UCC Insurance for Real Estate Transactions

A Practical Guidance® Practice Note by
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This practice note describes the role of Uniform Commercial Code (UCC) insurance in commercial real estate transactions, particularly those involving pledges of equity. This practice note provides an overview of the UCC and pledges of equity in the real estate mezzanine loan context, both of which are essential to understanding UCC insurance. This note also describes two types of UCC insurance policies: lender's policies and owner's policies. In addition, the practice note describes the development of UCC insurance and its use by real estate lenders, and the benefits of utilizing UCC insurance.

There are two caveats to what this practice note covers. Many land title companies in the country offer UCC insurance, and the policies that each title company issues vary from title company to title company. They are not uniform title policies in the way that real estate land title companies all use American Land Title Association (ALTA) forms. UCC insurance policies issued by the various land title insurance companies are, from a general standpoint, similar in their coverage with important exceptions and differences. And since policies do vary in their coverage, the pricing for UCC policies also varies. This practice note does not compare and contrast the various UCC policies that different land title companies issue; rather this practice note is intended to give you a general overview so that you may assess a UCC insurance policy when you encounter one in practice.

For resources and guidance on mezzanine financing transactions, see Mezzanine Financing Resource Kit. For information on title insurance for mezzanine financings, see Title Insurance for Mezzanine Financing. For guidance on structuring a mezzanine financing transaction, see Mezzanine Loan Structure Diagram (Real Estate Transaction). For a step-by-step guide on closing a mezzanine financing deal, see Mezzanine Loan Closing Checklist.

What Is the Uniform Commercial Code and How Does It Apply to UCC Insurance Policies?

The body of law that principally governs the underwriting of a UCC insurance policy is the Uniform Commercial Code. The generic name, "UCC Insurance Policy," comes directly from the abbreviation for the Uniform Commercial Code.

Overview

Article 9 of the UCC (titled Secured Transactions) provides how a lender (called a "secured party" in UCC parlance) may achieve a valid perfected first lien in any type of personal property collateral (that falls within the scope of Article 9) that a borrower (called the "debtor") grants and pledges to a secured party. Article 9 has been adopted by all 50 states, Guam, Puerto Rico, and the American Virgin Islands. From a 10,000-foot view, each state and territory that has adopted Article 9 has adopted a fairly uniform version of Article 9. There are nonstandard variations that have been adopted by individual states and territories. While each title company's staff of underwriters must be aware of these nonuniform provisions, the basic creation of a valid perfected first lien / security interest in collateral under the UCC varies little from state to state.

Article 8 of the UCC (titled Securities) also comes into play when a lender is collateralizing its loan with a pledge of equity. The most common way a lender will take a pledge of equity is in connection with a real estate mezzanine loan. See What Is a Mezzanine Loan? below for more information.

Elements

The essential elements for creating a valid perfected first security interest are as follows:

- The secured party's lien must attach to the collateral that the debtor is pledging to it.
- The secured party must properly perfect its security interest in the collateral pledged by the debtor. –and–
- In making the loan to the debtor, the secured party will want a first priority security interest in the collateral pledged to it.

The basic insuring provisions of a UCC insurance policy insure that the secured party has properly attached, properly perfected, and has achieved a first priority lien in the collateral that it is taking in consideration of making the loan.

For more on perfection under Article 9 of the UCC, see Perfecting Security Interests by Possession, Filing, and Control.

What Types of Collateral Does Article 9 Cover?

There are many different types of personal property that are covered by Article 9. More than 25 different types of personal property collateral are specifically defined in Article 9. Each type of collateral contained in Article 9 is defined very broadly.

A good example of this is the definition of an account under Article 9. U.C.C. § 9-102(a)(2). One common type of account is an account receivable in a business. The business sells a widget but does not get immediately paid. The purchaser has time to make the payment for the widget purchased. The selling company can show this sale without immediate payment as an account receivable on its books. Reviewing the first part of U.C.C. § 9-102(a)(2)—the definition of an account—illustrates how broad the code definitions are.

