Mitigating The Risk Of A Loan Portfolio Acquisition With UCC Insurance

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James D. Prendergast and Jill Sharif

Whenever personal property is reliance collateral or financial assets are being acquired, UCC insurance can be an effective and efficient risk management tool to mitigate the legal and financial risks inherent in such transactions.

WE HAVE, on many occasions, written about the utility of UCC insurance as it relates to specific market segments. Whether in connection with real estate mezzanine lending, asset-based lending, factoring, mixed real and personal property transactions, flooring arrangements with vehicle or equipment dealers, mining and other mineral extraction, or in other types of financial transactions, UCC insurance has demonstrated its risk management utility when personal property is the reliance collateral. Over $350 billion of UCC insurance coverage has been placed since Revised Article 9 became effective on July 1, 2001.

Now that the economy is under extreme stress, market conditions are requiring the recapitalization of financial institutions or the purchase of, or participation in, financial transactions and instruments. Financial institutions are disposing of loan portfolios and other financial assets to bolster their balance sheets. Problem assets are now targets of opportunity for financial speculators. With respect to any financial transaction in which personal property is reliance collateral or in which financial assets are being acquired, either directly through purchase or indirectly through participation in some manner, UCC insurance can be an effective and efficient risk management tool to mitigate the legal and financial risks inherent in such transactions. Up until the current credit crisis, the financial stability of the originating lender or seller of financial assets has been a sufficient hedge to inherent risk. Further, legal opinions were thought to be sufficient to satisfy any due diligence requirement demanded by prudent lending. This may no longer be the case.

LOAN SYNDICATIONS, ASSIGNMENTS, AND SYNDICATIONS • Because the structure of a transaction will determine the appropriate UCC insurance product to use, we need to agree on some definitions.

Loan Syndication

The first term to be defined is "Loan Syndication." Loan Syndication is the process of involving different lenders in providing various portions of a loan at the inception. It is used primarily in large loan situations. Syndication allows any one lender to provide a large loan to its customer while at the same time maintaining a more prudent and manageable credit exposure because it is not the only creditor. A syndicated loan is in contrast to a "Bilateral Loan" which only involves one lender.

After the loan transaction has been established, either as a Bilateral Loan or a Loan Syndication, the initial loan may be further fractionalized, either through a "Loan Assignment," or a "Loan Participation." People often use the term "Participation" to mean either a "Loan Assignment" or a "Loan Participation." Often they mean a "Loan Assignment" and often they don't understand the difference.

Loan Assignment

A "Loan Assignment" is the transfer or acquisition of a fractionalized portion of the lender's interest in the loan. *Loan Participation: Getting It Right*, by R. Kymn Harp, available at http://www.imakenews.com/iln/e_article000404223.cfm?x=b11,0,w. Typically, the interest transferred or acquired will be less than 100 percent, with the originating bank retaining a percentage interest in the loan and, often, retaining responsibility for servicing the loan and maintaining direct interaction with the borrower as the "lead bank." The acquiring bank, often referred to as the "participant," will become an "owner" of a portion of the loan with all benefits of full performance and all associated risks of loss, as if the participant had originated the loan itself. This assignment effects a novation between the assigning lender and the assignee. As a result, the assignee is obligated with respect to the remaining commitments and the assigning lender is relieved of any further obligations (with respect to the portion of the loan assigned). This type of "Participation" is identical in legal structure to a "Syndication," except that the "Participant" was not involved in the initial structuring, negotiation, and placement of the loan but is entering into the loan transaction after the fact to "buy" a portion of the loan from the originating lender. For purposes of this article, this type of participation will be called a "Co-Lender Assignment."

Loan Participation

Another application of the term "Participation," this time correctly, is a financing transaction in which the Participant is purchasing an interest in the loan from the lead lender but the lead lender remains obligated to the borrower to make any committed extensions of credit and there is no privity of contract between the borrower and the participant. For purposes of this article, this type of participation will be called a "Loan Participation."

