Supreme Court of Arizona Holds Lender's Diminution-in-Value Loss Required to Be Calculated as of the Date the Policy Was Issued Rather Than Date of Foreclosure

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In a significant decision for both the title and banking industries, the Arizona Supreme Court recently held that the diminution-in-value loss under a lender's title insurance policy could be calculated by the date that the policy was issued, rather than the date of foreclosure, if the court determines the title defect caused the borrower to default. See First Am. Title Ins. Co. v. Johnson Bank, 2016 WL 3247545 (Ariz. June 13, 2016). In the case, the plaintiff, First American, issued two title insurance policies to the defendant, Johnson Bank, for two properties which secured the bank's loans in the total amount of $2,050,000. Certain covenants, conditions, and restrictions ("CC&R") that prohibited commercial development on either parcel were not listed on the policies. In 2010, after the borrowers defaulted, the properties were sold at a trustee's sale and purchased by Johnson Bank. Johnson Bank subsequently notified First American of claims under its title insurance policies, asserting that the CC&R's prevented both properties from being developed for commercial purposes and that the CC&R's were not listed exceptions to coverage under the policies. Johnson Bank argued that the date of the policies should be used to calculate damages, while First American argued that damages should be based on the value of the properties at the time of foreclosure.

Both parties sought declaratory relief in superior court, with the court granting judgment in favor of First American, holding that the parcels should be valued as of the foreclosure date. On appeal, the Arizona Court of Appeals reversed, holding that, "in the absence of a specified date of comparative valuation identified in the policies, the date to measure any diminution in property value is the date of the loan." First Am. Title Ins. Co. v. Johnson Bank, 237 Ariz. 490 (Ct. App. 2015). The Arizona Supreme Court granted review on the issue of "how to calculate damages under a lender's title insurance policy that failed to disclose encumbrances substantially affecting the value of the property and thwarting its intended use."

The Court first looked at legislative goals, social policy, and the transaction as a whole, and found that "[s]ocial policies and fundamental aspects of the parties' transaction support using the date of the policy as the valuation date." The Court further stated here that using the foreclosure date as the damage-valuation date would allow the insurer to profit from a depreciating market even when the title defect caused the borrower to default. Moreover, it found that a case-by-case approach was warranted to value the insured's loss because defaulting to the foreclosure date as the valuation date would render courts and the parties involved unable to evaluate the insured's actual loss in a particular case. Most importantly, the Court explained that the "majority view," which would measure the loss as of the foreclosure date, involved situations in which the title defect was an undisclosed senior lien and thus was not applicable here. The Court held that the "minority view," adopted by the Court of Appeals and which measures the loss using the date of the loan, was applicable because it involved situations where, as here, the title defect caused the borrower to default. The Court therefore remanded the case to determine if Johnson Bank could prove the title defect caused the borrowers' default and subsequent foreclosure, which would justify using the date of the policies as the valuation date. Otherwise, the proper valuation date would be the foreclosure date.

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