IN THE

ARIZONA COURT OF APPEALS

DIVISION ONE

FIDELITY NATIONAL TITLE INSURANCE COMPANY,
Intervenor/Appellant/Cross Appellee,

v.

OSBORN III PARTNERS LLC, et al., *Defendants/Appellees/Cross-Appellants*.

No. 1 CA-CV 18-0040

FILED 03-09-2021

Appeal from the Superior Court in Maricopa County
Nos. CV2008-033080, CV2009-002138, CV2009-002641, CV2009-003123, CV2009-019132, CV2009-050918, CV2011-001213
CONSOLIDATED
The Honorable Randall H. Warner, Judge
The Honorable Michael J. Herrod, Judge

AFFIRMED IN PART, REVERSED IN PART, VACATED IN PART, AND REMANDED

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OPINION

Judge Kent E. Cattani delivered the opinion of the Court, in which Presiding Judge Maria Elena Cruz and Judge Paul J. McMurdie joined.

C A T T A N I, Judge:

¶1 In this case, we address the applicability of *United Services Automobile Ass'n v. Morris*, 154 Ariz. 113 (1987), in the context of title insurance. Under *Morris*, which arose in the context of liability insurance, when an insurer agrees to defend its insured against a third-party claim but reserves the right to challenge coverage, the insured may independently settle with the third-party claimant without violating the insured's duty of cooperation under the insurance contract. *Id.* at 119. We hold that *Morris* applies to title insurance. We further hold that a common provision in title insurance policies that denies coverage for liens or other defects "created, suffered, assumed or agreed to by the insured claimant" (here, Exclusion 3(a)) applies to mechanics' liens that arise because of insufficient funds when a lender cuts off funding for a construction project. Accordingly, and for reasons that follow, we affirm the superior court's *Morris* rulings, but we reverse its ultimate coverage determination as well as the resulting judgment in favor of the insureds. Because our resolution affects the prevailing party calculus for purposes of an award of attorney's fees, we vacate the award in favor of the insureds and remand for further proceedings on the parties' attorney's fee requests and entry of judgment consistent with this opinion.

FACTS AND PROCEDURAL BACKGROUND

¶2 In 2006, Mortgages Ltd. loaned developer Osborn III Partners $8.5 million, secured by a deed of trust, to fund construction of the Ten Lofts condominium complex in Scottsdale. In a second loan agreement, Mortgages Ltd. committed to loan the developer $41.4 million, again secured by a deed of trust on the property. The developer used a portion of the second loan to satisfy the first loan and obtain a release of the first deed of trust. Mortgages Ltd. procured a title insurance policy (the "Policy") from the predecessor to Fidelity National Insurance Company ("Fidelity") to insure the priority of its security interest, including over later-recorded mechanics' liens.

¶3 The developer hired Summit Builders ("Summit") as general contractor for the project. Before construction was completed, Mortgages Ltd. failed to disburse about $1.1 million of the $41.4 million it had agreed to provide, and the developer stopped paying Summit. Summit and its subcontractors later recorded mechanics' liens against the Ten Lofts property seeking payment for completed but unpaid work.

¶4 Meanwhile, Mortgages Ltd. suffered financial problems that led to an involuntary bankruptcy proceeding in 2008. As part of the reorganization, the bankruptcy court transferred Mortgages Ltd.'s interest in the Ten Lofts project to a newly created company, Osborn III Loan LLC, and several individual fractional interest holders (collectively, the "Successors"). The court also created ML Manager to manage this and other elements of the overall restructuring of Mortgages Ltd.

¶5 In December 2008, Summit and several subcontractors filed a lien foreclosure action in superior court asserting that their mechanics' liens had priority over the deed of trust on the Ten Lofts property recorded by Mortgages Ltd. and now held by the Successors. Fidelity accepted the defense but did so under a reservation of rights.

¶6 While the state-court action was ongoing, ML Manager noticed and held a trustee's sale of the Ten Lofts property, at which ML Manager acquired the property with an $8 million credit bid. ML Manager then sought permission from the bankruptcy court to sell the Ten Lofts property to a third party, free and clear of all liens. Summit objected, arguing that the trustee's sale had not extinguished its mechanics' lien. The bankruptcy court ultimately approved the sale but ordered that over $3.4 million of the proceeds (enough to cover all the lien claims) be held in escrow until the resolution of the lien litigation. The order to that effect included language that "[n]othing in [the sale o]rder . . . shall waive, release or impact the coverage or liability of the title insurance policy for the payment of the alleged mechanics' liens."

¶7 ML Manager and Summit then agreed to settle the lien priority litigation through what they characterized as a *Morris* agreement. The agreement provided that Summit would receive $1.75 million of the escrowed sale proceeds, assign all its mechanics' lien claims to ML Manager, and indemnify ML Manager against any other lien claims. Contesting the validity of this agreement, Fidelity filed a limited objection to ML Manager's request for approval of the settlement in bankruptcy court. The bankruptcy court approved the split of the escrowed sale proceeds but made no finding regarding the agreement's validity under *Morris*.

¶8 Meanwhile, in state court, Fidelity intervened in the lien priority case to challenge the settlement agreement's validity and filed a separate complaint contesting coverage; the Successors counterclaimed for breach of contract and bad faith. The superior court consolidated the cases.