Another distinction between a Co-Lender Assignment and a Loan Participation is that a Co-Lender Assignment usually involves a restatement of the loan documents between the new lenders and the borrower. The new lender coming into the loan transaction as a co-lender is added to the loan documents as a lender, perhaps an administrative or collateral agency structure is added to the documentation, and if the borrower's obligation is evidenced by a promissory note, the original note will be severed and cancelled and replaced with individual notes to the lenders in their proportional relationship.

The reasons financial institutions fractionalize existing loans are many and varied. For some, the primary motivation is to enable the institution to originate loans that would otherwise exceed the legal lending limit of the institution. By fractionalizing loans to other financial institutions, a lead bank can stay within its legal lending limits while continuing to serve as the primary banking contact for a valuable customer whose borrowing needs are outgrowing the legal limits of the bank. For other financial institutions, purchasing interests, directly or indirectly, in established loans allows them to earn market interest rates for money lent, even when lending opportunities in their own banking community may be limited. In other cases, financial institutions may sell or purchase fractionalized interests in loans as a risk-management vehicle to diversify loan risks among a variety of loans in multiple lending locations.

Direct Loan Transactions

There is another form of transaction that is often confused with either a Co-Lender Assignment or a Loan Participation, and this is a loan made by Lender A to Lender B. The loan may be secured by specific assets of Lender B, including loan transactions that are assets on the books of Lender B. If secured by loan assets, this direct loan has the similarity with a Loan Participation in that Lender A does not have a direct legal relationship or privity of contract with the borrower. However, it is confusing to label this loan transaction as a "Participation," so for purposes of this article, the direct loan will be called a "Direct Loan Transaction."

LOAN PORTFOLIO ACQUISITIONS • In addition to describing the privity relationship between the lenders and borrower, it is useful at this point to add a few definitions, briefly, from the UCC. This article is primarily concerned with a loan portfolio acquisition (from an Article 9 of the UCC perspective) and the use of UCC insurance to mitigate market risk. The asset being acquired will usually be a payment obligation, either an Account, Chattel Paper, a Promissory Note, or a Payment Intangible.

Accounts, Chattel Papers, Promissory Notes, And Payment Intangibles

A promissory note is an Instrument, as defined by UCC section 9-102(a)(47), whether negotiable or not under UCC section 3-104. If there is no note but only a contractual obligation of the borrower to pay amounts outstanding under the loan documents, the asset being acquired or collateralized might constitute a Payment Intangible as defined by UCC section 9-102(a)(61). These terms are useful to remember because Article 9 distinguishes between the sale of or a lien in the various forms of payment obligations. First of all, the sale of Accounts, Chattel Paper, Promissory Notes and Payment Intangibles comes within the scope of Article 9, thereby requiring perfection of a security interest in the payment obligation to defeat other creditors or the trustee in bankruptcy. *See* §9-109(a)(3) as to the scope of Article 9. Further, Article 9 provides for automatic perfection in the case of the sale of a Payment Intangible or a Promissory Note, but requires the filing of a financing statement to perfect a security interest in a Promissory Note (possession will also perfect a security interest in an Instrument and, in a priority contest, will prime perfection by filing) or a Payment Intangible. *See* §9-309 for automatic perfection.

The approach taken with respect to Promissory Notes and Payment Intangibles is to be distinguished from the approach taken with respect to

Accounts and Chattel Paper, for which the filing of a financing statement is needed for either sale or lien (again possession trumping filing perfection in the case of Chattel Paper). *See* §9-310 and §9-312.

