



UCC Insurance Insights

Equity Control Pledges: An Invaluable Exit Strategy Tool



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Summary

- Equity Control Pledges have become a best practice for a mortgage lender to build a comprehensive loan security structure.
- Equity Control Pledges allow lenders to expedite taking ownership of collateral compared to a traditional foreclosure on real property.
- Lenders must be aware of potential pitfalls when documenting Equity Control Pledges and of options to best protect themselves in the event of a loan default.

Pledges of equity have been used for many years as the vehicle to allow mezzanine lenders to secure mezzanine loans. Now, lenders use pledges of equity as an essential structuring tool to implement a logical exit strategy in case of a default. Although sometimes referred to as “accommodation” pledges — a term that engenders and ascribes little value to the pledges — the pledges of equity taken in conjunction with a lender making and securing a mortgage loan are valuable tools to the lender and are more accurately described as **Equity Control Pledges**.

This article will explore a quick history of equity pledges in the context of mezzanine loans and the increasing use of Equity Control Pledges, describe the advantages of taking an Equity Control Pledge when no mezzanine financing is contemplated, and cover the danger to the lender that can occur if these pledges are not properly documented and perfected.

Equity Pledges and Mezzanine Finance

Mezzanine financing was developed as a method for the lender to achieve a higher return on their investment by making a loan at a higher, more risky level in the capital structure. After the 2008 economic implosion, mezzanine financing further increased. This growth was due, in part, to 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.

With the recent rise in interest rates, loan-to-value ratios have lowered on lenders' senior loans, which has created yet another opportunity for mezzanine finance to fill the need for increased debt on a borrower's balance sheet. Because all mezzanine lenders secure their loans with a pledge of equity in the property-owning entity, obtaining a Uniform Commercial Code (UCC) insurance policy has become best practice among both the law firms representing these lenders and the mezzanine lenders themselves.

Use of Equity Control Pledges

It has become common to see a lender make a loan with a parcel of real property as the primary asset and secure that loan by means of a deed of trust/mortgage and the taking of an equity pledge in the ownership interest in the entity that owns the underlying real property. The required pledge is often referred to as an "accommodation pledge". The connotation of this phrase is that the borrower is obliging a small, insignificant "throw-in" request from the lender that is making the loan. The term "accommodation pledge" further implies that the pledge is an afterthought, a belt and suspenders duplicative lender request, or something not to be taken very seriously by the lender. However, the terminology is a complete misnomer.

The primary purpose of the equity pledge is to allow a lender to expedite taking ownership of the underlying collateral in the event of a default under the terms of the loan. **By using the more appropriate designation, Equity Control Pledge, the lender adds an important strategic option available to it in a default/workout scenario.**

A Common Scenario

- A default has occurred under the underlying mortgage documents by and between the borrower and the lender.
- The Equity Control Pledge is cross defaulted with the mortgage loan.
- Any cure periods built into the loan documents have not been remedied by the borrower.
- The lender is able to exercise its remedies under either the terms of the mortgage loan documents or the terms of the Equity Control Pledge documents.

The lender will have the remedial option of:

- Proceeding with a foreclosure of the underlying real property under the applicable state foreclosure statute/law; or
- Proceeding with the exercise of remedies provided for in Part 6 of Article 9 of the UCC as adopted in each state.

The most common method by which a lender chooses to dispose of its collateral is to conduct a public sale.

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Advantages of Conducting a Public Sale

As a result of obtaining an Equity Control Pledge, the lender may quickly dispose of its collateral by successfully conducting and completing a public sale in a commercially reasonable manner and becoming the successful bidder at the public sale. After the sale, the lender would own property-owning entity, thereby “stepping into the shoes” of the property-owning entity and be in position to manage the underlying real estate asset. This also allows the lender to dispose of the underlying real property by being the party who is authorized to direct a deed to a third-party purchaser.

Another possible outcome of a public sale is equally satisfactory to a lender. Rather than being the successful bidder at the public sale, another party could qualify itself to bid in at the sale and outbid the foreclosing lender. Since a lender, in the context of a public sale, can credit bid all the indebtedness owed to it by the defaulted borrower, any successful third-party qualified bidder would have to outbid the lender’s credit bid and the lender (who required the Equity Control Pledge) would be made whole.

As noted above, the principal advantage of a lender obtaining an Equity Control Pledge is the time frame in which a lender can successfully conduct a public sale. Lender’s counsel (who presumably has experience and knowledge of Article 9 and conducting Article 9 public sales) should be able to conduct a public sale within 60 to 90 days after the lender is able to exercise its remedies under the applicable loan documents.

Contrast that scenario with the lender’s other option – foreclose on the underlying mortgage. In many states, a mortgage foreclosure can take more than two years to conclude. This lengthy process is partly due to court backlogs.

Pitfalls and Traps

There are some very important caveats to the strategies and options of the lender that have been laid out above.

If a lender and its counsel make any mistake in the process and/or documentation that causes the lender to: i) not properly attach the security interest to the pledge of equity; ii) improperly perfect its security interest in the pledged collateral; or iii) fail to achieve a first-priority lien on that equity pledge, then the lender’s security interest on that pledged collateral will fail. The consequences of that type of error would be:

- Only a lender that has a properly perfected first-priority security interest in the pledge of equity can avail itself of the remedies available under Article 9 of the UCC as embodied in the loan documents and can thereby conduct a public sale and dispose of the collateral.
- If not properly perfected, borrower’s counsel will detect the defects and attempt to enjoin the public sale.

As is the case for mezzanine loans secured by pledges of equity, experienced counsel and their lender that they represent utilize best practice by obtaining a UCC title insurance policy for Equity Control Pledges, thereby shifting risk of claims against attachment, perfection and priority from the lender to the title company.

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