

An Analysis of
The Secured Lender's UCC Article 9 Insurance Policy

By Sandra Stern¹

If a real estate mortgage lender can obtain mortgage title insurance with respect to its interest in real property, why can't the secured party lending against personal property insure that its security interest will take precedence over all others?

It is now able to do so. Under a new title insurance policy recently approved by the New York State Insurance Department, the secured party will be able to insure attachment, perfection and priority under Revised Article 9 of the Uniform Commercial Code.²

The development of the UCC Article 9 insurance policy arose from the convergence of two trends. The first is that Revised Article 9, while promoted as a simplification of prior rules governing perfection and priority, has actually induced a great degree of confusion among practitioners. New filing forms, the five year "look back" requirement imposed by the transition rules, alternative perfection methods, and the expansion of Revised Article 9 to cover more categories of transactions have all increased the practitioner's burden.

Under pre-revision Article 9 the practitioner who was uncertain as to how to perfect might simply have filed a financing statement in a number of jurisdictions. That simple solution is unlikely to suffice under Revised Article 9. Revised Article 9 generally requires the practitioner to identify, among alternative permissible methods of perfection, the method that will entitle it to priority, and, if the proper perfection step is filing a financing statement, to identify the correct jurisdiction and the type of filing that should be made. As contrasted with pre-revision Article 9, Revised Article 9 requires the practitioner to have a thorough grasp of *all* of the Article in order to be sure that the proper steps will be taken to ensure perfection and priority.

As the law governing perfection and priority became more complex, legal opinions addressing these topics became less reassuring to the lender. If such an opinion is given at all, it is typically so highly qualified as to provide no meaningful statement concerning these issues. Reflecting this trend in opinion giving, Standard and Poor's has issued a press release stating that it would no longer require legal opinions as a part of its evaluation process.

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² This article is based upon the UCC-9 policy as filed with the New York State Department of Insurance by Fidelity National Title Insurance Company of New York and its sister company, Chicago Title Insurance Company, on November 1, 2001. The conclusions reached in this article about policy coverage relate solely to that policy. Further information about the UCC 9 policy is available from UCCPlus@fnf.com or may be obtained by calling 1-877-892-5474 (toll free).

The coincidence of these two factors – the lack of reliance that may reasonably be placed on the legal opinion with respect to perfection and priority, and the lender’s increasing need for certainty concerning these issues after the enactment of Revised Article 9 – led to the development of UCC insurance.

Coverage of Policy

What coverage does the UCC Article 9 insurance policy provide? As stated in the Insuring Clauses, the policy covers the risks of lack of (1) attachment;³ (2) perfection,⁴ and (3) priority. Significantly, the policy covers “future advances”, or “advances made by the insured subsequent to Date of Policy pursuant to Commitment under the Debtor Security Agreement and prior to the time the Debtor becomes a debtor in a federal bankruptcy proceeding, state insolvency or similar proceeding.” Thus, the advances made in a revolving credit in which funds are borrowed, repaid, and reborrowed are within the coverage of the policy even though made after the date on which the policy is issued. If scheduled, the policy can cover after-acquired property as well as property owned by the debtor on the date of issuance.

The coverage of the UCC Article 9 insurance policy is not limited to perfection by filing. Under Revised Article 9, perfection may be accomplished in a number of ways. Some types of collateral are best perfected by filing, while other types of collateral may be perfected by “control” (entering into an agreement with a third party in which the third party recognizes the lender’s interest), by possession, or automatically upon the happening of a stated event. The UCC Article 9 insurance policy covers all four Article 9-mandated types of perfection.

What types of transactions does the policy insure? The policy is generic; it could cover, *inter alia*, real estate mezzanine loans, asset-based loans, the personalty acquired or generated in a construction loan, and cooperative apartment loans, in addition to asset securitizations.⁵ The scope of Article 9 is outlined in section 9-109. If a transaction is within that section, it is a transaction that can potentially be insured.⁶

Payment of Claims

The liability of the insurer is limited to the smaller of: (1) the face amount of insurance purchased; (2) the indebtedness outstanding at the time of loss, reduced by the recovery value of the collateral; or (3) the value of the collateral, likewise reduced by its recovery value. “Indebtedness” is broadly defined so as to include all amounts owed by the debtor

³ “Attachment,” as set forth in section 9-203, means that the debtor has rights in the collateral sufficient to transfer the collateral to the secured party, that the lender has given value, and that the debtor has authenticated a security agreement or has taken certain other steps that evidence its intention to grant a security interest in the collateral.

⁴ “Perfection” means that the lender has taken the steps that will generally protect it against creditors of and transferees from the debtor, including representatives of creditors in insolvency proceedings.

⁵ Revised section 9-109(a)(3) treats sales of accounts, chattel paper, payment intangibles, and promissory notes as Article 9 transactions.