Supporting Obligation

Because the payment obligation evidenced by the Promissory Note or Payment Intangible being acquired in some manner may itself be secured, we also need to define a "Supporting Obligation." Section 9-102(a)(77) defines Supporting Obligation as a letter-of-credit right or secondary obligation that supports the payment or performance of an account, chattel paper, a document, a general intangible, an instrument, or investment property. If the Payment Intangible or Promissory Note is secured by either real or personal property, the attachment of a security interest in a right to payment or performance secured by a security interest or other lien on personal or real property is also, automatically and without further effort, the attachment of a security interest, in the security interest, mortgage or other lien. *See* §9-203(g). Therefore, obtaining a security interest in a promissory note automatically gives the attaching creditor a security interest in any real property mortgage or deed of trust securing the repayment obligation of the Account Debtor under the note. The mortgage follows the note! The same functional relationship between the note and a collateral mortgage also applies to perfection. *See* §9-308(e). Finally, a secured party is given the right to proceed against the Account Debtor under the underlying mortgage upon default in the obligation supported even if there is a break in real property recorded title.

Secured Party's Rights Upon Default

Section 9-607 provides in part with respect to collection and enforcement by a secured party that, if so agreed, and in any event after default, a secured party:

- May notify an account debtor or other person obligated on collateral to make payment or otherwise render performance to or for the benefit of the secured party;
- May take any proceeds to which the secured party is entitled under Section 9-315;
- May enforce the obligations of an account debtor or other person obligated on collateral and exercise the rights of the debtor with respect to the obligation of the account debtor or other person obligated on collateral to make payment or otherwise render performance to the debtor, and with respect to any property that secures the obligations of the account debtor or other person obligated on the collateral;
- If it holds a security interest in a deposit account perfected by control under Section 9-104(a)(1), may apply the balance of the deposit account to the obligation secured by the deposit account; and
- If it holds a security interest in a deposit account perfected by control under Section 9-104(a)(2) or (3), may instruct the bank to pay the balance of the deposit account to or for the benefit of the secured party.

Further, If necessary to enable a secured party to exercise under subsection 9-104(a)(3) of the right of a debtor to enforce a mortgage non-judicially, the secured party may record in the office in which a record of the mortgage is recorded:

- A copy of the security agreement that creates or provides for a security interest in the obligation secured by the mortgage; and
- The secured party's sworn affidavit in recordable form stating that a default has occurred and the secured party is entitled to enforce the mortgage non-judicially.

APPLICATIONS OF UCC INSURANCE • With all of that as needed background, let us consider some examples of how UCC insurance may serve as a useful risk-management tool to facilitate the acquisition of financial assets.

Coverage For Direct Interest In The Loan

The first scenario is when the new lender is acquiring a direct interest in the underlying loan, what we referred to previously as either a Co-Lender Assignment or a Loan Participation. Because the new lender is buying a portion of the loan from the existing lender, the new lender is acquiring an asset of the existing lender subject to any liens of the existing lender applicable to the loan participation. If the asset being acquired is only a Payment Intangible (no Instrument changing hands), let us assume automatic perfection in the hands of the buying secured party. However, if we assume that an adverse security interest is also perfected in the Payment Intangible and was perfected prior in time, the buying lender would take subject to the senior perfected security interest. *See* §§9-325(a)(1), 9-322(a). As mentioned above, this result raises the concern of the financial stability of the selling lender. Section 9-320(a), which provides that a buyer in the ordinary course of business takes free of a security interest created by the buyer's seller, even if the security interest is perfected and the buyer knows of its existence, doesn't apply because that provision only applies to the sale of Goods. Adding to the problems facing the buyer of a Payment Intangible is the question of whether the selling lender had already sold the Payment Intangible to a third party. First off, the prior acquiring lender would be automatically perfected and the subsequent acquiring lender would be faced with the classic "hidden" lien. Additionally, Section 9-318 states that the buyer obtains no interest because the selling lender did not retain a legal or equitable interest in the collateral sold notwithstanding the classification of the buyer as a secured party under the Article 9 scope provisions.

A UCC Buyer's Policy can insure against liens following the Payment Intangible into the hands of the buying lender. Depending on the players involved and the availability of indemnities, the risk of prior automatic perfection can be shifted from the buying lender to the insurance company. Accompanying this coverage would be the affirmative coverage that the buying lender has Rights, as that term is used in Article 9, in the acquired Payment Intangible.

