

My Dog Ate the (Security) Certificates . . .

What's the Big Deal?

By Bradley Gibson

Let's say you want to buy an office building or some other piece of commercial real estate. Let's also say that your mortgage lender will only lend you 60 percent of the property's value. What can you do to avoid having to front the entire 40 percent difference? During the recent heady days of commercial real estate, developers looking to fully leverage their acquisition cost of commercial properties (and thereby avoid using their own money) applied an old corporate financing tool called "mezzanine financing" to real estate acquisitions. A recent Moody's Investors Service report defined mezzanine financing as "[f]inancing secured by pledges of *ownership interests* in the real property-owning entity rather than by security in the real property itself . . ." ("US CMBS and CRE CDO: Moody's Approach to Rating Commercial Real Estate Mezzanine Loans," Moody's Investors Service, *Special Report*, March 2007). Mezzanine financing was the perfect solution in cases in which the senior mortgage lender prohibited subordinated financing secured by the real property. As the collateral in a mezzanine transaction is not real property but personal property, these

secured transactions are governed by the Uniform Commercial Code (UCC), which has been adopted with slight variations in all 50 states.

In real estate mezzanine loans, the equity in the real property-owning entity is typically represented by security certificates issued by the pledged entity. The lender perfects its security interest in the equity by taking possession of the security certificate along with an endorsement executed in blank by the pledgor. Now that many of the numerous mezzanine loans made back in 2006 and 2007 are being refinanced, a difficult problem is being encountered with increasing frequency. The problem is lost equity certificates. More and more, prior secured lenders who perfected their security interests by control of a certificated security are discovering that they have misplaced the original certificates evidencing the equity interest. Their inability to return the certificates places the pledged entity in a very precarious position. This article describes the structure of typical real estate mezzanine loans. It also explains the problems caused by lost certificates and proposes some possible solutions.

Under Article 9 of the UCC, pledged ownership interests in limited liability companies and limited partnerships can be different types of personal property with different methods of perfection available for each type. Absent an affirmative "opting into Article 8" of the UCC, ownership interests in limited liability companies and limited partnerships are "general intangibles." (Shares of a corporation are automatically deemed securities under UCC § 8-103(a).) A security interest in general intangibles can only be perfected by filing a financing statement with the appropriate state agency. (UCC § 9-310.)

If a limited liability company or limited partnership "opts into Article 8," i.e., elects to have its ownership interests treated as a security under Article 8 of the UCC, then the ownership interests are investment property under Article 9. Article 9 provides that a security interest in investment property can be perfected via control, possession, or filing. Perfection by control trumps filing even if done with full knowledge of the prior filing. (Theoretically, control also trumps perfection by possession of the certificate without an endorsement; however, it is hard to imagine a scenario in which competing security interests could be perfected via control and possession.) If a lender treats the pledged ownership interests as general intangibles, it can only perfect its security interest by filing. This lender

Gibson is vice president and associate general counsel of the UCC Division at First American Title Insurance Company in Santa Ana, California. His e-mail is brgibson@firstam.com. The author wishes to thank his colleague, Jim Prendergast, for his assistance in drafting this article.

Architecture of a Mezzanine Deal

Different Types of Personal Property. As mezzanine lenders are granted security interests in personal property, the lenders must perfect their security interests in such a way to give the lender a first priority security interest.

will lose a priority dispute to a subsequent lender who perfects by control after having the issuer of the equity (the pledged entity) opt into Article 8. Accordingly, it is most common in mezzanine loans (and, in fact, recommended by Moody's) that the pledged entity "opt into Article 8." After the pledged entity opts in, the lender can perfect its security interest via control and defeat other secured parties who have only perfected by filing a financing statement.

How to "Opt into" Article 8. Opting into Article 8 is as easy as adding language to the pledged entity's operating agreement. While the UCC does not provide any form language for the operating agreement, it can be as simple as the following: "The Company hereby elects, pursuant to UCC § 8-103(c), that each limited liability company interest in the Company shall constitute a 'security' governed by UCC Article 8, and that any certificate evidencing its limited liability interest in the Company is a 'certificated security' within the meaning of UCC § 8-102(a)(4)."

How to Perfect via Control. Once the equity interest in the pledged entity becomes a security under Article 8 and thus investment property under Article 9, a security interest in this collateral can be perfected by more than mere filing of a financing statement. A mezzanine lender can perfect its security interest via control in one of two ways. If the security is certificated, the lender takes possession of the membership certificates with an endorsement from the pledgor assigning the interests in blank. If the securities are uncertificated, the lender can perfect through a tripartite control agreement in which the pledged entity agrees to comply with the lender's instructions regarding the ownership interests without further consent of the pledgor.

The biggest disadvantage to perfecting with a control agreement is that should the lender foreclose on the collateral, it will be forced to present the pledged entity with instructions to transfer the ownership interests to the lender or to purchasers of the equity at a foreclosure sale. Most likely, the

lender presents this instruction to the same person or entity that just defaulted on the mezzanine loan and who will not be overly cooperative. Now the mezzanine lender has two lawsuits; a costly scenario. Perfecting with possession of the certificates and endorsements allows the lender to foreclose simply by conveying the certificates at a foreclosure sale and avoid the second lawsuit.

