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TABLE OF CONTENTS

Chairperson's Message 1
 Paula S. Caplinger

Frequently Asked Questions About CRESPA 3
 James M. McCauley

The 2003 ALTA Commercial Endorsements 11
 Robert S. Bozarth

*Power of a Personal Representative to Sell Real Estate:
 What is a Settlement Attorney to Do in the Twenty-First Century?* 38
 Douglass W. Dewing

The Power and Protection of Mezzanine Financing 51
 Theodore H. Sprink

Real Estate Practice in a Post-Enron World 55
 John P. Flannery

Summary of Loudoun County Downzoning Litigation 59
 Mari M. Hommel

Survey 62
 Courtland L. Traver

*Implications of Federal Appellate Court Decision Allowing Bankrupt
 Company to Sell Real Estate Free and Clear of Tenant's Lease* 67
 Steve Fuhrman

*Book Review of REAL ESTATE PRACTICE IN THE DISTRICT OF
 COLUMBIA, MARYLAND AND VIRGINIA (Paul D. Pearlstein ed.)* 68
 Peter A. Dingman

THE POWER AND PROTECTION OF MEZZANINE FINANCING

by Theodore H. Sprink*

In a bold move to position itself as a market leader, a well-known and respected real estate development company planned to acquire its leading competitor and combine their respective product lines.

Both companies had 15+ years under their current ownership and management. Each had solid balance sheets and positive cash flows. The price was right, and the newly formed company expected to eliminate duplicate functions for considerable savings. In the developer's opinion, this merger was a slam-dunk.

Rejecting the idea of raising capital by issuing new stock through a private placement, the developer requested a loan of \$75 million from a bank to fund the acquisition and provide working capital.

Despite adequate cash flow to service the proposed new debt, the developer was dismayed to learn that the bank could approve a loan of only \$60 million.

The bank's reason for the \$15 million shortfall in required funding? *Insufficient collateral.*

BRIDGING THE FUNDING GAP

So where can a qualified borrower with a proven track record, strong management, a solid business plan, and healthy cash flow go when a "credit crunch" becomes a factor?

A growing number of middle-market businesses have discovered mezzanine financing as an effective way to secure additional capital. Mezzanine financing provides access to equity, or capital which can be utilized by the owner for various purposes, not the least of which is to "re-invest" in an acquisition, project, or development. The net effect of this new capital frequently serves to enhance the project for the benefit of both lenders and borrower.

A powerful resource for funding growth, mezzanine financing is often used for working capital, acquisitions, expansions, leveraged buy-outs, and re-capitalizations. Loans for these financial structures, which are often in the \$5-100 million range, are attractive to mezzanine fund lenders and investors due to the high yields they generally offer.

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Unlike many banks seeking an early return of principal, mezzanine lenders generally focus on the relationship's overall yield, particularly if they foresee future equity participation. Typical exit strategies for the mezzanine lender include: the borrower going public, an equity issuance, or the borrower being sold or otherwise re-financed. With any of these events, the mezzanine lender secures principal, interest, and any capital gains on the sale of the stock.

DEFINING THE BRIDGE

Essentially, mezzanine funding provides subordinated debt financing with greater returns than traditional bank debt. Mezzanine capital is a form of junior debt that bridges the gap between private equity investment and the traditional bank loan. Senior to the original equity but junior to the bank, the mezzanine debt is considered "in the middle" and is sometimes referred to as a "bridge."

The mezzanine component generally represents well below 50 percent of a transaction's capital structure. With the loan-to-value (LTV) ratio of first mortgage financing commonly limited by the loan agreement to 75 percent (which often restricts further encumbrances in the form of second mortgages), the additional mezzanine component can contribute to an aggregate LTV of up to 95 percent. The 20 percent "differential" in this example serves as the equity that can be used by the borrower or its principals to gain access to additional capital through the mezzanine loan.