Coverage For Promissory Notes

Similar coverage can also be provided through UCC insurance if the acquired payment obligation is evidenced by a Promissory Note. The rules are similar between Promissory Notes and Payment Intangibles. However, if the Promissory Note is negotiable, enhanced "ownership" coverage may be obtained. *See* §§3-103 to 3-109, and the related Official Comments, for a thorough discussion of negotiability of Instruments. Depending on the facts of a specific transaction, if the Promissory Note involved is a negotiable instrument, some insurers can attach to the Buyer's Policy a Holder in Due Course Endorsement insuring that the acquiring lender is a holder in due course of the Instrument under Article 3 of the Uniform Commercial Code. Further, section 9-317(b) makes it clear that a buyer takes subject to a prior perfected security interest in an instrument. UCC insurance can provide that bridge, risk-management solution.

The other type of transaction mentioned above is the "Direct Loan Transaction," in which the participating lender is, in fact, just making a loan to the originating lender. This loan may or may not be secured with the collateral of the actual loan to the borrower in question or a more general security interest against the assets of the originating lender. In this context, a UCC Lender's Policy is the appropriate vehicle for insuring the participant's security interest in any assets of the originating lender offered as collateral for the repayment of the loan obligation of the originating lender to the participant. The Lender's Policy is the original and most basic of the UCC insurance products offered. At its core, the Lender's Policy insures that the lending participant has a first priority security interest in the financial assets that serve as collateral for the repayment of the participant's loan.

In summary, as to the acquisition of financial assets in these troubled times, UCC insurance may be able to provide that added level of risk management to facilitate the acquisition. Until the current economic downturn, the counterpoint to any concern over the hidden nature of the lien provided by automatic perfection for the sale of Promissory Notes and Payment Intangibles was the "inherent" financial stability of the selling lender and the reliance on its representations and warranties. Such reliance may no longer be well placed and UCC insurance can provide the necessary hedge to facilitate closing the transaction and bridging the confidence gap.

FORECLOSING CREDITORS' RIGHTS • One additional issue that needs to be considered is the utility of UCC insurance in insuring the foreclosing creditor's rights to enforce an underlying mortgage under Section 9-607(b) of the UCC. This issue may arise as a result of the following fact pattern. Loan Originator LLC makes a number of loans, evidenced by notes, and secured by mortgages on various office buildings throughout the United States. As may seem to many a stunning event, not all of the loan documentation was fully in place at the time the loans funded. In fact, many of the real estate mortgages, although duly executed, were not recorded. Soon after the origination of the loan portfolio, the loan portfolio was sold to Loan Holding LLC. At the close of the loan portfolio sale transaction, the notes were duly assigned by Loan Originator LLC to Loan Holding LLC, but still without recordation of the underlying mortgages and therefore no recorded assignment of those mortgages.

We now have what is affectionately referred to as a "break in title." Loan Holding LLC now takes out a loan from a bank syndicate and the notes are collaterally assigned by appropriate documentation to a collateral agent. Now Loan Holding LLC surprisingly is in default on its loan to the bank syndicate and collateral agent seeks to foreclose against the collateral consisting of the notes and the supporting mortgages. Counsel for the foreclosing collateral agent is now faced with conducting a commercially reasonable public foreclosure sale pursuant to Section 9-610 of the UCC. Counsel believes that having available land title insurance showing the purchaser at the foreclosure sale as mortgagee on the underlying mortgages would be necessary to support the commercially reasonable nature of the foreclosure, especially because in all probability the foreclosing collateral agent may be, in this market, the only bidder at the sale. Also add to the equation that it would be extremely expensive or otherwise impractical to close the gap in the real property title through recording assignments of the underlying mortgages to the collateral agent. Maybe the conversation between the collateral agent and Loan Originator LLC had grown a bit tense.

UCC Buyer's Policy

With a UCC Buyer's Policy, insuring the lien status of the Notes acquired by the winning bidder at the foreclosure sale, an endorsement could be added insuring the winning bidder against any actual loss or damage resulting from the winning bidder being unable to enforce its rights under Section 9-607(b) of the UCC to non judicially foreclose on the underlying mortgages. Again, using endorsements to a UCC insurance policy to craft a creative solution has greatly benefited the insured.