¶9 The parties moved for summary judgment on various issues, with a stipulation that if *Morris* applied to title insurance, the settlement was reasonable, not fraudulent or collusive, and made with appropriate notice to Fidelity. The superior court ruled that: (1) *Morris* applies to title insurance, (2) the agreement here fell within *Morris* even though it lacked certain terms (i.e., a stipulated judgment, covenant not to execute, and assignment of insurance claims) that generally appear in typical *Morris* agreements, (3) the sale of the Ten Lofts property to a third party did not terminate coverage for the Successors' claim (which related to a lien that arose before the sale), (4) the Successors stood in Mortgages Ltd.'s shoes for coverage issues (meaning Fidelity could assert against the Successors any defense it would have had against Mortgages Ltd.), and (5) Mortgages Ltd. had not "created" the lien (which would implicate Exclusion 3(a)) by failing to fully fund the loan because Mortgages Ltd. had the right under the loan agreement to stop funding when it did.

¶10 Fidelity successfully moved for reconsideration of the Exclusion 3(a) ruling based on an issue of fact as to whether Mortgages Ltd. had acted within its rights under its loan contract. After a bench trial, the superior court found the developer's prior default under the loan agreement gave Mortgages Ltd. a contractual right to withhold the final $1.1 million, and thus held that Exclusion 3(a) did not apply and the Successors' claim was covered under the Policy.

¶11 Fidelity then moved for summary judgment on the Successors' bad-faith claim. The superior court granted the motion, concluding as a matter of law that the coverage issue was fairly debatable, so Fidelity's conduct did not constitute bad faith.

¶12 The court entered judgment in favor of the Successors for $1,750,000 (the amount paid to settle with Summit), plus attorney's fees and costs. Fidelity timely appealed, and the Successors timely cross-appealed. We have jurisdiction under A.R.S. § 12-2101(A)(1).

DISCUSSION

¶13 The parties' appeal and cross-appeal challenge the superior court's various rulings in interconnected ways. Fidelity's primary contention is that *Morris* does not apply to title insurance and, alternatively, that if it does, the form of the Successors' settlement agreement did not comply with *Morris*. Fidelity further challenges the court's coverage determinations, positing both that coverage terminated under Condition 2(b) of the Policy upon the property's conveyance to a third-party buyer and that coverage was excluded under Exclusion 3(a) of the Policy because Mortgages Ltd. "created" the defect by cutting off loan funds, which led to Summit's mechanics' lien.

¶14 For their part, the Successors counter all of Fidelity's arguments contesting the court's rulings. Additionally, they challenge the superior court's conclusion that they stand in Mortgages Ltd.'s shoes for purposes of Exclusion 3(a), asserting instead that the exclusion can be applied only against the individual insured that created the defect (here, Mortgages Ltd. itself). The Successors further argue that the court wrongly granted summary judgment in favor of Fidelity on their bad-faith claim, asserting that Fidelity's position on the applicability of Exclusion 3(a) was not fairly debatable.

¶15 As described in more detail below, we conclude that the principles of *Morris* apply in the context of title insurance. We also hold that a settlement agreement's form need not mirror the elements of the settlement in *Morris* itself (stipulated judgment with a covenant not to execute accompanied by an assignment of insurance claims), and that the agreement here fell within *Morris*'s parameters. We affirm the superior court's rulings in this regard.

¶16 Regarding coverage, the superior court correctly concluded that the Ten Lofts property sale did not terminate coverage for the Successors' claim, and the court properly determined that the Successors were subject to exclusions to the same extent Mortgages Ltd. would have been. We reverse the ultimate coverage decision, however, because we conclude that even though Mortgages Ltd. had a contractual right to stop funding under the loan agreement, its cutoff of loan funds created the mechanics' lien at issue, triggering Exclusion 3(a). We affirm the summary judgment in favor of Fidelity on the Successors' bad-faith claim.

I. *Morris*.

¶17 Fidelity first argues that the superior court erred by concluding *Morris* applies to title insurance. We review this question of law de novo. *See Kopp v. Physician Grp. of Ariz., Inc.*, 244 Ariz. 439, 441, ¶ 7 (2018); *Associated Aviation Underwriters v. Wood*, 209 Ariz. 137, 171, ¶ 107 (App. 2004).

A. *Morris* in Substance.

¶18 The principles underlying *Morris* begin with the obligations at play in the insurer–insured relationship. The insurer agrees to defend its insured against any potentially covered claim and to indemnify its insured against anything actually covered by the policy. *Morris*, 154 Ariz. at 117. The insured, in turn, is bound to cooperate with the insurer and aid in the defense, which is subject to the insurer's exclusive control. *Id.* Before *Morris*, an insured was released from its cooperation obligation (and thus could independently settle with a third-party claimant without breaching the insurance contract) only if the insurer first breached one of its contractual duties. *See, e.g.*, *Damron v. Sledge*, 105 Ariz. 151 (1969); *Ariz. Prop. & Cas. Ins. Guar. Fund v. Helme*, 153 Ariz. 129 (1987).

¶19 *Morris*, however, recognized the conflict that arises between the interests of the insurer and the insured when the insurer accepts the defense, but does so under a reservation of rights. 154 Ariz. at 118. Because of the difference in scope between the insurer's duty to defend and its duty to indemnify, the insurer can properly (absent bad faith) reserve its right to contest coverage without breaching its policy obligations. *Id.* But because the insurer has not accepted full responsibility for the insureds' potential liability, the insureds are left in a "precarious position." *Id.*

¶20 Under then-existing law, the insureds had no control over the litigation and no right to accept a settlement, no matter how reasonable, even though they faced the possibility of a judgment exceeding policy limits or one that, even if within policy limits, ultimately might not be covered—what the court characterized as "the sharp thrust of personal liability." *Id.* (citation omitted); *see also Apollo Educ. Grp., Inc. v. Nat'l Union Fire Ins. Co. of Pittsburgh*, No. CV-19-0229-CQ, 2021 WL 710224, at *4, ¶¶ 21–22 (Ariz. Feb. 17, 2021) (noting that *Morris* was based on an "unfair allocation of risk" when the insurer retained exclusive control of the litigation). The insurer, on the other hand, enjoyed a "double bite at escaping liability"—it could avoid having to pay the claim if it defeated the third-party claimant (which would protect the insured as well) or, if the insured were found liable, it could prevail on the coverage defense. *Morris*, 154 Ariz. at 118. And (again, absent bad faith) the insurer's risk would, in any event, be capped at the policy limit, *id.*, "a risk for which it bargained and was paid." *Leflet v. Redwood Fire & Cas. Ins. Co.*, 226 Ariz. 297, 301, ¶ 19 (App. 2011).

