IN THE SUPREME COURT
STATE OF ARIZONA

CENTERPOINT MECHANIC LIEN CLAIMS, LLC,

Plaintiff/Appellant/Appellee,

vs.

COMMONWEALTH LAND TITLE INSURANCE COMPANY,

Defendant/Appellee/Appellant.

No. CV-23-0164-PR

Arizona Court of Appeals
No. 1 CA-CV 21-0039

Maricopa County Superior Court
No. CV2011-008600

PETITION FOR REVIEW

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Defendant/Petitioner Commonwealth Land Title Insurance Company ("Commonwealth") asks the Court to provide guidance on the application of *United Servs. Auto. Ass'n v. Morris*, 154 Ariz. 113 (1987), and *Quihuis v. State Farm Mut. Auto. Ins. Co.*, 235 Ariz. 536 (2014), to first-party title insurance cases, and to resolve apparent confusion between the insured's liability to the underlying plaintiff and the insurer's coverage obligations to its insureds. Commonwealth also urges the Court to correct the court of appeals' drastic and unwarranted alteration of bad faith law in Arizona, as the opinion improperly opens the door for bad faith claims even where there is no proof of actual harm.

On the first issue, the court of appeals muddled the application of *Morris* and *Quihuis* to this first-party coverage case. *Morris* usually applies in third-party coverage cases, allowing the insured to stipulate to entry of a judgment in plaintiff's favor where the insurer is defending under a reservation of rights. After a stipulated judgment is entered, the insurer is generally bound to the fact of the insured's liability to the plaintiff and plaintiff's damages; but the insurer retains the right to contest coverage. *Id*. at 120 ("An insured's settlement agreement should not be used to obtain

coverage that the insured did not purchase."), and 121 ("the insurer. . . is free to litigate the facts of the coverage defense.").

In *Quihuis*, the Court further explained that when parties to a *Morris* agreement stipulate to facts that are common to both liability and coverage, the insurer is not bound by the liability "determination" in the *Morris* judgment. *Id*. at 541-42.

In a third-party auto accident case like *Quihuis*, it is an easier task to determine which facts relate to liability, which relate to coverage, which relate to both, and, thus, which facts are binding on the insurer. But this is a first-party title insurance case, not a garden variety, third-party auto accident case; and that is why this Court's guidance is needed to clarify the analysis regarding which facts the insurer may contest in a coverage case.

The insureds in this case (Universal and VRCP, two private lenders who loaned money and held deeds of trust ("DOTs") on property to secure loan repayment) did not stipulate to "liability and damages" as in a typical *Morris* third-party case. Instead, in the mechanic's lien claimants' suit claiming priority of their liens on the property, Universal and VRCP stipulated (i) that mechanic's liens recorded against the property were valid, (ii) that the mechanic's liens had priority over the insureds' DOTs, and (iii)

to the amount the mechanic's lien claimants could recover from the property owner's sale proceeds (<u>not</u> from the insured lenders). The property was then sold, the mechanic's lien claimants were paid from the sale proceeds, and Universal and VRCP's loans were fully repaid (principal, interest, and fees).[1]

Commonwealth is not contesting the validity or priority of the mechanic's liens, nor the compromised amount of the liens—the facts to which the mechanic's lien holder (CMLC) and Universal/VRCP stipulated. It contests coverage for the insured lenders' claims that Commonwealth's policies should have indemnified them for their "losses arising from the mechanic's liens[.]" *Id.*, ¶¶ 12, 31. Specifically, (a) Commonwealth's policies expressly exclude coverage if the insured lenders suffer no loss;[2] and (b) the record is undisputed that the insured lenders here suffered no loss because

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[1] VRCP was fully repaid from the sale proceeds, and Universal was fully repaid from the sale proceeds and the proceeds from the sale of other collateral securing its loan. Slip op., ¶¶ 58, 73.