> An Account means a right to payment of a monetary obligation, whether or not earned by performance, (i) for property that has been or is to be sold, leased , licensed, assigned or otherwise disposed of, (ii) for services rendered, (iii) for a policy of insurance issued or to be issued, (iv) for a secondary obligation incurred or to be incurred, (v) for energy provided or to be provided . . . .

Accounts are a valuable asset to a business. Many lenders will make loans secured by businesses' accounts.

Tangible and Intangible Collateral

Unlike real property, Article 9 collateral can be both tangible and intangible. An example of tangible collateral is a business's inventory. Goods are inventory if they are leased by a lessor or held by a person for sale or lease. You can physically see and touch inventory.

The prime example of intangible collateral is something the UCC calls general intangibles. Examples of general intangibles are various categories of intellectual property that include rights that arise under a license of intellectual property, such as the right to use the intellectual property without liability for infringement. You cannot see or touch intellectual property. A practical example is an iPhone. While we can see and touch an iPhone, we cannot see or touch the technology that makes it perform yet it is extremely valuable intellectual property. That technology is a general intangible under the UCC.

A UCC insurance policy can cover any type of collateral—tangible or intangible—that is covered by Article 9.

In the context of a mezzanine loan, an ownership interest in a limited liability company or a limited partnership is also a general intangible. For more detail, see What Is a Mezzanine Loan? below.

What Is a Mezzanine Loan?

Overview

Mezzanine financing was formulated on the east coast around 25 years ago as a byproduct of mortgage lenders seeking lower loan-to-value ratios in their real estate transactions and a method for the lender to achieve a higher return on their investment by making a loan at a higher, more risky level of the capital structure. The use of mezzanine financing increased after the 2008 economic implosion. Increased government tightening on the loan-to-value ratios of mortgage lenders and the introduction of the concept of a high volatility commercial real estate loan led to increased use of mezzanine financing after 2008. Due to low interest rates over the past years, many new mezzanine lenders have entered the marketplace in search of a vehicle to achieve a higher return on their investment.

For more on real estate mezzanine loans, see Mezzanine Financing Resource Kit.

Structure

Mezzanine financing, from a legal and structural viewpoint, involves making a loan to the equity owners of a property-owning entity which is typically a limited liability company (LLC). The mezzanine lender will take a pledge of the ownership interest (the equity) in the property-owning LLC as collateral for the loan. This is a secured transaction because the lender is a secured party being granted a security interest by the debtor (and owner of the property-owning LLC) in collateral that falls under the scope of Article 8 as a security or Article 9 as a general intangible.

The most common example of a mezzanine loan is one where the debtor (i.e., the equity owner) pledges its 100% limited liability company interest in the property-owning entity to the secured party (i.e., the mezzanine lender).

Type of Collateral

An ownership interest in an LLC or a limited partnership (LP) is either:

- A general intangible or investment property under Article 9 –or–
- Investment property in the form of a security under Article 8

See “Proper Perfection” below for more information.

Proper Perfection

The mezzanine lender will require that its lien on its borrower’s ownership interest in the limited liability company interest of the property-owning entity be properly perfected and have priority over any other competing secured parties and any liens of any lienholders. By properly perfecting its security interest, the mezzanine lender will also be able to have priority over the trustee in bankruptcy in case its borrower files for protection under the bankruptcy code.

Perfection of a security interest in a pledge of an interest in an LLC or LP can be accomplished by the following methods:

- File a UCC financing statement in the appropriate jurisdiction (under U.C.C. § 9-310) against the borrower, if the security interest is deemed a general intangible or is investment property (Investment property is defined under U.C.C. § 9-102(a)(49) as a security (whether certificated or uncertificated), security entitlement, securities account, commodity account, or commodity contract. While a security interest in investment property may be perfected by filing a financing statement as noted above, the most common way to perfect is under Article 8.)
- Opt in to Article 8 and:
  - o Take possession of the collateral (under U.C.C. § 9-313(a)) by means of the secured party getting physical possession of the certificate (similar to a stock certificate) and related power executed in blank that is issued by the property-owning entity –or–
  - o Achieve control (under U.C.C. § 9-314(c)), if the lender wishes to achieve control of the security

How to Opt In to Article 8

The operating agreement of a property-owning LLC or LP must specifically provide that the limited liability company / membership/partnership interests are securities under Article 8 of the UCC. (Note that these securities generally are not securities under the Securities Act of 1933 or the Securities Exchange Act of 1934.)