¶21 To navigate this conflict, the Arizona Supreme Court held that "an insured being defended under a reservation of rights may [settle the case] without breaching the cooperation clause." *Morris*, 154 Ariz. at 119; *see also Apollo Educ. Grp.*, No. CV-19-0229-CQ, at *4, ¶ 20; *Leflet*, 226 Ariz. at 301, ¶ 15 ("The overarching goal of *Morris* is to permit the insured and the insurer to balance their competing interests in an atmosphere of fairness and defined risk . . . ."). By maintaining its coverage defense—in effect a "reservation of the privilege to deny the duty to pay"—an insurer relinquishes its exclusive control over the conditions of payment and thus over this aspect of the litigation, "narrow[ing] the reach of the cooperation clause" to "forbid[] an insured from settling only claims for which the insurer unconditionally assumes liability under the policy." *Morris*, 154 Ariz. at 119.

¶22 At the same time, recognizing that the insured might not prioritize the insurer's interests when negotiating a settlement, the court built in protections to ensure an insurer will not be bound by a settlement that is unreasonable. *Id.* Accordingly, any *Morris* agreement "must be made fairly, with notice to the insurer, and without fraud or collusion on the insurer." *Id.* Moreover, consistent with basic indemnification principles, the insurer is bound by the agreement only if "the settlement was reasonable and prudent under all the circumstances," assessed by "what a reasonably prudent person in the insureds' position would have settled for on the *merits* of the claimant's case" taking into account the facts bearing on liability and damages, "as well as the risks of going to trial." *Id.* at 120–21.

¶23 Although this case involves title insurance rather than the third-party liability coverage at issue in *Morris*, the principles underpinning *Morris* apply equally to the circumstances presented here. Fidelity owed the Successors the duty to defend and, in the case of a covered loss, indemnify; the Successors owed Fidelity a contractual duty to cooperate in the defense. Because the duties to defend and to indemnify are not coextensive, Fidelity could, without breaching its obligations, accept the defense while reserving its right to contest coverage. And that defense under a reservation of rights created the same imbalance and conflicting interests motivating the decision in *Morris*: the Successors were left to face the risk of an excessive or uncovered loss while Fidelity retained two bites at entirely avoiding (its contractually limited) liability. Here, as in *Morris*, Fidelity's reservation of a right to assert a coverage defense narrowed the reach of the cooperation clause, permitting the Successors to independently settle without breaching their obligations so long as the settlement was reasonable and made fairly, with notice, and without fraud or collusion.

¶24 Fidelity nevertheless argues that *Morris* should not apply here, asserting that the principles driving *Morris* are inextricably tied to third-party liability coverage (and not first-party title insurance) because of the type of risk insured. *See Clearwater v. State Farm Mut. Auto. Ins. Co.*, 164 Ariz. 256, 258–59 (1990) (distinguishing first- and third-party coverage). Because a third party's injury can result in virtually unlimited damages, an insured defended under a reservation of rights can face "the sharp thrust of personal liability" for a crippling sum. In Fidelity's view, this means that the "conflict created by a reservation of rights is . . . significant *only* insofar as it threatens the insured with *personal liability*."

¶25 To be sure, title insurance insures against a different kind of risk (loss or damage resulting from a defect in title or, as here, an insured lien's loss of priority) than does third-party liability coverage. But *Morris*'s rationale is not as narrow as Fidelity suggests. Both the problem presented in *Morris* and the solution it devised were not constrained to a particular type of risk but instead were grounded in more basic structures and principles of indemnity law, and they have been applied to other types of indemnity agreements. *See A Tumbling-T Ranches v. Flood Control Dist. of Maricopa Cnty.*, 220 Ariz. 202, 207–08, ¶¶ 11–15 (App. 2008); *see also Apollo Educ. Grp.*, No. CV-19-0229-CQ, at *5, ¶¶ 25–26 (reasoning based on the substance of the parties' rights and obligations under an insurance contract rather than simply distinguishing based on first-party action versus third-party action).

¶26 And although title claims are different than third-party liability claims, insureds under title policies are not necessarily insulated from a loss exceeding policy limits. Granted, given the value of the mechanics' liens involved in this case, the resulting loss was unlikely to exceed the Successors' policy limits, so the insureds here did not face the risk of an excess judgment. But the same was true in *Morris* itself. *See Morris*, 154 Ariz. at 118 n.5 (describing the possibility of an excess judgment on the facts presented as "less than overwhelming"). In a different case, depending on the particular circumstances presented or on changes in the property's value, an insured under a title policy could risk a loss greater than policy limits—or even one that wholly eclipses the value of the insured property. Moreover, *Morris* was based not just on the risk of an excess judgment (the risk on which Fidelity focuses) but also on the risk of an uncovered loss—the same risk the Successors faced when Fidelity defended under a reservation of rights. *Id.* at 118–19; *see also Safeway Ins. Co. v. Guerrero*, 210 Ariz. 5, 9, ¶ 9 (2005) (describing the "difficult situation[]" that *Morris* seeks to reconcile as encompassing the insured's risk "that any judgment, even one within policy limits, may not be covered by the policy").