Mezzanine financing is most often extended to the partners or equity holders of a borrowing entity, frequently a Limited Liability Company (LLC). As security, the lender takes a pledge of the party's equity interest. The pledge of the equity interest in the LLC can be defined as either "investment property" or "general intangible" (personal property) under Revised Article 9 of the Uniform Commercial Code (UCC), and can be insured for attachment, perfection, and priority—similar to traditional real estate title insurance—for the real estate portion of the loan transaction. Such protection is commonly referred to as "UCC insurance."

STRENGTHENING THE BRIDGE

The mezzanine market segment is commonly linked to income-producing commercial real estate, such as a shopping center, hotel, office building, apartment complex, or development project with similar characteristics.

As a result, mezzanine lenders have underlying concerns about declining real estate values, aggressive low-interest-rate lenders, buyers who may have over-paid for a property and general economic factors that can impact property-rent growth and future revenue streams. Naturally, any new debt can represent potential strain on a property, as can increased vacancies and declining rents. Highly leveraged assets may be difficult to refinance or sell.

UCC insurance covering the membership interest in a partnership or LLC is a major development to provide additional protection to mezzanine lenders in insuring their security interest. Perfection of a security interest can be accomplished by:

- Filing the appropriate UCC-1 Financing Statement in the appropriate jurisdiction;

- Taking possession of the “collateral” if the interest is certificated or otherwise subject to a Control Agreement (such as a Deposit Account); or
- Controlling the collateral if the security interest is deemed investment property.

Control is generally considered the strongest of these three methods.

In certain cases, a mezzanine lender may improve its position by the treatment of its security interest in the pledged collateral. At the request of the mezzanine lender, a partnership or LLC can “opt-in” to Article 8 of the Uniform Commercial Code and elect to have its interest treated as securities.

Experienced legal counsel is important for such complex loan transactions. A qualified lawyer’s expertise in negotiating the primary loan documents to fair and equitable mezzanine loans have reduced long-term costs associated with loan origination for their clients.

PROTECTING THE BRIDGE

The relationship between borrower and lender is extremely important, and there are a number of steps that can be taken to provide protection from outside interference. A security interest that is *insured against defects* in the search, documentation, or filing process benefits the lender, borrower, and outside counsel representing both parties.

In a manner similar to traditional title insurance for real estate secured loans, UCC insurance is available to insure the lender’s security interest in “*non-real estate collateral*.” The equity pledge securing the mezzanine loan falls into this category, and through UCC insurance, the lender gains protection complementing both the existing *real estate* title insurance as well as outside counsel’s traditional legal opinion.

The lender and counsel find comfort in a product that *insures* the validity, enforceability, attachment, perfection, and priority of the security interest, while at the same time avoiding the drawbacks of the perfection and priority portion of the traditional legal opinion. The relatively modest cost of UCC insurance is an investment in finding, avoiding and/or correcting collateral-related problems *prior to funding*, and UCC insurance provides coverage for the life of the loan, while at the same time serving to enhance the value of the loan(s) sold into the secondary markets.

The responsibility for searching the proper public record for the correct entity, the correct collateral, and in the correct jurisdiction—the very foundation in which non-real estate lending is based—shifts risk to an insurance company, in a manner far exceeding the current “indemnity” available from UCC search vendors relying on proprietary indexes. Such indemnity or liability generally is limited to the review cost of providing the service.

The “second set of eyes” of UCC insurance can prevent third parties from intervening in the relationship between borrower and lender, while also serving to prevent claims of negligence or malpractice against outside counsel for failure to properly perfect a security interest. *See Lory v. Parsoff*, 745 N.Y.S. 2d 218 (N.Y. 2002).

UCCPlus Insurance Protection, introduced by the Fidelity National Financial family of companies in late 2001, insures mezzanine and asset-based loans secured by non-real estate assets for attachment, perfection, and priority. Coverage extends to validity, enforceability, fraud, and forgery, and provides for the costs of defense in the event of a dispute or claim. UCCPlus Insurance Protection policies are underwritten by Alamo Title, Chicago Title, Fidelity National Title, Security Union, and Ticor Title insurance companies.

Mezzanine financing offers an innovative solution to fund the growth and expansion of commercial projects. With knowledgeable legal counsel and proper title insurance coverage, borrowers and lenders can secure both the advice and protection they need for their mutual and collective success.