⁶ In some cases, it may not be clear whether collateral is or will be treated as personalty or reality. This issue may exist, for example, with hotel rents and leases. In such instances, the lender’s counsel may wish to cover all bases by insuring under both a title policy and the UCC policy.

to the secured party under the security agreement (including legal fees and court costs, if provided for in the security agreement).

Payment of claims is to be made by the insurer within thirty days after the insured's loss or damage has been established. If litigation ensues, the policy provides that payment is postponed until there has been a final determination adverse to the insured, and all appeals have been exhausted.

As in many other types of insurance policies, the insurer assumes the duty of defense. Under the policy, the insurer can litigate, paying the claim if there is an adverse determination, or it can purchase the loan from the Insured. Thus (as in other types of insurance unrelated to the UCC) the defense costs are likely to be an important consideration for lender's counsel in assessing the value of the policy to the insured.

Finally, the policy contains a feature that should prove reassuring to lender's counsel: "Anything that may be contained herein to the contrary notwithstanding, the insurer will not seek subrogation against any attorney of any Insured under this policy for liability other than fraud." Therefore, the lender's attorney need not be concerned that the insurer will pay the client's claim and then pursue the attorney for misfeasance or malfeasance.

Insurance Versus Opinion

How does the UCC Article 9 insurance policy compare with a legal opinion? In order to answer this question, it is necessary to consider the risks addressed by each.

First, it is common for legal opinions to take an exception for the application of the bankruptcy laws. For example, the opinion may state: "Our opinions are subject to bankruptcy, insolvency, reorganization, moratorium and other similar laws of general application relating to or affecting the rights and remedies of creditors."

The problem with this exclusion in an opinion addressing perfection and priority, from the lender's viewpoint, is that bankruptcy court is precisely the crucible in which the steps taken to achieve perfection and priority are most likely to be tested. The UCC Article 9 insurance policy covers bankruptcy, subject to several specific exclusions. Thus, the UCC Article 9 insurance policy provides additional coverage with respect to the bankruptcy risk as compared with a legal opinion.

Additionally, the legal opinion "speaks" only as of its date. The problem with this limitation, from the secured lender's point of view, is that much secured lending is structured as a revolving facility in which the lender anticipates that it will make advances subsequent to the date of closing. Therefore, it is important for the lender to know that it will have a perfected security interest in collateral that secures such advances, as well as after-acquired collateral. The UCC Article 9 insurance policy expressly covers each of these.

Next, there is the question of to whom the legal opinion speaks. The typical legal opinion states that it may not be relied upon by a person other than the addressee, without the

opinion giver's written consent. The UCC Article 9 insurance policy, however, contemplates that the debt may be transferred and extends coverage to successors in interest of the original insured.

Additionally, the legal opinion commonly is rendered under the governing law of a single state or a limited number of states (plus federal law). If any mention is made of the laws of other states, the opinion writer will sometimes opine as to such laws on the expressed assumption that such laws do not differ significantly from the laws of the state under which the opinion is rendered.

This qualification is a significant limitation for the secured lender, since the laws of a jurisdiction other than the jurisdiction that governs the legal opinion may be implicated in a determination concerning perfection and priority, particularly if the debtor becomes bankrupt. Although Revised Article 9 was enacted in substantially similar form in all enacting jurisdictions, there are some important variations (some of which address filing issues).⁷ The UCC Article 9 insurance policy does not contain any limitation relating to the laws of a specific jurisdiction.

Finally, depending on the structure of the firm and the language of the legal opinion, the opinion recipient may not have access to the resources of the firm rendering the opinion, but only to those of the lawyers who were actively involved in negotiating and documenting the transaction, whereas the policy is backed by the assets of an insurer.

Will the existence of UCC coverage supplant or supplement the legal opinion? Although it is too early to tell, it is clear that the UCC Article 9 insurance policy affords a significant additional level of protection to the secured lender beyond that offered by the contemporary legal opinion. In appropriate instances, lender's counsel might elect to require borrower's counsel to opine only as to the valid existence and due qualification of the debtor, the due authorization and execution of the loan documents, the legal, valid, and binding nature of the obligations, and like matters, and omit any opinion it would have formerly given concerning perfection and priority, other than the opinion that a valid security interest has been created. Thus, the existence of this insurance is likely to reduce the risks for borrower's counsel in rendering opinions, as well as providing greater assurance to the lender's counsel and its client.

⁷ See West's Uniform Commercial Code Reporting Service, which contains a "State UCC Variations" volume. Many of these variations are discussed in "Under the Surface of Revised Article 9: Non-Uniformity and Filing Office Procedures," published by the American Bar Association Section of Business Law (Committee on Uniform Commercial Code).

