed documents.

But what constitutes a reasonable inspection? Although guidance on this issue was first outlined in *Kivel v. United States of America* (9th Cir. 1989) 878 F.2d 301, few cases have actually detailed objective legal standards of what is reasonable. Therefore, there is currently no clear objective answer and a final determination of reasonableness will ultimately hinge on the particular facts at hand. However, *Kivel* is instrumental in providing a starting point for reasonable searching practices, so that title insurers need not assume any unnecessary risks.

In *Kivel*, the plaintiff had purchased the subject property from a successful bidder at a foreclosure sale, which was commenced against *Bobbie Morgan Lane*, the record owner of the property. Unbeknownst to the purchaser, the Internal Revenue

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Service (IRS) had recorded two prior liens against *Bobbie Morgan*. It was argued that a *reasonable inspection* of the index would have never led to discovery of liens recorded against *Bobbie Morgan*, since the plaintiff's title was based on a chain going back only to *Bobbie Morgan Lane's* acquisition. The *Kivel* court, after quickly indicating that title industry practices are not determinative of reasonableness, went on to say that a title searcher must actually look at the documents that are in the chain of title, "and must then act on the notice imparted." While refusing to decide the outer limits of the reasonable inspection requirement, the court found that a document in the chain of title had made reference to *Bobbie M Morgan*, also known as *Lane*. Thus, it was determined that a reasonable searcher would have been put on notice that *Bobbie Morgan Lane* was also known as *Bobbie M Morgan*, thereby necessitating an additional search under the alternative name, and that this additional search would have disclosed the existence of the liens recorded against *Bobbie Morgan*. As a result, the court concluded that the tax liens did in fact encumber the plaintiff's property.

As stated above, reasonableness of an inspection will ultimately turn on the particular facts at hand, but it is important to

note that the court in *Kivel* in no way limited the universe of potential ways in which notice of an alternative name may be provided. By way of example, one document referred to in this decision, although not ultimately dispositive to the ruling, was a Declaration of Married Person's Separate Homestead, in which the top of the Homestead form provided a statement that the recording had been requested by *Bobbie Morgan*, although the Homestead was filed in the name *Bobbie Morgan Lane*. A broad reading of this case could potentially impute knowledge of an alternative name based merely on this perceived inconsistency.

Federal tax liens can present grounds for significant liability on the part of a title insurer, often in the hundred thousand dollar plus range. Therefore, whenever the use of an alternative name has been identified on a particular document in the chain of title, regardless of whether the alternative name was actually disclosed on the SI, the title searcher should be mindful that a diligent search will often equate to what is *reasonable*, and should not be so cavalier in dismissing the need to act on that finding. ■

## Broken Cookies and Title Insurance

By: Ken E. Dzien, General Counsel, United Title Company

Two of my co-workers recently returned from Scotland. On the first day back to the office, they were kind enough to bring some Scottish cookies and candy back for the staff. The packaging for the products was beautiful and the products as lovely to look at as to eat. They went on to explain that they had a rather financially well off relative for whom they brought a gift of generically packaged bulk purchased broken cookies. They explained, "He is so frugal he will appreciate the thought that went into providing the extra value to him."

The title industry does not have seconds or outlet sales for deformed title products. In those relatively infrequent cases in which the title processing machine goes mad (so to speak), the files generally find their way to the Claims Department. It is there that an attempt is made to salvage the broken titles, like broken cookies are salvaged. It is valuable for title and escrow personnel to get some idea of the role played by this title salvage operation (the Claims Department) so that they may better understand how to assist the people who, by analogy, deal with the cookie crumbs.

Title and escrow personnel are conditioned to be accommodating and helpful to customers both prior to and after the closing. Being knowledgeable professionals, title and escrow staff are often the first people to be asked to provide data. It is

important to understand the distinction between answering a customer inquiry, giving damaging misstatements or admissions to a claimant, and even unknowingly handling a claim. When personnel are not sure about the nature of their discussion with a customer or they suspect that a claim is to be made, perhaps the simplest approach is to just ask as early in the conversations as possible whether the customer is making a claim.

In any event, it is critical to remember that the customer may not know that the staff member they are talking to has no claim authority. The customer may think (and a jury might later conclude) that an unauthorized person is actually handling the claim. The correct action by anyone in this situation is simple: (1) inform the customer about how the claim is to be processed, and (2) provide the name and address of individuals at the company with claims authority, so the customer can put the claim in writing, and to addressed to the appropriate person at the company. Providing this information establishes a clear direction as to how the claimant should proceed.