¶27 Fidelity next argues that applying *Morris* in the title-insurance context would undermine other critical terms of title-insurance contracts, including the insurer's right to establish title as insured and its right to "a final determination by a court of competent jurisdiction" of the existence of a title defect. But given that Fidelity is defending under a reservation of rights, allowing it to use these clauses to prevent the insured from settling a claim would mean that "[f]rom a practical standpoint, the insurer, not the insured, will once again be in control of the litigation for purposes of settlement." *Monterey Homes Ariz., Inc. v. Federated Mut. Ins. Co.*, 221 Ariz. 351, 356, ¶ 21 (App. 2009). That result would be inconsistent with *Morris*. *See id.*

¶28 Just as Fidelity otherwise would have had the sole right to litigate to the end rather than pursue settlement, its reservation of rights allowed the Successors to "step into the insurer's shoes" for these purposes. *See Parking Concepts, Inc. v. Tenney*, 207 Ariz. 19, 24, ¶ 24 (2004). Fidelity could have regained full control of the litigation—including the right to insist on a judicial determination, to establish title by alternative means, or to reach its own settlement with the claimant—simply by withdrawing its reservation and accepting responsibility for any resulting loss. *Morris*'s requirement that the insured provide notice to the insurer before entering a settlement agreement—notice that Fidelity agreed the Successors provided here—ensures that an insurer can make this decision with full knowledge of the issues and risks in play, including the likelihood of establishing the defect, the amount of the potential loss, the likelihood of success on a coverage defense, and the potential benefit (or not) from the proposed settlement. *See* 154 Ariz. at 119. What Fidelity could not do, however, was "hamstring the insured's ability to negotiate a settlement even though it ha[d] not accepted full responsibility" for the insured's loss. *See Monterey Homes*, 221 Ariz. at 356, ¶ 21.

¶29 Finally, Fidelity argues that recognizing *Morris* in the title-insurance context would invite fraud: "every insured could simply get someone to claim a lien against the property and, before the insurer could adjudicate lien priority and prove otherwise, stipulate to the priority of the claimant's lien and collect the insurance proceeds." But the risk of outright fraud (as well as the risk that an insured "might settle for an inflated amount or capitulate to a frivolous case merely to escape exposure or further annoyance," as the *Morris* court put it) is likewise present in the third-party liability context. *See Morris*, 154 Ariz. at 120. And *Morris* expressly addressed this risk by providing safeguards for the insurer: the settlement "must be made fairly, with notice to the insurer, and without fraud or collusion on the insurer," and the settlement does not bind the insurer unless it is "reasonable and prudent" given the merits of the case and the risks of going to trial. *Id.* at 119, 121. The same protections are present here.

¶30 Accordingly, we hold that the principles of *Morris* apply in the context of title insurance, permitting an insured that is defended under a reservation of rights to independently settle a claim against its insured interest without thereby breaching its contractual obligations. And because Fidelity stipulated that, if *Morris* applies, the Successors' settlement agreement was reasonable and made fairly, with notice, and without fraud, we affirm the superior court's ruling upholding the Successors' settlement agreement.

B. *Morris* in Form.

¶31 Fidelity next argues that the form of the Successors' settlement agreement fell "outside the permitted parameters" of *Morris*, *see Leflet*, 226 Ariz. at 301, ¶ 16 (quoting *Safeway*, 210 Ariz. at 15), rendering the settlement unenforceable against Fidelity and a violation of the Successors' obligation under the Policy's cooperation clause. We have previously described the form of a "typical" *Morris* agreement by reference to the terms of the settlement entered in *Morris* itself: a stipulated money judgment in favor of the claimant and against the insured, accompanied by an assignment to the claimant of the insured's rights against the insurer, as well as a covenant by the claimant not to execute against the insured (with an understanding that it will instead collect the judgment only from the insurer). *See Morris*, 154 Ariz. at 115; *Fid. Nat'l Title Ins. Co. v. Centerpoint Mech. Lien Claims, LLC*, 238 Ariz. 135, 141, ¶ 26 (App. 2015) (as amended); *see also Parking Concepts*, 207 Ariz. at 20, ¶ 3 n.1. Here, in contrast, the Successors agreed to an unconditional settlement, paying Summit $1.75 million without any covenant not to execute, and keeping their claims against Fidelity rather than assigning them to Summit. Fidelity asserts that because this agreement lacked the "typical" characteristics, *Morris* does not apply. *See Centerpoint*, 238 Ariz. at 137, ¶ 2.

¶32 But the cases warning against agreements "outside the permitted parameters of *Morris*" prohibit those that diverge from the *substantive* principles underlying *Morris*, not the technical form of the agreement in that case. *See Safeway*, 210 Ariz. at 15, ¶ 34 (focusing on violation of the substantive requirements of *Morris*—settlement by an insured "if there has been no reservation of rights or bad faith by the insurer"—when describing a purported *Morris* agreement falling "outside the permitted parameters"). And we have upheld agreements that depart from the "typical" form but stay true to *Morris* in principle. *See Monterey Homes*, 221 Ariz. at 353–54, 356–57, ¶¶ 8, 22 (upholding under *Morris* a walk-away settlement agreement releasing an insurer's subrogation rights).

¶33 The cases on which Fidelity relies highlight the distinction. In both *Leflet* and *Centerpoint*, the parties to the purported *Morris* agreements took pains to follow the *Morris* form; the agreements were noncompliant, however, because they violated its principles. *See Leflet*, 226 Ariz. at 302, ¶ 21 ("[A] settlement that mimics *Morris* in form but does not find support in the legal and economic realities that gave rise to that decision is both unenforceable and offensive to the policy's cooperation clause."); *Centerpoint*, 238 Ariz. at 139, 141–42, ¶¶ 17, 29–36.

