THE TITLE GUARANTY: AN ATTRACTIVE IMPORT

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As nearly every investor in Poland knows, Poland's turbulent past can create considerable confusion over the ownership of Polish land. Historically, investors in Polish real estate have relied on three basic things to determine whether they are purchasing good title: (1) an excerpt from the relevant land book, (2) a lawyer's opinion of title and (3) an express or implied warranty of title from the party that transfers an interest in land.

In the United States, by contrast, virtually no significant real estate investment is undertaken without the purchase of a "**title guaranty**" (or similar instrument) from a large company that specializes in analyzing and confirming title to real estate. The title guaranty offers indemnification to the party that purchases it (the "holder") against losses caused by unanticipated claims on title. Because of its ability to undo the economic harm resulting from adverse title claims, the title guaranty is a principal requirement in virtually every U.S. commercial mortgage loan and virtually every rated real estate securities offering.

As Polish real estate investors and mortgage lenders seek greater access to international securities markets, they can expect that the international rating agencies—and the investors who purchase the securities—will require title guaranties on Polish projects as well. To preserve the opportunity for future securitization of loans, conventional lenders might also be expected to begin insisting on title guaranties as a standard underwriting requirement.

Title guaranties are now available in Poland through **Stewart International Sp. z o.o.** ("Stewart"), the Polish subsidiary of U.S.-based Stewart Title Guaranty Company ("STGC"). STGC is a "Fortune 400" company with more than 100 years' experience in issuing title guaranties. STGC's substantial assets (more than USD 1.27 billion in 2001 revenues) and sound credit rating (AA Moody's and A+ Fitch and LACE) provide strong backing for Stewart's title guaranty obligations in Poland.

Why Not Rely on Traditional Evidences of Title?

Investors in the U.S. (and in many other countries) recognize that reliance on title warranties and legal opinions—and even on excerpts from official land records—may provide inadequate protection against a possible title dispute.

Although the principle of the "warranty of the book" in Poland gives substantial protection to the registered owner of land, *the warranty is not foolproof*.

For example, a registered owner who acquires title with knowledge of an adverse claim is not necessarily protected by the warranty of the book. Determining whether "knowledge" exists can be difficult. Despite no *actual* knowledge of a claim, an investor can still be *deemed* to have knowledge based on the information available to him at the time of purchase. Even where a purchaser is innocent, the mere *allegation* that he or she had prior knowledge of an adverse claim can expose the investor to years of litigation and considerable losses from project delays.

An investor's protection under a typical lawyer's opinion of title is similarly limited. Claims against title can exist that are outside the scope of the lawyer's professional responsibility. Human error, court delays, missing records, fraud, misunderstanding and disagreement over relevant facts can create significant doubt as to the ownership of an interest in land—even where the excerpt from the land and mortgage registry or the lawyer's opinion appears to be unambiguous.

How Can a Title Guaranty Help?

A title guaranty offers greater protection than the traditional evidences of title. Economies of scale allow the title company to bear title risks at a cost equal to a fraction of the loss that the individual investor might suffer if its title to a particular project came into dispute. A legal opinion or title warranty might allow for the recovery of losses if they fail to disclose a valid adverse claim, but recovery is possible only if the responsible party has the financial ability to pay the investor's claim. A title guaranty covers the expense of defending against a covered claim even if the claim turns out to be invalid, and the title company's substantial assets make it a far more attractive source for recovering losses.

What Does the Title Guaranty Cover?

The title guaranty is basically an indemnity contract. It compensates a holder for its losses (up to the value of the guaranty) if title claims are asserted that are not described in (or otherwise excluded by) the guaranty. Currently, Stewart offers two basic forms of title guaranty in Poland. They are:

- The "owner's" title guaranty, which covers losses suffered because (a) ownership of a specified real estate interest is not as described in the guaranty or (b) a third party makes certain claims against the real estate; and

- The "lender's" title guaranty, which covers losses suffered because (a) a specified mortgage is invalid or does not have the priority stated in the guaranty, (b) ownership of the real estate encumbered by the mortgage is not as described in the guaranty or (c) title to the property or the mortgage becomes the subject of certain third party claims.

Any interest in real estate (e.g., a freehold, a usufruct, a land lease, an easement or a mortgage) can be covered by a title guaranty. The guaranty describes the ownership of the covered interest as it exists on the date it is issued (the "effective date") and indemnifies the holder if that description is incorrect. To be covered, a claim under an owner's or lender's guaranty must be based on a right or interest in the subject property that (1) existed on the effective date, (2) impairs the holder's interest, (3) was not disclosed in or otherwise excluded from the guaranty and (4) results in actual loss to the holder. A title guaranty does *not* cover future changes in title (most of which cannot occur without some act on the part of the owner), but it does cover future *assertions* of claims based on rights that are alleged to have existed on the effective date.