[2] Exclusion 3(c) states, "Defects, <u>liens</u>, encumbrances, adverse claims, or other matters…(c) <u>resulting in no loss or damage</u> to the Insured Claimant" are "<u>expressly excluded from the coverage of this policy.</u> . . ." [TE 10, 22 (emphasis added).] The policies further state that <u>coverage</u> is subject to all Conditions in the policies, and Conditions 8(a)(ii) and 10(b) limit coverage to the insureds' actual monetary loss or damage. The opinion cites the Conditions, Slip op. ¶¶ 41-43, but does not mention Exclusion 3(c).

their loans were fully repaid—months before the *Morris* judgment was even entered, and before the insured lenders assigned their claims to CMLC. Slip op., ¶, 58 ("Universal and VRCP received full repayment of their loans. . . .").

Under *Morris* and *Quihuis*, Commonwealth should have been able to contest coverage. Yet the court of appeals, contrary to both cases, held that Commonwealth was precluded from contesting whether the insureds suffered a "loss" because that fact purportedly addressed only "liability and not coverage." Slip op., ¶¶ 41-52. In an apparent attempt to "fit" within *Morris*'s framework, the court conflated the issue of an insured's liability to a third-party claimant (which didn't exist here) with the issue of Commonwealth's contractual liability to its insureds, and in doing so, eliminated Commonwealth's coverage defenses. Slip op., ¶ 48 (incorrectly stating the *Morris* judgment determined "the fact and amount of Commonwealth's liability").

The effect of the opinion is to (a) completely confuse the analysis of which facts address liability only, which address coverage only, and which address both; and (b) muddle the law on how *Morris* and *Quihuis* apply to coverage cases that are not simple third-party tort cases. This conflation

creates confusion not only for title insurers, but also other first-party insurers and lower courts, regarding which policy defenses remain at issue in a post-*Morris* proceeding. Review by this Court is needed to set the law straight and provide clear and correct guidance.

On the second issue, the court of appeals improperly held (i) a theoretical "diminution in value" of a DOT constituted "the fact of actual pecuniary damage" in a bad faith case, notwithstanding that the loans secured by the insured DOTs were fully repaid, and (ii) this alleged "damage" could support a bad faith judgment against Commonwealth. Slip op., ¶¶ 71-75. This holding ignores the reality that a DOT does not, by itself, have any intrinsic value, but only has "value" as a mechanism to secure repayment of a loan. Where, as here, a loan secured by a DOT is repaid, the DOT cannot be impaired or damaged. The opinion is thus not only legally incorrect, but it improperly suggests that a plaintiff can sustain an insurance bad faith claim based solely on hypothetical, unrealized harm. The ruling is a drastic and incorrect alteration of bad faith law in Arizona, as it improperly opens the door for bad faith claims even where there is no proof of the fact of harm. Commonwealth urges the Court to grant review and relief.

I. FACTS

The "long and complicated history" is fully set forth in the court of appeals' opinion. Slip op. ¶¶ 4-43. The introduction gives the Court the factual overview. Here are a few more details:

Developers began building the Centerpoint property with financing from Mortgages Ltd (ML), a lender. ML was forced into bankruptcy. *Id.*, ¶¶ 5-6. The insureds in this case, Universal and VRCP, are private lenders who loaned ML money to pay its bankruptcy and other costs. The insureds secured their loans with DOTs on Centerpoint and, in the case of the Universal loan, other properties as well. *Id.*, ¶¶ 9, 11, 12. Commonwealth issued title insurance policies to Universal and VRCP, insuring their lien priorities on Centerpoint. *Id*. The policies specifically excluded coverage if the insured lenders sustained no loss. *See* n. 2, *supra*.

$38 million in mechanics' liens were also filed against the property, which led to litigation over which liens had priority (the "lien priority litigation"). *Id.*, ¶ 7. Commonwealth defended Universal and VRCP in that litigation under a reservation of rights. *Id.*, ¶¶ 22-23.