¶34 *Leflet*, for example, addressed an attempt by an *insurer* (in a case involving multiple layers of insurance) to harness *Morris* to reduce its own liability below policy limits while shifting the risk and cost to other insurers. 226 Ariz. at 301–02, ¶¶ 17, 20. But absent bad faith, the insurer was "subject to liability only to the extent of its policy limits, a risk for which it bargained and was paid" and thus "face[d] neither of the insured's risks that gave rise to the *Morris* doctrine: the prospect of an excess judgment or a judgment within policy limits for which it may not receive coverage." *Id.* at 301, ¶ 19. Because of this divergence from "the confines of the doctrine that created [*Morris* agreements]," we held the agreement in *Leflet* invalid. *Id.* at 301–02, ¶¶ 16, 19, 21.

¶35 Similarly, *Centerpoint* involved a purported *Morris* agreement "between the insureds and an entity they controlled" rather than an arm's-length settlement agreement between opposing sides. 238 Ariz. at 141, ¶ 29. This "unity of parties" was exacerbated by an artificially inflated judgment—almost three times the amount the insureds had paid to the original claimants. *Id.* at 142, ¶¶ 32, 34. Because these facets of the agreement departed from the substantive principles motivating *Morris*, we held the agreement invalid. *Id.* at 142, ¶ 36.

¶36 Unlike the agreement in *Centerpoint*, which demonstrated the dangers of collusion and an inflated judgment amount, *see id.* at 141–42, ¶¶ 29, 32, the form of the agreement here in fact minimized those risks. The covenant not to execute included in a typical *Morris* agreement leaves the insured "little incentive to minimize the amount of the judgment," and the claimant "has every incentive to obtain the largest judgment possible." *Parking Concepts*, 207 Ariz. at 22, ¶ 14 (citing *Morris*, 154 Ariz. at 120); *see also Leflet*, 226 Ariz. at 300, ¶¶ 13–14. But here, the Successors settled with Summit unconditionally and thus paid the full amount upfront—knowing that coverage remained to be determined. Thus, the Successors had every incentive to reach a reasonable settlement agreement for the minimum amount Summit would accept. And Fidelity has, of course, stipulated that the settlement was reasonable. Similarly, the fact that the settlement here left the bad-faith claim to be prosecuted by the Successors rather than assigning it to Summit makes no difference from Fidelity's perspective—regardless who pursues the bad-faith claim, the risk to the insurer remains the same.

¶37 In short, while the Successors' settlement with Summit eschewed the "typical" *Morris* form, it remained true to the principles of the doctrine. The superior court thus did not err by upholding the settlement under *Morris*.

II. Coverage Issues.

¶38 Fidelity next argues that the superior court erred in ruling on two coverage issues, first by determining that the conveyance to a third party did not bar coverage for the Successors' claim and second by deciding that the exclusion for title defects created by the insured did not apply. Because these issues involve interpreting the insurance contract, we review the superior court's rulings de novo. *See First Am. Title Ins. Co. v. Action Acquisitions, LLC*, 218 Ariz. 394, 397, ¶ 8 (2008). We interpret unambiguous provisions according to their terms. *See id.* If a clause is ambiguous, we consider it in the context of the transaction as a whole and in light of legislative goals and social policy, and if an ambiguity remains thereafter, we generally construe the ambiguous term in favor of the insured. *Id.*

A. Condition 2(b): Conveyance.

¶39 Fidelity first asserts that the sale the bankruptcy court authorized that transferred all of Mortgages Ltd.'s interest in the Ten Lofts property to a third party terminated coverage under the Policy's conveyance clause. That provision (Condition 2(b)) specifies that coverage "shall continue . . . only so long as the insured retains an estate or interest in the land."

¶40 Fidelity relies on several out-of-state cases to support its position that the conveyance clause bars the Successors' claim, but the superior court's contrary ruling was correct under Arizona case law addressing this provision. In *Centennial Development Group, LLC v. Lawyer's Title Insurance Corp.*, 233 Ariz. 147 (App. 2013), this court interpreted an identical clause in a title insurance contract and held that although "coverage continues only so long as the insured owns the property," sale of the property does not bar a "claim for damages [the insured] alleges it incurred prior to the sale." *Id.* at 151–52, ¶¶ 12–14, 22. Here, the mechanics' lien at issue was recorded before the Ten Lofts property was sold, so the Successors' damages resulting from that pre-sale defect (the amount paid to settle Summit's lien claim) arose before the sale. The sale thus did not bar the Successors' claim. *See id.* at 152, ¶ 22.

B. Exclusion 3(a): Responsibility for Creating the Lien.

¶41 Fidelity next argues that Mortgages Ltd. created Summit's mechanics' lien by withholding funding for the project and that the superior court thus erred by concluding that the Successors' claim was not excluded from coverage by Exclusion 3(a) of the Policy, which "expressly excluded from coverage" any "[d]efects, liens, encumbrances, adverse claims or other matters . . . created, suffered, assumed or agreed to by the insured claimant." This type of exclusion has been described as "the most litigated provision in the standard-form title-insurance policy purchased by real-estate lenders to protect their security interests in ongoing construction projects." *BB Syndication Servs., Inc. v. First Am. Title Ins. Co.*, 780 F.3d 825, 826 (7th Cir. 2015).