The way the property-owning entity would opt in to Article 8 is by amending its operating agreement and adding specific language to it. The property-owning entity is generically referred to as the issuer, since it is the one that is issuing the certificate evidencing that its equity owner owns it. If that is done, the ownership or equity interests will be treated as a security under Article 8 rather than a general intangible under Article 9.

One example of an amendment to an operating agreement for an LLC or LP that contains the necessary language to opt in to Article 8 is the following:

> The Member hereby agrees that its interest in the Company shall for all purposes be personal property. The Member has no interest in specific Company property. Each limited liability company interest in the Company constitutes a “security” within the meaning of, and governed by, (i) Article 8 of the Uniform Commercial Code (including U.C.C. §§ 8-102(a)(15) and 8-103 thereof) as in effect from time to time in the State of _________ (the “UCC”) and (ii) the corresponding provisions of the UCC of any

other applicable jurisdiction that now or hereafter substantially includes the 1994 revisions to Article 8 thereof as adopted by the American Law Institute and the National Conference of Commissioners on Uniform State Laws and approved by the American Bar Association on February 14, 1995 (and each limited liability company interest in the Company shall be treated as such a "security" for all purposes of each such UCC, including, without limitation, perfection of a security interest therein under Article 8 of each applicable UCC as the Company has "opted-in" to such provisions). Notwithstanding any provision of this Agreement to the contrary, to the extent that any provision of this Agreement is inconsistent with any non-waivable provision of Article 8 of the UCC, such provision of Article 8 of the UCC shall control.

Priority between Articles 8 and 9

The general rule of Article 9 (for collateral that can be perfected by the proper filing of a financing statement) is that the first secured party to properly file a financing statement establishes priority. Perfecting by opting in to Article 8 and achieving control will prime (i.e., take priority over) a security interest in the same personal property that is perfected by any other method of perfection, even if the control under Article 8 occurs after the time of first perfection.

When investment property collateral is pledged to a secured party under Article 8, Article 9 defers to the rights of protected purchasers under Article 8. As a result, most mezzanine lenders elect to perfect their security interest in pledges of equity/LLC/LP interests under Article 8.

Protected Purchaser Status

The primary reason that a lender will require the issuer to opt in to Article 8 is to achieve the status of a protected purchaser under Article 8. A lender achieves protected purchaser status when it:

- Gives value for the interest, which is accomplished by making the loan to the debtor
- Obtains control (as explained above) of the security, typically by taking physical possession of the certificate and power executed in blank –and–
- Has no notice of any adverse claim (as defined and described in Article 8)

Protected purchaser status will enable the lender to defeat any adverse claim, including claims of third parties that treat their interests as general intangibles and who perfect by properly filing in the jurisdiction in which the debtor is located.

Some UCC insurance policies will give a mezzanine lender assurance that it has coverage over a loss incurred as a result of its failure to comply with all three elements of becoming a protected purchaser.

Other Examples of Lenders Requiring Pledges of Equity

Real estate lenders are increasingly taking pledges of equity as collateral for the loans that they are making. In addition to making a basic mezzanine loan, some lenders are making loans secured by a mortgage / deed of trust and a pledge of equity. Other lenders are requiring a pledge of equity as security for a payment or performance guaranty, or as collateral for the issuance of a bond. Lenders to the energy industry take pledges of equity from the owner of the underlying project finance entity that owns a gas plant, solar farm, or wind farm for example.

UCC Insurance for Mezzanine Loans

Background

UCC insurance arose to fill a void created by the rise in popularity of mezzanine financing. Mezzanine lenders wished to securitize their mezzanine loans similar to the way mortgage lenders had been securitizing their mortgages. Since a mortgage lender had to provide the rating agencies with a real estate title insurance policy to ensure (1) that the loan was documented correctly and (2) that the mortgage was a first and senior lien on the underlying real property, the rating agencies sought similar title insurance coverage for a mezzanine loan. The title insurance industry created a title insurance product that would insure personal property in a manner similar to what it had been doing for decades, insuring the lien of mortgages and deeds of trust.