UCC Foreclosure Notice Policy

In addition, some insurers offer UCC Foreclosure Notice Policies. The UCC Foreclosure Notice

Policy covers the UCC search to determine secured creditors of record. It insures against filing office error and similar matters, and provides the assistance of trained professionals to help counsel orchestrate the foreclosure notice process in accordance with the requirements of Part 6 of Article 9. This policy provides the insured coverage as to the accuracy of the filing office records searched to determine the creditors of record to be noticed regarding a contemplated public or private Article 9 foreclosure sale. In addition, by periodic searching, the insurer can assist by maintaining the notice list and keeping it up-to-date so that, for example, if workout negotiations fail, the foreclosure notice can immediately be sent. The UCC Foreclosure Notice Policy is another example of the proactive effort taken to provide needed risk-management solutions.

LEGAL OPINIONS • There is an additional discussion that is needed in evaluating the utility of UCC insurance in the acquisition of financial assets, and that is as an alternative to an opinion of seller's counsel (if you can get the opinion). Because there is usually no registry to track title or ownership of personal property, counsel rarely, if ever, will provide an opinion that the seller of the financial asset actually "owns" the financial asset in question. The reasons remain valid in support of the statement that "[e]xperienced lawyers seldom opine that a security interest has attached because of the 'rights in collateral' aspect of attachment." Arthur Norman Field and Reade H. Ryan, Jr. *Legal Opinions in Corporate Transactions*, Matthew Bender Business Law Monograph No. 26, 1988, at 8-4 to 8-5.

Limited By The Records

Any opinion with respect to title must start with the assumption that the purported owner or someone in the chain of title has good title or the power to transfer good title. All that a lawyer can do in this context is to examine the public records and documents furnished by the client. But the examination of such records and documents, while affording substantial practical comfort, cannot provide conclusive support for a title opinion. All that the lawyer can meaningfully speak to is the adequacy of the search made for security interests and federal tax liens and the circumstances in which the UCC confers the power to transfer a better title than the transferor had. This is a complex area that requires familiarity both with the special rules applicable to various kinds of personal property, tangible and intangible, and the creation of non-consensual liens and interests. If a meaningful opinion is to be given, an expository opinion should be delivered in which the procedures undertaken, and those not performed, are clearly detailed in preparing to render the opinion and the limitations upon the certainty of the firm's views on the matter of title. Such an opinion would refer to, among other things, an examination of UCC Information Requests from appropriate jurisdictions, the examination of appropriate state and federal court records, the review of local tax payment and tax clearance certifications, study of title insurance commitments, and such opinion further would be subject to the knowledge of counsel.

Consult The TriBar Opinion Committee Special Report

An accepted guide on the scope of commercial law legal opinions is the Special Report of the TriBar Opinion Committee, UCC Security Interest Opinions—Revised Article 9, is informative as to how to structure a UCC perfection opinion. (References to the TriBar Report are to the published report in the August 2003 issue of The Business Lawyer, Volume 58, p. 1449.) However, given the structuring needs to avoid opining on the entire commercial law of Delaware, the utility of the "perfection" opinion to the lender is now seriously called into question, if such an opinion ever had any utility to justify the attendant cost.

The TriBar Report begins by suggesting that a security interest opinion should be limited in scope to the UCC. As stated in Section 2.1(b), an opinion limited to the UCC of a particular state customarily is understood to be subject to a three-part limitation:

- Only Article 9 of the Uniform Commercial Code is covered by the opinion. As stated in the TriBar Report: "The only law [addressed] is Article 9 of the UCC of the specified state, even when the character of the collateral or the identity of the debtor indicates that non-UCC laws may be relevant." TriBar Report, p. 6, reprinted in 58 Bus. Law. at 1458;
- Thus, this scope limitation excludes from the opinion other laws of the specified state and any federal laws that may be relevant to the transaction;
- Only UCC collateral or transactions are covered. Through this scope limitation, certain types of collateral or transactions, such as real estate and claims under and interests in insurance policies, are excluded from the coverage of the perfection opinion.