1. Applicability to the Successors.

¶42 As a preliminary matter, the Successors argue that Exclusion 3(a) excludes coverage only for "the" insured that allegedly created or "suffered" the defect or lien (here, Mortgages Ltd.) and does not apply to "an" or "any" other insured under the Policy. They rely on case law construing the use of "the term 'the insured' rather than 'any insured' or 'an insured[]' [to] evidence[] an intent to allow recovery by innocent coinsureds." *See Nangle v. Farmers Ins. Co. of Ariz.*, 205 Ariz. 517, 522, ¶ 29 (App. 2003); *see also Century-Nat'l Ins. Co. v. Garcia*, 246 P.3d 621, 624 (Cal. 2011). But the Successors are not "innocent coinsureds" alongside Mortgages Ltd. *Compare Nangle*, 205 Ariz. at 518–19, 521, ¶¶ 2–3, 23;

Century-Nat'l, 246 P.3d at 622. Instead, their status and rights as insureds derive from Mortgages Ltd.'s rights under the Policy: when the Successors seek to exercise the rights of an insured under the Policy, they stand in Mortgages Ltd.'s shoes.

¶43 The Policy defines "insured" to include, in addition to named insured Mortgages Ltd., "each successor in ownership of the indebtedness" secured by the insured deed of trust. The parties agree that the Successors qualify as "successor[s] in ownership" because they purchased fractional ownership interests in Mortgages Ltd.'s promissory note and deed of trust related to the Ten Lofts project.

¶44 And the Policy expressly reserves against successors any rights or defenses that would have been available against the predecessor in interest:

> The term "insured" also includes . . . the owner of the indebtedness secured by the insured mortgage and each successor in ownership of the indebtedness . . . (*reserving, however, all rights and defenses as to any successor that [Fidelity] would have had against any predecessor insured, unless the successor acquired the indebtedness as a purchaser for value without knowledge of the asserted defect, lien, encumbrance, adverse claim or other matter insured against by this policy* as affecting the title to the estate or interest in the land)[.]

(Emphasis added.)

¶45 Because the Successors became insureds as successors to Mortgages Ltd., by the terms of the Policy they are subject to any defense Fidelity could have raised against Mortgages Ltd.—including one based on Exclusion 3(a)—unless they "acquired the indebtedness as purchasers for value without knowledge of the asserted defect" (i.e., were bona fide purchasers). Neither side, however, attempted to establish in the superior court that the Successors either were (or were not) bona fide purchasers.

¶46 The parties now dispute which side had the burden to show bona fide purchaser status. Although the Successors argue that Fidelity had the burden to do so as part of proving that Exclusion 3(a) applies, the core of the issue is not the applicability of the exclusion (whether the Successors are "insureds" under the Policy is an issue to which the exclusion does not speak) but rather depends on the Successors' status as insureds and the scope of coverage—matters on which the insured bears the burden. *See Keggi v. Northbrook Prop. & Cas. Ins. Co.*, 199 Ariz. 43, 46, ¶ 13 (App. 2000)

("Generally, the insured bears the burden to establish coverage under an insuring clause, and the insurer bears the burden to establish the applicability of any exclusion."); *cf. Davis v. Kleindienst*, 64 Ariz. 251, 257 (1946) (noting, in a different context, that the party seeking the benefit of bona fide purchaser status bears the burden to prove that status).

¶47 The Successors thus had the burden to show that they had acquired their interests without knowledge of the mechanics' lien to escape from defenses, like Exclusion 3(a), potentially applicable to their predecessor, Mortgages Ltd. Because they did not do so, we affirm the superior court's ruling that the Successors stand in Mortgages Ltd.'s shoes for purposes of Exclusion 3(a) and other defenses.

2. Failure to Fund and Creating the Lien.

¶48 In the final months of construction, Mortgages Ltd. agreed to allow the developer to temporarily divert $414,000 from the construction impound account to make its monthly interest payment. A few months later, Mortgages Ltd. withheld disbursement of the final $1.1 million of its loan commitment. Fidelity argues that even if the loan agreement allowed Mortgages Ltd. to take these steps, the diversion and cutoff of construction funding prevented the developer from paying contractors for work performed, leading to the mechanics' lien at issue. Fidelity posits that liens caused by insufficient funding qualify as liens "created" or "suffered" by an insured lender and thus are squarely excluded from coverage under Exclusion 3(a).

¶49 The superior court held otherwise, reasoning that a lender does not create a mechanics' lien by exercising its rights under its loan agreement with a developer because, so long as it is within its contractual rights to stop funding, a lender has "no obligation to continue lending good money after bad." Because the court found the loan agreement allowed Mortgages Ltd.'s actions, it concluded that Mortgages Ltd. had not created the mechanics' lien, so coverage was not excluded.

¶50 The superior court's ruling, however, improperly grafted a misconduct requirement onto Exclusion 3(a): that to have created (or "suffered") the mechanics' lien under these circumstances, the lender must have breached its contract with the developer. But the Arizona Supreme Court has construed the language of Exclusion 3(a) (albeit in an owners' title policy rather than lenders' policy) *not* to require misconduct, holding instead that Exclusion 3(a) "applies whenever the insured intended the act causing the defect, not only when the insured intended the defect or when the insured engaged in misconduct." *Action Acquisitions*, 218 Ariz. at 400, ¶ 28.