What Is a UCC Insurance Policy?

UCC insurance is title insurance. Like a real estate policy, a UCC insurance policy is indemnity insurance that provides title insurance coverage for proper attachment, priority, and perfection of the lender's security interest. (There is also UCC insurance for owners/buyers; see What Is a UCC Insurance Owners Policy? below for more information.)

By obtaining a UCC title insurance policy, the insured lender transfers the risk of failing to properly attach, perfect, or achieve the desired priority of the lender's security interest in its collateral to the title insurer.

Just like a real estate policy of title insurance, a lender that purchases a UCC policy and pays one premium obtains full legal defense costs in the event a claim is made in accordance with the policy provisions. The lender also obtains the benefit of all of the title insurance company's practices and procedures that are specifically designed to assure compliance with the most current provisions of the UCC.

Advantages of Purchasing a UCC Insurance Policy

Article 9 Perfection Requires Precision

When pledges of equity are involved, the lender will always file a UCC financing statement to perfect its security interest in the general intangible if no opt-in is required, or, if there is an opt-in, to perfect on investment property in addition to achieving control under Article 8.

Properly filing a financing statement is a complex, detailed, and exacting task to accomplish this goal.

The lender must:

- Ascertain the exact legal name of the debtor
- Conduct a search of the name of the debtor in the correct jurisdictions
- Utilize proper search logic in conducting the search
- Hope that the search company's search results are accurate
- Complete the financing statement properly and exactly
- File the financing statement at the correct time
- File the financing statement in the proper jurisdiction and in a manner acceptable to it –and–
- Verify that no other secured parties have filed a financing statement between the through date of the most recent search and the date of the filing of its financing statement

A UCC insurance policy covers all of the foregoing, shifting risk from the lender to the title insurance company. Most importantly, the UCC insurer provides, at the title company's cost, for a defense (and very expensive attorney's fees to defend) against a claim made by the insured with respect to any one of the insuring provisions of the policy as the result of a loss occurring under the UCC insurance policy.

Risk Shifted to the Title Insurance Company

As noted above, one of the steps to proper perfection is verifying that no other secured party has previously filed a financing statement against your debtor. To accomplish this, a UCC search is conducted by a search and filing company. The secured party/lender must hope and trust that the search company's search results are complete and accurate. If the search results are not accurate and the search company missed a prior filed financing statement in its report, but the lender relies on the search results and makes the loan, the lender may suffer a loss as a result of its lien not being a first priority lien. Worse, if there is a default and an ensuing bankruptcy (explored in more depth below), the lender's lack of a first lien position will be fully exposed, and the lender may have to write off all or a portion of its loan because of a loss of priority. While the lender can go back to the search company (and probably get its money back for the cost of the search), the lender cannot go back to the search company to be reimbursed for its loss.

This does not happen in the real estate world because real estate lenders have utilized real estate title insurance for decades.

If the lender purchased a UCC insurance policy and the same scenario happened (with the title company relying on the results of the UCC search), the lender could file a claim under the terms of the UCC insurance policy for its loss.

By obtaining a UCC insurance policy, search and filing risk is shifted from the lender to the title insurance company.

Avoid Bankruptcy Issues and Concerns

The goal of every bankruptcy trustee or unsecured creditors committee is to obtain and preserve the greatest amount of cash and assets, from all available sources, for the benefit of the estate and its general unsecured creditors and to pay the expenses of administering the estate. The trustee/committee is highly incentivized to carefully review the lender's documents to test whether the lender has properly perfected its security interest in the collateral that it has taken for its loan. If there is any mistake, however slight, the trustee/committee will aggressively challenge the status of the lender as a secured party to strip the lender of this status and move them down to be just another unsecured creditor.