No opinion is given on the law governing perfection. This scope limitation makes clear that the perfection opinion subject to the scope limitation is not a choice-of-law opinion. The law of the physical location of certain types of tangible collateral (such as goods) continues to govern the perfection of a security interest by possession, the effect of perfection or non-perfection, and the priority of the security interest, however the security interest is perfected, whether by filing or otherwise. *See* §§9-301(2) and 9-301(3)(c).

Given the foregoing, a security interest opinion subject to the UCC Scope Limitation does not address:

- Laws of jurisdictions other than the jurisdiction specified;
- Laws of the specified jurisdiction, except for Article 9 of the jurisdiction's UCC;
- Collateral and transactions of a type not subject to Article 9 of the specified jurisdiction's UCC; and
- Under the specified jurisdiction's UCC Section 9-301, what law governs perfection of the security interest granted in the collateral covered by the opinion.

TriBar Report, p. 8, reprinted in 58 Bus. Law. at 1458-59. The TriBar Report provides, within the requirement of the foregoing Scope Limitation, that an opinion-giver may provide an opinion on the perfection of a security interest under the law of a state on which he or she would not normally render an opinion. TriBar Report, p. 22, reprinted in 58 Bus. Law. at 1510-11. The TriBar Report continues with its justification for this position: "This departure from normal practice would be possible because the UCC has been enacted in substantially similar form is all states." This assumes that the opinion is subject to a UCC Scope Limitation and therefore the opinion giver does not have to determine whether the collateral is subject to the UCC as adopted in the state where the collateral is located. TriBar Report, at 26, reprinted in 58 Bus. Law. at 1514-15.

The TriBar Report then provides that such a perfection opinion should specify the limited extent of the opinion giver's review of the law governing perfection and, in this regard, adopt the approach of the second alternative above. The opinion should specify that it is limited to a review of the text of the UCC as it appears in the official statutory compilation or a recognized reporting service such as the CCH Secured Transactions Guide.

If the perfection opinion covers perfection by filing (which will usually be the case) the opinion giver would therefore address whether:

- The state of the debtor's location provides for the filing of a financing statement to perfect a security interest in the relevant collateral. *Id.*;
- The financing statement meets the requirements of UCC Section 9-502(a) as adopted in that state; and
- The financing statement has been properly filed in that state (or is expected to be so filed).

The TriBar Report then continues that the foregoing determinations are to be made under the law of the state of the debtor's "location." For a "Registered Organization" (as defined in Section 9-102(70)), the more typical situation, the "location" is the state of organization. Because the opinion does not address which state meets this requirement, the opinion would be given under the law of the state where the opinion recipient has decided to file the financing statement. TriBar Report, p. 27, reprinted in 58 Bus. Law. at 1514-15.

So much for a legal opinion attesting to the seller's ownership of the financial asset being transferred! That leaves the buyer's recourse to the representations and warranties of the seller in the asset-transfer agreement. But, the representations and warranties of a seller are only as good as the solvency of the seller.

So What CAN You Say?

There is, however, an alternative. As discussed briefly above, a UCC Buyer's Policy coupled in the appropriate circumstance with a Financial Asset Ownership Endorsement will insure with indemnity insurance and not the negligence standard of a legal opinion provider, that:

- The Buyer will effectively be in title to the transferred financial asset immediately on transfer by insuring against any other party having rights in the financial asset; and
- The Buyer is effectively a Holder in Due Course of the financial asset.

Further, as stated in the Tri-Bar Report Draft:

"Opinions under Article 9 also call for familiarity with Article 9. While this Report provides a detailed discussion of Article 9 and opinions on security interests created under Article 9, opinion preparers who do not regularly work with article 9 should consider whether to involve a lawyer familiar with Article 9 in the preparation of a security interest opinion."