¶51 Accordingly, the relevant inquiry is not whether Mortgages Ltd. breached its loan agreement when it curtailed funding for the project, but instead whether it "created" or "suffered" the lien, within the meaning of the policy exclusion, when it did so. To support their conflicting positions, Fidelity and the Successors each offer constellations of federal cases interpreting and applying this oft-litigated exclusion in the context of construction loans, insufficient funding, and resulting mechanics' liens. *Compare BB Syndication*, 780 F.3d 825, *Captiva Lake Invs., LLC v. Fidelity Nat'l Title Ins. Co.*, 883 F.3d 1038 (8th Cir. 2018), *and Bankers Tr. Co. v. Transamerica Title Ins. Co.*, 594 F.2d 231 (10th Cir. 1979) (generally holding that Exclusion 3(a) applies), *with Am. Sav. & Loan Ass'n v. Lawyers Title Ins. Corp.*, 793 F.2d 780 (6th Cir. 1986), *Chi. Title Ins. Co. v. Resol. Tr. Corp.*, 53 F.3d 899 (8th Cir. 1995), *and Mid-South Title Ins. Corp. v. Resol. Tr. Corp.*, 840 F. Supp. 522 (W.D. Tenn. 1993) (generally holding to the contrary).

¶52 We agree with and adopt the Seventh Circuit's reasoning in *BB Syndication* and thus hold that when a construction lender cuts off funding, Exclusion 3(a) excludes coverage for liens that arise when completed work goes unpaid as a result of a funding shortfall. This interpretation preserves coverage for mechanics' liens generally while also giving meaning to the exclusion for liens caused by the policyholder, tracks the respective capabilities and responsibilities of lender and insurer in this context, and "also has the advantage of being a clear rule that parties can bargain around." *BB Syndication*, 780 F.3d at 836.

¶53 As the Seventh Circuit explained, "insufficient construction funding isn't the type of risk that title insurance is built to bear." *Id.* at 833 (citing *Bankers Tr.*, 594 F.2d at 234, and *Brown v. St. Paul Title Ins. Co.*, 634 F.2d 1103, 1110 (8th Cir. 1980)). While a lender's decision to cut off funding to a developer implicates the rights and obligations established by a loan agreement, the rights and obligations under the lender–insurer relationship are distinct. *Id.* at 831; *see also Captiva Lake*, 883 F.3d at 1047 (rejecting, under Missouri law, any requirement that the insured commit "intentional misconduct or inequitable dealings" to warrant invocation of Exclusion 3(a)); *cf. Action Acquisitions*, 218 Ariz. at 400, ¶ 28. In essence, holding the title insurer liable in these circumstances would convert the title insurer into a guarantor of payment for all work actually performed. *BB Syndication*, 780 F.3d at 833; *see also Bankers Tr.*, 594 F.2d at 234; *Brown*, 634 F.2d at 1110. The result would be a windfall for the lender, whose security would be enhanced by the contractor's performance of work for which the lender has disbursed no funds. *BB Syndication*, 780 F.3d at 835–36; *see also Bankers Tr.*, 594 F.2d at 234; *Brown*, 634 F.2d at 1110. Here, for example, Mortgages Ltd. did not pay in the first instance for the work underlying Summit's mechanics' lien (that is the whole point of the lien), and the Successors' insurance claim would shift that cost to Fidelity. *Cf. Action Acquisitions*, 218 Ariz. at 400, ¶ 28 (taking into account, in construing Exclusion 3(a), that "[o]therwise, the insured would be able to use title insurance to make windfall profits").

¶54 The rule we adopt also better tracks "the respective roles of the insured lender and the title insurer in this context" and allocates the risk associated with a funding shortfall to the party with knowledge and control over funding issues. *BB Syndication*, 780 F.3d at 836; *cf. Action Acquisitions*, 218 Ariz. at 400, ¶ 28 ("Title insurance principally protects against unknown and unknowable risks caused by third-party conduct, not intentional acts of the policyholder."). "[C]onstruction lenders have significant ability to ensure that the projects they finance remain economically viable—both at the beginning when deciding whether to finance a project and how much money to commit, and also throughout construction." *BB Syndication*, 780 F.3d at 834. Before agreeing to lend, a lender can require a developer to provide it with financial statements, appraisals, contracts, and plans that will enable the lender to assess the financial viability of a project at the outset. *Id.* Thereafter, the lender can require the developer to deliver regular reports documenting the project's progress, allowing the lender to monitor the continuing financial viability of the project so that it can demand the developer provide a cash infusion if the project is heading out of balance. *Id.* at 834–35. The loan agreement here, for example, gave Mortgages Ltd. broad authority to monitor the project's economic viability: it had the power to insist that all loan proceeds be used for construction; to inspect for satisfactory progress and to see that prior disbursements had been paid out for construction before making progress payments; to declare a default if the project became out of balance; and to demand the developer contribute additional funds to cover construction costs, including cost overruns.

¶55 The lender's ability to monitor the project and control funding also underscores the flaw in the alternative rule—that Exclusion 3(a) does not apply once the lender has fully funded its loan commitment—proposed by two cases on which the Successors rely (although we note that here, Mortgages Ltd. had not disbursed all loan proceeds). *See Am. Sav.*, 793 F.2d at 785; *Chi. Title*, 53 F.3d at 906. As the Seventh Circuit observed, "construction lenders have significant ability to ensure that the projects they finance remain economically viable . . . throughout construction." *BB*

Syndication, 780 F.3d at 834. These tools allow a lender to determine when a loan is out of balance or heading that way, and to protect its interests when that happens. Moreover, shifting the burden of any resulting lien simply because a lender has fully disbursed its commitment would compound the resulting moral hazard created when the lender's security is increased by the work of contractors for which the lender has not disbursed funds: "Knowing that unpaid contractors' claims will be covered by title insurance once the loan proceeds run out may in some circumstances encourage lenders to continue to fund a project even after it becomes clear that it has no chance of succeeding." *BB Syndication*, 780 F.3d at 835–36.