The owner's and lender's guaranties are issued for a one-time up-front fee that is typically in the range of 0.3% to 1.0% of the amount of coverage purchased (depending on the complexity of title and other factors). These forms of guaranty do not have a fixed expiration date. They continue in effect for as long as the holder owns the covered interest (and they continue to cover title warranties that are made by the holder even after the interest is transferred).

A third form of guaranty—the "gap period" guaranty (so called because it covers the holder's risk during the "gap period" between the date a document is filed for registration and the date the land court issues its decision concerning registration)—is available to protect against a different sort of risk.

Unlike the owner's and lender's forms of guaranty, the gap period guaranty is issued on the basis of a monthly fee, and it expires when the document it covers has been accepted for registration. If registration occurs, the gap indemnity is no longer needed; any filings made during the "gap" period would normally be subordinate to the registered interest by operation of Polish law (so the holder suffers no harm). If registration is denied, however, and a superior interest is filed during the "gap" period, the holder may suffer loss (which means there is heightened risk involved in investing funds in a project prior to the formal registration of title). By covering the registration risk during the "gap" period, the guaranty allows investment to be made safely at an earlier date, with obvious benefits to the project.

The Title Guaranty Has Relevance in the "Real World"

For those who are not yet convinced that a title guaranty can offer protection where the traditional evidences of title might not, consider the following hypothetical examples, which are easy to imagine in Poland:

Example 1:

A Polish company acquires land for EUR 1,000,000 and intends to build a EUR 10,000,000 building on it; (2) before title is transferred, a member of the company's management board knows (or has enough information to be deemed to know) about a possible adverse claim that has not yet been filed; (3) the board member does not tell the shareholders or the other board members about the claim (perhaps because he is simply unaware of the importance of what he knows); (4) when the building is half-complete, the claim is asserted against the company.

An innocent purchaser of the land would normally acquire title free and clear of the claim in this example (because the claim was not filed for registration prior to the date of transfer). However, if a court were to conclude that the company had "knowledge" of the claim because one of its management board members knew about it, the shareholders might find that they have lost their entire investment *even though they acted in good faith*. Perhaps they would have a claim against the management board member, or against the party that sold the land (under an implied warranty of title), but those parties might not be able to reimburse the company for the EUR 6,000,000 that would have been spent—remember, the seller received only EUR 1,000,000 for the land. Even if recovery is possible, it might take many years to resolve the dispute. In the meantime, the development will be stalled and the investor is likely to face a rapidly declining return on its investment.

Example 2:

Where land is transferred by a gmina or other governmental body to a private company, the company would ordinarily acquire title free and clear of claims that had been made known to the government but were (a) not known to the company and (b) not yet properly registered. Where the transfer is made to a company in which the government is given a carried interest, Polish courts have not yet ruled whether the prior knowledge of one shareholder (in this case, the government) amounts to "knowledge" on the part of the company. If a claim is asserted that the company is not an innocent purchaser because of the shareholder's knowledge, it might be a difficult, time-consuming and expensive claim to resolve. While the dispute is in the courts, the project is likely to be delayed. In the absence of clear judicial guidance, it is unlikely that the investor would be able to obtain an unambiguous legal opinion on this issue (and even if he can, what does he do if the legal opinion is incorrect?). Under appropriate circumstances, it should be possible to obtain protection against this sort of risk under a title guaranty, and the title guaranty promises a better chance of recovery if the adverse claim is asserted and determined to be valid.

Example 3:

A lender that has made a mortgage loan to either of the companies in the prior examples (and who is otherwise unaware of any adverse claim) might find that its mortgage is invalid if the claim is asserted and noted in the land book after the lender advances money but before the lender's mortgage is registered. For this reason, lenders take a risk in advancing funds prior to the formal registration of their mortgages. Investors suffer delays if the lenders insist on registration of the mortgage before they advance funds.