Further, when discussing a matter with customers, it is imperative that untrained personnel not admit liability or even characterize the situation. Avoid making colorful statements like "We missed it." or "We botched the job." Equally troublesome are statements like "This title officer did not know what he was

doing." or "She was let go for mistakes like this." Along the same lines, when a matter appears significant, it is very important to document conversations. When someone attributes an outrageous statement from a staff member to the claims staff, it is very beneficial to have contemporaneous notes to disprove the accusation.

Consider this fictional example. Suppose a homeowner is down on his luck and is being pursued by creditors, including those holding abstracts of judgment on his home. He files a petition in bankruptcy and his debts are all fully discharged. After he is relieved by the bankruptcy, the homeowner seeks to use the equity in his home to secure a loan. In order to now throw gasoline on the fire, our fictional homeowner will need to find the only title officer left in California who has not learned that a discharge by the bankruptcy court of a debt secured by a lien (voluntary or involuntary) against the debtor's real property does not release the creditor's lien against the property. The homeowner might not be personally liable for any judgment debt because of the discharge. The lien, however, remains on the property in the absence of the bankruptcy court affirmatively extinguishing or avoiding it (such extinguishment or avoidance might be appropriate when the court concludes the abstract is a preference or because the court applies the homestead exemption to void the lien). Suffice it to say, the discharge of the debtor itself does not release the lien.

To proceed with the story, the homeowner/borrower [having been turned down for insurance by two competitors] now contacts our uninformed title officer. The title officer, flush with pride for snatching an order from the competition, assures the borrower that the liens are gone. The deal closes, the loan funds are disbursed and the borrower pockets the money. Thereafter, the insured lender is greeted with threats and demands from the holders of the abstracts of judgment. The borrower and lender each independently contact the title officer about the threats. The title officer assures them that there could be no problem. Thereafter, the title officer is mysteriously absent from the office as he leaves the employment of the company.

With a Writ of Execution to enforce the judgment now pending and the borrower anxious to sell the home, the borrower and the insured lender both contact the Advisory Title Officer (ATO). During the conversation the ATO announces "This title officer was an idiot." He adds, "The situation is a mess and I will send the file to the Claims Department for payment of the abstracts," The landowner now screams, "I listed my home for sale in reliance upon your title officer who told me the liens were gone. You have to issue an owners policy to anyone who might buy my home or this problem will go well beyond the amount of these judgment liens."

Upon receipt of the matter by the Claims Department, the claims officer immediately makes demand on the borrower to solve the problem of the abstract. He announces, "We only issued a lenders policy." The claims officer orders an appraisal which shows the value of the property to be sufficient to satisfy both the abstract and the insured trust deed. The insured lender is advised to foreclose on the trust deed on the basis that the existence of the abstract constituted the borrower's obligations as set out in the trust deed. The homeowner is told that he has no coverage under the lenders policy, that the liens were of his own making, and that the statements made regarding the abstracts were strictly related to the title insurer's decision regarding the issuance of lenders title insurance policy. The sale can take place, but only if a fully funded secured indemnity is provided by the borrower/seller.

At this point, the outrage of the lender and borrower cannot be contained. "We were told the abstracts would be paid." The lender screams, "The monthly payments under this loan are not being paid and we would never have made the loan if we knew of the abstracts!" The borrower shouts at the top of his voice, "Your title officer told me title was clear! I would have never been in this position had I known the abstracts remained a lien. Now, I am told that the person processing my title order was incompetent at his work. The Department of Insurance will hear about this." Notwithstanding the correctness of the claims officer's decision and even with the policy provisions supporting the title insurer's actions, it is hard to respond to the Department of Insurance or to a judge when so many damaging statements were made by company personnel untrained in claims work. Further, distressed with heightened expectations not meeting reality, a lender often will threaten to cease doing work with the company because of such emotionally charged circumstances.

Once it is determined by advisory staff that it is safe to proceed, how easy would it be to substitute the statement, "We are willing to insure the lender for this risk", as opposed to, "The lien is eliminated by the bankruptcy"? How easy is it to act professionally and say, "Here is a claim form.", or "The matter will be referred to the claims department who will provide a Notice of Claim form." Contrast this with, "We botched the job" In some claim handling contexts, a title insurer needs to ask a court to apply "equity" to correct honest mistakes made. In that instance, a court will balance the equities of all parties to a transaction. Inappropriate statements such as noted earlier become a theme utilized by adversaries to demonstrate the title insurance company was unfair, unreasonable, and not caring about, dare I say, how the cookie crumbles. ■