Since the lender made the loan in full reliance on having a properly perfected security and being able to file a secured claim in bankruptcy, a successful challenge to the perfection or priority of such interest could have devastating consequences as the lender might be forced to write off its entire loan if its security interest is classified as an unsecured claim. The lender's counsel also faces severe consequences if the bankruptcy court determines that the lender's security interest is defective or ineffective, including malpractice liability, damage to the lawyer's (and his or her law firm's) reputation, and loss of future clients and income.

Underwriting Expertise

Another very significant benefit of obtaining a UCC insurance policy is that experienced underwriters provide a seasoned second set of eyes on the transaction and all of the related documentation necessary to achieve a properly perfected first security interest under the UCC. These underwriters engage in constructive and instructive dialogue with the lender, the lender's counsel, the borrower, and its counsel. They provide guidance and assistance and advise counsel during every step of the transaction. Benefits include evaluating and ordering necessary UCC searches and document review to ensure compliance with Article 9 to issue a UCC policy. UCC insurers also offer assist in filing UCC financing statements.

Title Company Strength and Reserves for Losses

National title insurance companies are experienced, stable, and well capitalized. They are regulated by the state insurance departments in which they do business. As insurance companies, they can spread their exposure among a large pool of customers and charge relatively low premiums for the risk assumed. Without such coverage, lenders would either have to self-insure such risks or have their law firms assume them, neither of which is cost-effective nor results in the extent of coverage provided by a UCC insurance policy.

What Is a UCC Insurance Owners Policy?

Insuring ownership of Article 9 collateral is a very difficult and risky proposition since there is no recordation statute in the world of personal property to publicly document a chain of title. As an example, title to personal property for each and every account of a business would be almost impossible to determine. Not every account on a business's books is owned by that business. The concepts of setoff, contra accounts, and accounts where not 100% of the account is truly owed to the business are impediments to ownership.

Since UCC insurance policies for lenders do cover attachment in the contact of pledges of equity, some title insurance companies have created a UCC policy for owners. These policies cover the sale and transfer of an ownership interest in a limited liability company, a limited partnership interest, or a corporation.

The coverage provided is fairly straightforward. The title insurance company insures against a loss as a result of the failure of the seller to own the LLC/LP/corporate interest. It also insures that:

- Upon transfer of that interest to the purchaser, the purchaser owns that interest
- The interest is free and clear of lines created by other secured parties or liens of lien creditors

As an example of a common use of a UCC insurance owner's policy, many real estate investment trusts (REITs) purchase select real estate portfolios from other REITs or parties selling select commercial real estate assets. And many times, the purchasing REIT is not purchasing the real estate directly but purchasing the ownership of the limited liability company or limited partnership that owns the entity that owns the underlying real property.

The purchaser gets top-to-bottom title insurance coverage by obtaining a UCC insurance owner's policy for the equity purchase and by obtaining a real estate title insurance policy for all of the underlying real property.

Final Note on UCC Insurance

Now that UCC insurance has been available from the major title insurance companies for almost 20 years, the use of UCC insurance is a best practice for lawyers and law firms. Real estate title insurance followed the same pattern as they migrated from abstractor's opinions to the full use of title insurance in real estate transactions. For a relatively small cost, a UCC policy provides indemnification coverage for a loss occurring as a result of a lack of attachment, perfection, and priority and also provides for defense costs.

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A leading authority on Articles 8 and 9 of the Uniform Commercial Code (UCC) and UCC Insurance, Gary Zimmerman supervises the UCCPlus team and participates in all of the company's underwriting and policies.

As the Chief Underwriting Counsel for UCCPlus, Gary reviews and evaluates transaction structure and provides feedback on the insurability of real estate mezzanine loan transactions, project finance and energy transactions, and major-market working capital and term loans. He also advises outside counsel and major commercial lenders on UCC matters. In addition, Gary provides input to the Fidelity National Title Group companies on secured lending and UCC Articles 8 and 9 issues.

A practicing attorney since 1982, Gary is a frequent lecturer on matters involving Articles 8 and 9 of the UCC, commercial lending practices, UCC foreclosure rules and practice, and the terms, conditions and exclusions of personal property title insurance and endorsements. He is also on the faculty of the Commercial Finance Association's Professional Education Programs.