Other Examples:

Even the best real estate closing practices cannot entirely eliminate the risk of potential title claims. A buyer or its attorney can review the perpetual book minutes before a land transfer occurs, but they cannot eliminate entirely the risk that a claim affecting the land could be filed moments later—or that a claim might have been filed the day before but not yet entered into the perpetual book. A prior filing may have been lost by the registry court or filed incorrectly, in which case there is likely to be a dispute as to whose filing is entitled to priority. In cases such as these, the purchaser or its lawyer may be unable to discover the problem, but the purchaser could nonetheless suffer economic harm. A transfer might be made under an apparently valid power of attorney, but the power of attorney might later be determined to be invalid because the person who gave it is determined not to have been mentally sound at the time the power of attorney was given or because the document is a fake. Even if everything is done perfectly, third parties can still *allege* that a new owner is not "innocent" because it had prior notice of their interest. Whether or not such a claim is determined to be valid, the new owner will incur expense in defending against it and will probably suffer project delays while the dispute is ongoing.

In short, notwithstanding Poland's generally reliable land registration system, there are numerous title risks that cannot be eliminated through a lawyer's opinion or a check of the land registry. The inevitability that mistakes will occur in at least *some* real estate transactions—and the possibility that the parties who are liable for the error will not have sufficient assets to pay the resulting damages—suggests that a title guaranty should be considered for almost any real estate investment.

Some Limitations on the Scope of the Guaranty

The title guaranty does not protect against *every* risk of real estate ownership. It covers only claims against title that arise out of Poland's land transfer and ownership laws. Consistent with this, the title guaranty contains a variety of limitations that are generally in line with the following principles: (1) the guaranty says nothing about the physical characteristics of land or the uses that can be made of it; (2) it does not cover changes in title based on future events; (3) it does not protect a party against its own wrongful acts (such as fraud, a failure to pay taxes, or a failure to take certain actions to minimize damages after an adverse claim becomes known); (4) it does not cover matters that cannot be determined by a search of the public records (e.g., statutory tax liens or unrecorded easements that can be discovered by the buyer's inspection of the land); (5) it does not cover matters the holder knew about at the time of purchase but did not disclose to the title company; and (6) it does not cover events that have not resulted in actual economic loss. Damages that might occur because of restrictions under zoning, building code, environmental or other laws are not covered by the guaranty (unless coverage over these issues is specifically negotiated). Nor are losses that might result from the exercise of the government's police powers (e.g., expropriation) or from wars or civil strife. Defects in title that result because a transfer is made without fair consideration or by a company that was insolvent at the time of the transfer (or became insolvent as a result of it) also are not covered.

The good news is that many of these limitations can be eliminated or narrowed based on the delivery of certain materials to the title company. For example, the exception concerning the physical characteristics of the land might be omitted if a satisfactory geodesic survey is delivered to the title company. Special language might be added to the guaranty assuring the owner that the boundaries of the land are as shown on the survey or that there are no encroachments of physical improvements across the boundaries. The exceptions for possible tax liens might be narrowed based on a certification from a creditworthy seller affirming that (a) it has paid all taxes it owes and (b) it will pay any taxes it might later be determined to owe and that might result in a lien against the land. Protection against unrecorded easements or other interests that might in some cases survive a transfer might be obtained by providing a certification from the existing owner as to the absence of any such interests. Exceptions for possible losses resulting from third party fraud, events of bankruptcy or failures of the holder to comply with certain laws might be omitted based on the delivery of appropriate evidence that these issues have no relevance in the particular transaction. Where an investor or lender stands to lose its entire investment if a potential title claim proves to be valid (however remote that possibility might be), a project developer may find that its sources of capital are unwilling to advance funds if any uncertainty exists regarding the ownership of the land on which the project is located. Because a title company is able to spread the relatively unlikely risk of a complete failure of title across many properties, it is often able to provide guaranty protection on the basis of documentation and legal analysis that might not ordinarily be acceptable to the project's debt or equity investors. By offering a reimbursement claim against a solid company in place of a less certain claim under a title warranty or an ambiguous legal opinion, a developer may find that funding of its project can be significantly accelerated.

In short, the terms of a title guaranty are *negotiable*. Proper negotiation, however, requires a thorough familiarity with the customs and practices of the title guaranty industry. Experienced counsel should therefore be engaged to review every title guaranty, to explain its terms and limitations to the holder and to assist the holder in negotiating appropriate modifications. An investor whose counsel does not have the requisite experience with title guaranties may find someday that it has suffered a claim against title that should have been covered by a properly negotiated title guaranty, but that is not.

Because of the substantial benefits that the title guaranty offers to investors and their lenders, it is somewhat surprising that the European real state sector has not developed a title guaranty tradition of its own. As Polish real estate projects compete for increasing levels of U.S. investment, and as investors and lenders in Poland seek to position their assets for inclusion in international real estate securities transactions, it seems likely, however, that the purchase of a title guaranty will become an increasingly common underwriting requirement as a means to protect yields in the event a title dispute on a given project occurs.