TriBar Report p. 2, reprinted in 58 Bus. Law. at 1503. Given the above, and assuming counsel has the expertise to address Article 9 issues, there is little counsel can do in the world of acquisition that is suitable for opinion practice. Counsel should not even address the issue of whether the debtor has rights in the assets being transferred because title to most categories of personal property is not a matter of public record. UCC insurance in the acquisition context can bridge the gap.

LIMITATIONS OF LIABILITY • Lien priority is not the only risk mitigated by the Lender's Policy or for that matter the Buyer's Policy as to liens in acquired assets. As to other covered risks, UCC insurance is, after all, insurance. Its role is fundamentally different than the role of a lawyer in a financing transaction. Its role is also fundamentally different than the role of a search company.

In the Washington State Supreme Court case of *Puget Sound Financial, L.L.C. v Unisearch, Inc.*, 47 P.3d 940 (Wash. 2002), Puget Sound Financial L.L.C. (then known as Factors of Puget Sound ("Factors")) filed a lawsuit against Unisearch, Inc. ("Unisearch"), a lien search company, alleging negligence and breach of contract. The trial court denied Factors motion for summary judgment on liability and held that even if Unisearch were ultimately liable to Factors, the measure of damages would be limited to $25 as provided in its invoices to Factors. The Court of Appeals overturned the trial court's ruling and remanded the case for trial on the issues of both liability and damages. Unisearch subsequently sought review of the appellate court's reversal of the trial court's ruling.

This case arose because Unisearch failed to report a filing against "The Benefits Group, Inc." in response to a search request under the name "The Benefit Group, Inc." The question on appeal was whether limitations on consequential damages presented in regular invoices for the purchase of commercial services could be enforced against a business purchaser. The Washington Supreme Court held that the liability limitation clauses were a part of the contract for the services between the parties. The court concluded that after 48 transactions, a course of dealing was clearly established. Also, according to the court there was no unfair surprise; the liability-limiting clause was not hidden in "a maze of fine print"; and the clause was not inconspicuous. Although the absence of negotiations may have weighed in Factors favor, they had reasonable opportunity to understand the terms of the clause, which remained unchanged throughout the course of dealing. The court therefore ruled that the liability limitation clause in the contract for services between the parties was not unconscionable.

The importance of this case to our discussion is the near universality of such limitations on damages in the contracts of search companies. An expert for the search company testified that, "It is a standard practice in the UCC search industry to disclaim any liability resulting from the use of the information provided, and to provide a limitation of damages equal to the fee paid for the service." *Id.* at 435.

The limit on damages is not difficult to understand or justify. Loss of priority can result in the loss of significant amounts of money and a search company does not want to face that degree of contingent liability for a $25 search fee, as was the case in the Puget Sound Financial decision. If it were otherwise, the search company would be an insurance company and the charge for the UCC search would be commensurate with the assumed risk. However, the search company is not an insurance company nor are the law firms reviewing the searches.

The *Puget Sound Financial* case addresses only one issue related to searching: the failure to discover an enforceable filing against a similar name of the debtor. There are many other issues under the general theme of sufficiency of search reports that are not covered by this case but are covered by the premise that the State itself is normally not liable for a mistake under sovereign immunity. There is no recourse against the State, or a search company, for mis-indexed financing statements that are valid but undiscoverable filings against a debtor. Similarly, there is no way of telling from a search report if a termination statement was authorized by the secured party. If not authorized, a termination statement is an invalid filing and has no effect of the secured party's security interest.

The answer is for the searching party or its lawyer to utilize UCC insurance to provide the protection against search company or State filing office error. Some insurers include a $10,000 acceptance of liability for filing office error at no additional cost for any database search conducted by its UCC division. (The $10,000 in base indemnity sometimes covers errors in the UCC searches and is included in the basic charge for the search.) This indemnity coverage amount can be increased by purchasing the appropriate title insurance products. This level of protection can apply not only to UCC searches of the State central filing office, but also to bankruptcy, judgment, pending litigation, tax lien, DMV (Department of Motor Vehicles) and other database searches.