¶56 While our reading of Exclusion 3(a) will exclude coverage for some mechanics' liens, it does not "effectively nullify the mechanic's lien coverage" at large. *Id.* at 836 (quoting *Chi. Title*, 53 F.3d at 907). As the Seventh Circuit put it, coverage for mechanics' liens insures against faults in the payment process (once the lender has disbursed the funds), not the lender's business risks. *Id.* Mechanics' lien coverage in a lender's title policy still will protect the lender against the risk of paying *twice* for the same work—just not provide a windfall by allowing the lender not to pay even once. *Id.* Moreover, a lender seeking protection against this kind of risk has other options—performance bonds, third-party guarantees, or even a separately negotiated endorsement not to invoke Exclusion 3(a) in these circumstances. *Id.*

¶57 The Successors argue that the critical factor in *BB Syndication* and the other cases applying Exclusion 3(a) was the existence of a separate disbursement agreement (not present here) allowing the title insurer to control the disbursement of loan proceeds, and thereby giving rise to a duty on the part of the lender to provide sufficient funds to pay the developer and the contractors. *See Home Fed. Sav. Bank v. Ticor Title Ins. Co.*, 695 F.3d 725, 734 (7th Cir. 2012) (analyzing *Brown*, 634 F.2d at 1110, and *Bankers Trust*, 594 F.2d at 232–33). But *BB Syndication* expressly and persuasively disapproved of this distinction. 780 F.3d at 837–38. Although several cases noted and even emphasized the presence of a disbursement agreement, their analysis "relied more heavily on the fact that title insurance isn't built to cover this sort of risk." *Id.* at 837 (reiterating *Bankers Trust*'s and *Brown*'s characterization of coverage in these circumstances as converting the insurer into a guarantor of payment for all work performed, even if no loan funds had been advanced for that work). And this rule would, anomalously, insulate a title insurer that acts as a disbursing agent from covering liens arising from insufficient funds precisely when the insurer's control over proper disbursement gives it greater control over whether mechanics' liens will arise. *Id.* at 838.

¶58 Here, as a matter of law, Exclusion 3(a) excludes coverage for the Successors' claim because Summit's lien resulted from Mortgages Ltd.'s cutoff of funding. While the developer also helped create the title defect (it began construction before the second deed of trust was filed, giving Summit's later-filed mechanics' lien priority over Mortgages Ltd.'s security interest), Mortgages Ltd. itself created or "suffered" the mechanics' lien by allowing funds to be diverted from the construction impound account and ultimately by cutting off funding entirely, even though the loan agreement allowed it to do so. *See id.* at 831, 836. This holds true even though, as the Successors note, the face value of the mechanics' liens initially filed exceeded the amount of funding that Mortgages Ltd. diverted or withheld—although we note that the value of Summit's lien (and the value the Successors paid to settle with Summit) was much closer to that amount. *See id.* at 836. While Mortgages Ltd.'s loan agreement with the developer did not require it "to continue lending good money after bad," *Home Fed.*, 695 F.3d at 734–35, the Successors cannot now shift to Fidelity the obligation to pay for work that presumptively increased the value of Mortgages Ltd.'s security interest but for which Mortgages Ltd. did not pay. *See BB Syndication*, 780 F.3d at 835–36; *cf. Action Acquisitions*, 218 Ariz. at 400, ¶¶ 28–29.

¶59 Accordingly, Exclusion 3(a) applies, and we reverse the superior court's contrary coverage decision and the resulting money judgment in favor of the Successors.

III. Bad Faith.

¶60 Finally, the Successors challenge the superior court's grant of summary judgment in favor of Fidelity on their bad-faith claim. Although an insurer may challenge a claim for which coverage is "fairly debatable," it commits the tort of insurance bad faith when it "intentionally denies, fails to process or pay a claim without a reasonable basis." *Zilisch v. State Farm Mut. Auto. Ins. Co.*, 196 Ariz. 234, 237, ¶ 20 (2000) (citation omitted). Whether a claim is fairly debatable is generally a question of fact reserved for the jury. *Id.* Here, however, the issue turns on questions of contract interpretation, which are questions of law. *See Emps. Mut. Cas. Co. v. DGG & CAR, Inc.*, 218 Ariz. 262, 264, ¶ 9 (2008).

¶61 The Successors asserted bad faith based on Fidelity's reliance on Exclusion 3(a) to contest coverage. But as described above, *see supra* ¶¶ 42–58, the operative facts were simple and not reasonably in dispute, and Fidelity's position on the applicability of Exclusion 3(a) was not only reasonable but ultimately correct. In any event, at the time Fidelity asserted the Exclusion 3(a), its position was consistent with one branch of the conflicting federal authority; under those circumstances, the superior court did not err by concluding Fidelity's position was fairly debatable as a matter of law.

¶62 Accordingly, we affirm summary judgment in favor of Fidelity on the Successors' bad-faith claim.

IV. Attorney's Fees.

A. In Superior Court.

¶63 Our reversal of the superior court's coverage decision changes the prevailing-party calculus for purposes of an award of attorney's fees under A.R.S. § 12-341.01. Accordingly, we vacate the court's award of fees in favor of the Successors and remand for the court to consider the issue of attorney's fees in light of our disposition.

B. On Appeal.

¶64 Both sides request attorney's fees on appeal under A.R.S. § 12-341.01. In the exercise of our discretion, we decline these requests. As the prevailing party on appeal, Fidelity is entitled to its costs on appeal upon compliance with ARCAP 21. *See* A.R.S. § 12-342.

CONCLUSION

¶65 For the foregoing reasons, we affirm the superior court's *Morris* rulings, reverse its coverage determination and the resulting judgment in favor of the Successors, vacate the Successors' award of attorney's fees, and remand for further proceedings and entry of judgment consistent with this opinion.

AMY M. WOOD • Clerk of the Court
FILED: HB