ML's buyer for the property required the property to be free of mechanics' liens for the sale to occur. *Id.*, ¶ 16. To effectuate the sale, CMLC

bought the mechanic's liens (with the sale proceeds) and then entered into a *Morris* agreement with Universal and VRCP whereby (a) CMLC and the insured lenders agreed to subordinate their liens to the buyer's fee interest, (b) CMLC agreed to refrain from executing on Centerpoint, and (c) the insured lenders agreed to assign to CMLC any claims they had against Commonwealth. *Id.*, ¶ 28. Before the assignment became effective, the property was sold to the buyer for $30 million, and Universal and VRCP were fully repaid for their loans. *Id.*, ¶ 58.[3] It was only after Universal and VRCP's loans were fully repaid, that Universal and VRCP's assignment of rights to CMLC became effective. [R. 338-41, Ex. 7.]

Commonwealth sought a declaratory judgment of no coverage, and CMLC, as the insured lenders' assignee, asserted claims against

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[3] VRCP's principals received $5.9 million in February 2011, equaling all principal and interest due under the loan; Universal received $4.2 million, its loan being fully repaid from the sale of Centerpoint and the other ML properties securing the loan by the end of 2011 [TR Day 4, pp. 9-13, 17-31]; and the mechanic lien claimants received $13.65 million in full satisfaction of their liens. [Slip op. ¶¶ 14-16; Trial Ex. 126; TR Day 3, pp. 10-13.] Not only were the insureds' loans fully repaid, but Universal received $17.9 million in *profit* on its loan: $6.7 million in interest, $3.7 million in origination and repayment incentive fees, and $7.5 million in a "loan disposition fee." [TR Day 4, pp. 20-31; Trial Ex. 130.]

Commonwealth for "failing to indemnify [the insured lenders] for losses arising from the mechanics liens[.]" Slip op., ¶¶ 30-31. The trial court granted Commonwealth summary judgment on CMLC's contract claims, ruling there was no coverage under the policies because the insured lenders' loans were fully repaid and thus they suffered no covered loss. [R. 377.] The court of appeals reversed, ruling that the *Morris* agreement precluded Commonwealth from disputing the issue of "loss" because, according to the court, that issue bears only on liability and not on coverage. Slip. op., ¶¶ 41-52.

II. <u>ISSUES PRESENTED FOR REVIEW</u>

1. When an insured, in a *Morris* agreement, stipulates to facts that constitute defenses to both liability and coverage, *Quihuis* allows the insurer, in a third-party insurance coverage case, to contest those facts. In this first-party title insurance case, the insured lenders stipulated in a *Morris* agreement that their deeds of trust on the property were inferior to competing mechanic's liens, and to the amount the lien claimants would receive from the sale of the property to satisfy their liens. Commonwealth, their insurer, does not challenge those stipulations. Instead, it contests coverage for the insured lenders' title insurance claims because (a) the

policies expressly exclude coverage where the insured suffers no loss, and (b) the insureds here suffered no loss because their loans were fully repaid. Does *Quihuis* allow Commonwealth to raise this challenge, and did the court of appeals contravene *Quihuis* in ruling otherwise?

2. Where the loans secured by a deed of trust are fully repaid, can the purported "diminution in value" of the insured deed of trust constitute actual pecuniary damage to the insured lender so as to support a bad faith claim?

III. REASONS REVIEW SHOULD BE GRANTED

1. In a published opinion, the court of appeals misunderstood and mis-analyzed *Morris* and *Quihuis* in the context of this first-party title insurance case. Review is necessary to correct this faulty analysis and provide guidance to courts and litigants regarding how *Morris* and *Quihuis* apply to first-party insurance coverage cases.

a. In a typical *Morris* situation, the insured stipulates that it is liable to the plaintiff and to the amount of plaintiff's damages. The insurer is precluded, in a subsequent coverage action, from contesting the existence of the insured's liability to the third-party plaintiff and the extent of that liability. *Associated Aviation Underwriters v. Wood*, 209 Ariz. 137, 143, 150

(App. 2004). But the insurer may still contest coverage. *Morris*, 154 Ariz. at 120 (any stipulation of facts "essential to establishing coverage would be worthless.").