The land title insurance companies offering UCC insurance are in fact insurance companies, with underwriting guidelines and pools of customers over which to spread assumed risk. The result is effective protection against these types of exposure at a reasonable premium—a premium well below the cost a search company would have to charge a customer who wanted to hold the search company liable for consequential damages. There is no amount of money that would get the State central filing office to be liable for the consequential damages resulting from mis-indexing. UCC insurance is the only effective coverage for these types of problems, from the perspectives of both cost and scope of coverage.

CONCLUSION • Given the financial state of our economy and many syndicated loans, there may be new situations in which risk management is becoming an issue. Through its multitude of UCC insurance products, and a staff that understands the legal issues involved, UCC insurers can provide effective risk-management solutions for rapidly changing market conditions. If creative thinking and legal expertise are of importance, consider including a UCC insurer as an important part of your transaction team.

PRACTICE CHECKLIST FOR
Mitigating The Risk Of A Loan Portfolio Acquisition With UCC Insurance

Given current economic conditions, recapitalization of financial institutions or the purchase of, or participation in, financial transactions and instruments is becoming more common. There are risks inherent in using personal property as reliance collateral or in acquiring financial assets, either directly through purchase or indirectly through participation. UCC insurance can help to manage that risk.

- The structure of a transaction will determine the appropriate UCC insurance product, so it is important to know some of the terms:

__ A Loan Syndication is the process of involving different lenders in providing various portions of a loan at the inception. A syndicated loan is in contrast to a "Bilateral Loan" which only involves one lender;

__ After the loan transaction has been established, either as a Bilateral Loan or a Loan Syndication, the initial loan may be further fractionalized through:

__ A "Loan Assignment," which is the transfer or acquisition of a fractionalized portion of the lender's interest in the loan. The acquiring bank, often referred to as the "participant," will become an "owner" of a portion of the loan with all benefits of full performance and all associated risks of loss;

__ A "Participation," which is a financing transaction in which the Participant is purchasing an interest in the loan from the lead lender but the lead lender remains obligated to the borrower to make any committed extensions of credit and there is no privity of contract between the borrower and the participant;

__ A "Direct Loan Transaction," which is a loan made by Lender A to Lender B. The loan may be secured by specific assets of Lender B, including loan transactions that are assets on the books of Lender B.

- When there is Direct Interest in the loan, A UCC Buyer's Policy can insure against liens following the Payment Intangible into the hands of the buying lender. Accompanying this coverage would be the affirmative coverage that the buying lender has Rights, as that term is used in Article 9, in the acquired Payment Intangible.

- Similar coverage can also be provided through UCC insurance if the acquired payment obligation is evidenced by a Promissory Note. The rules are similar between Promissory Notes and Payment Intangibles. However, if the Promissory Note is negotiable, enhanced "ownership" coverage may be obtained.

- When there is a "Direct Loan Transaction," a UCC Lender's Policy is the appropriate vehicle for insuring the participant's security interest in any assets of the originating lender offered as collateral for the repayment of the loan obligation of the originating lender to the participant. The Lender's Policy insures that the lending participant has a first priority security interest in the financial assets that serve as collateral for the repayment of the participant's loan.

- UCC insurance can be useful in insuring the foreclosing creditor's rights to enforce an underlying mortgage under Section 9-607(b) of the UCC:

__ With a UCC Buyer's Policy, insuring the lien status of the Notes acquired by the winning bidder at the foreclosure sale, an endorsement could be added insuring the winning bidder against any actual loss or damage resulting from the winning bidder being unable to enforce its rights under Section 9-607(b) of the Uniform Commercial Code to non-judicially foreclose on the underlying mortgages;

__ A UCC Foreclosure Notice Policy covers the UCC search to determine secured creditors of record. This policy provides the insured coverage regarding the accuracy of the filing office records searched to determine the creditors of record to be noticed regarding a contemplated public or private Article 9 foreclosure sale.