That framework is easily applied to third-party insurance cases where the insured has personal exposure to the plaintiff. But the lower court understandably had trouble applying that framework to a first-party insurance case—like this title insurance case—because in a first-party case, the insured does not face any personal, monetary liability exposure to a third party.[4] As such, in a first-party insurance case, the insured does not stipulate to "liability" (or to a third-party claimant's damages). This point is critical to determining what the insurer can and cannot contest in a later coverage action like this one, because while *Morris* precludes the insurer from contesting stipulated "liability"; it does not preclude the insurer from contesting "coverage."

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[4] That is the purpose of a *Morris* agreement—to protect the insured "from the 'sharp thrust of personal liability'" to a third-party claimant. *Morris*, 154 Ariz. at 118 (quoting *Ariz. Prop. and Cas. Ins. Guar. Fund v. Helme*, 153 Ariz. 129, 137 (1987)).

Here, Commonwealth's insured lenders were not facing personal, monetary exposure to the mechanic's lien claimants. Thus, they could not stipulate to "liability" because they were not, and never would be, found "liable" to pay the mechanic's lien claimants the amounts of their liens. Rather, the lien litigation simply determined who, as between the lenders and the mechanic's lienors, had a superior lien position with respect to Centerpoint's sale proceeds. All Universal and VRCP could stipulate to—and all they did stipulate to—was that the mechanic's liens were valid and had priority over their DOTs, and the amount the lien claimants would get from the property sale.

Commonwealth's coverage defense has nothing to do with its insured lenders' "liability" to the adverse parties (the mechanic's lien claimants) in the underlying litigation, as the court of appeals incorrectly suggested. Slip op., ¶ 48. Nor does the lien claimants' first-position claim to the property sale proceeds affect Commonwealth's coverage. Instead, Commonwealth is contesting—and under *Morris* and *Quihuis* should be entitled to contest—the existence of coverage on the ground that the policies expressly exclude

coverage where the insured lenders suffer "no loss or damage."[5] Plainly, the court of appeals misunderstood and misapplied the *Morris* and *Quihuis* analysis to this first-party insurance case, and this Court's guidance is needed on the proper analysis to apply.

b. Not only is guidance needed on the application of *Morris/Quihuis* to first-party insurance cases, but relatedly, also on which stipulated facts in a first-party *Morris* case relate to liability only, to coverage only, or to both. As noted above, when the issues "determined" by a *Morris* judgment bear on both liability and coverage, the insurer remains free to litigate those issues in a post-*Morris* proceeding. *Quihuis*, 235 Ariz. at 541. Whether the insured lenders in this case suffered a "loss" on their loans was not determined in the *Morris* judgment—only lien priority was—but even if it had been, Commonwealth was nevertheless entitled to litigate the "no loss, no coverage" issue because the issue of "loss" bears on both liability and coverage.

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[5] The "characterization" of the loan payoff is irrelevant here. Slip op., ¶¶ 71, 74. All that matters is the loans were fully repaid and the insured lenders did not suffer any loss. The characterization of the proceeds, or the source of repayment, is irrelevant to coverage.

The court of appeals' contrary opinion conflicts with *Quihuis* and sends the wrong message to lower courts and parties who are navigating first-party insurance coverage litigation. The determination of which issues an insurer may contest in such situations is certainly a legal issue of statewide importance that the court of appeals incorrectly decided.

2. This petition raises a second legal issue of statewide importance which the court of appeals incorrectly decided: Does a theoretical "impairment to the value of a DOT" constitute "the fact of actual pecuniary damage" in a bad faith case when the loans the DOTs secured have been fully repaid?

a. Before recovery is allowed in tort, a plaintiff must prove, by a higher order of proof, the fact of actual damage. *See Farr v. Transamerica Occidental Life Ins. Co. of Cal.,* 145 Ariz. 1, 6 (App. 1984) (theoretical, potential, "[s]peculative or uncertain damages . . . will not support a judgment and proof of the fact of damages must be of a higher order than proof of the extent thereof."). The Arizona appellate courts have yet to apply this rule in the context of a bad faith case.

b. In this case, because the loans were fully repaid, CMLC was unable to prove the fact of actual pecuniary damage to Universal and

VRCP.[6] Instead, CMLC argued that Universal and VRCP suffered "diminished value" to their DOTs securing the loans, and the court of appeals accepted this as a "plausible" damage theory. Slip op., ¶¶ 72, 75.[7] That holding, however, ignores the fact that a DOT does not have any intrinsic value except as a mechanism to secure loan repayment. If the loan is repaid, as here, the DOT cannot be "impaired or damaged." Once the loan is repaid, there is no need for security, and the DOT ceases to have utility or "value" and cannot be "diminished." *See, e.g.*, *Robinson v. Mortg. Elec. Registration Sys., Inc.*, No. CV 19-2185 (PSG (ASx), 2019 WL 2491550, at *4,

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[6] CMLC was limited to proving the fact of actual pecuniary damage because, as limited liability companies, Universal and VRCP could not recover emotional distress damages, and as single purpose entities (formed solely for the purpose of these loans without any intent to conduct further business), they could not recover for damage to their "credit reputation." Accordingly, CMLC could prevail on its claim only if it proved "monetary damage or loss experienced resulting from Commonwealth's" bad faith. [R. 744, p. 7.]

[7] For this reason, the court incorrectly upheld the jury's $5 million bad faith verdict even though the insureds did not suffer any actual damage. Slip op., ¶¶ 9, 11-12, 58, 72, 75.

n.1 (C.D. Cal. June 14, 2019) (in suit to declare DOT unenforceable, where there is no longer any outstanding debt, the amount in controversy is zero).[8]

The only circumstance in which an alleged "diminished value" of a DOT could amount to actual monetary damage is where the loan secured by the DOT is not repaid or if the other, unaffected properties serving as security proved to be insufficient to satisfy the loan, neither of which happened here.

c. The court of appeals, despite acknowledging Universal and VRCP's loans were repaid (plus millions in profit), erroneously bought into CMLC's argument that the insureds suffered the "fact of actual pecuniary damage" because the value of their DOTs were somehow "diminished". Slip op., ¶¶ 71-75. Not only is this legally incorrect, since the

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[8] *See also* *Green v. Evesham Corp.*, 430 A.2d 944, 946 (N.J. App. Div. 1981) ("To say that the loss here consisted of the diminution in the security misses the point that the diminished security is now supplied by the title policy, ***but only*** to the extent that there ***has been a debt loss*** which remained unsatisfied from the proceeds of the mortgaged property…" (emphasis added)); *Twin Cities Metro-Certified Dev. Co. v. Stewart Title Guar. Co.*, 868 N.W.2d 713, 718 (Minn. App. 2015) (rejecting argument that "devalued" security constituted "actual damage," and holding that diminished value of security of property caused by the presence of liens could constitute damage but "only 'to the extent to which the insured debt is not repaid'" (citation omitted).

alleged "diminution" did not affect the lenders' ability to collect every penny they loaned, but it suggests a plaintiff can sustain an insurance bad faith claim based solely on hypothetical, but unrealized, harm. This is not, and cannot be, the law in Arizona. Indeed, the court of appeals' ruling is a drastic and incorrect alteration of bad faith law in Arizona, as it improperly opens the door for bad faith claims even where there is no proof of the fact of harm. This is an issue of statewide importance that cries out for this Court's correction.

CONCLUSION

For the foregoing reasons, Defendant/Petitioner Commonwealth Land Title Insurance Company respectfully requests the Court grant review and relief.

RESPECTFULLY SUBMITTED this 7th day of August, 2023.

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