Protected Purchaser Status

Once the lender becomes a secured party through control under Article 9, it can then become a "protected purchaser" under Article 8, which affords the lender even more protection. A "purchaser" under Article 8 is not only one who buys the security as the name suggests but includes any voluntary transferee including a secured party. Section 8-303(a) of the UCC defines a protected purchaser as a "purchaser of a certificated or uncertificated security, or of an interest therein, who (1) gives value; (2) does not have notice of any adverse claim to the security; and (3) obtains control of the certificated or uncertificated security."

A few points about the definition warrant mentioning. The lender must purchase a security that requires the pledged entity to opt in prior to the execution of the pledge and security agreement. Typically the organizational documents opting into Article 8 and the pledge and security agreement are signed the same day, and the parties act in a manner consistent with the opting in documents having been signed first, which should be sufficient to establish the "purchase" of a security. The lender then gives value with a binding commitment to loan or by actually funding the loan. Notice of an adverse claim is actual notice of a claim adverse to the protected purchaser's property interest in the collateral. Adverse here does not mean senior but hostile, so a consensual inter-creditor relationship is not adverse. A previously filed financing statement also does not constitute actual or constructive notice of an adverse claim. A protected purchaser must perfect its

security interest via control (not filing), but it can do so in either certificated or uncertificated securities. Most conspicuous by its absence is a requirement that the purchaser be able to trace good title of the security to ensure that it is purchasing the security from a party who actually owns it or has the right to transfer it.

Benefits of Protected Purchaser Status. As a protected purchaser, a secured lender receives heightened protections. Section 8-303(b) provides that "in addition to acquiring the rights of a purchaser, a protected purchaser also acquires its interest in the security free of any adverse claim." The protected purchaser status is like a holder in due course of a negotiable instrument. The status cuts off all prior adverse claims (even if perfected with a prior filing). Accordingly, the protected purchaser acquires rights in the purchased security even if the seller did not have the ability to transfer such rights. Coupled with the absence of the requirement that the purchaser trace good title to the security, this powerful protection allows protected purchasers to confidently trade in securities without risk of loss to an adverse interest.

Protected Purchaser Status Presents Real Problems When Certificates Are Lost. Every mezzanine lender will eventually need to produce the membership certificates either to return to the pledgor when the loan is paid off or to sell at a foreclosure sale. When the certificates with endorsements cannot be located because they have been lost, stolen, or destroyed, the certificated security which allowed the lender to obtain super priority now rears its ugly head as a possible loss. Security certificates with endorsements executed in blank are like bearer instruments. Given the relatively minimal requirements to become a protected purchaser, these lost certificates could end up in the hands of a protected purchaser other than the secured lender. Under section 8-303(b), this protected purchaser would hold the interests free of any adverse claim, including the lender's security interest. This is a huge problem.

When security certificates cannot be located, it is not uncommon for lender's counsel to tell borrower's counsel to simply cancel the certificates on the books and records of the issuer and reissue new certificates because the debt has been paid off. While this is a workable solution for real property collateral that requires the tracing of good title, this does not solve the solution in the personal property world. Section 8-303 does not require that a protected purchaser trace the certificates' lineage all the way back to its respective Adam. Accordingly, it is entirely possible that a thief could get his hands on the certificates with endorsements and sell them to a protected purchaser who would take the securities free of adverse claims, including the lender's security interest. This is a rare exception to the general legal principle "*Nemo dat quod non habet*," or "No man can give what he does not have."

While the risk of "lost" certificates reappearing may be considered slight, it has happened. A Los Angeles commercial finance lawyer represented a well-known bank in a pledged equity transaction. Within a year of closing the deal, he received a call from borrower's counsel because the borrower had received a call from a New York brokerage house advising that it had been contacted about selling the pledged certificates. The borrower had not defaulted on the loan and the lender had not given notification of a foreclosure sale. After some investigation, the bank learned that the certificates and endorsements were separated from the file in the bank vault. An overzealous bank employee found the certificates and endorsements and turned them over to the state of California as abandoned property. The state was then looking to sell the certificates to add to its \$5.1 billion bank account of abandoned property. The sale never went forward, and after navigating the complex application procedure, the certificates were returned to the bank to hold until the loan was paid off. While this was not a tragic ending, the story does illustrate the very real risk of certificates falling into the hands

of a subsequent protected purchaser. What if the New York brokerage house had not bothered calling the borrower to inquire of the certificates? Section 8-303(a) does not require such investigation for the brokerage house to transfer the certificates to a protected purchaser.

Solutions for Lost Certificates. The UCC addresses the issue of lost securi-

Security certificates with endorsements executed in blank are like bearer instruments.

ties certificates. Section 8-405(a) provides that if "an owner of a certificated security claims that the certificate has been lost, destroyed, or wrongfully taken, the issuer shall issue a new certificate, if the owner (1) so requests before the issuer has notice that the certificate has been acquired by a protected purchaser; (2) files with the issuer a sufficient indemnity bond; and (3) satisfies other reasonable requirements imposed by the issuer."

Providing the indemnity bond is a costly and difficult solution. It may not be uncommon for the lost certificate to represent the sole collateral in a \$100 million mezzanine deal such that the issuer should require a \$100 million indemnity bond. With surety companies charging 2 to 5 percent as premium, this could be a \$5 million solution. (Of course, the high cost of a surety bond has motivated more than one party to look hard enough to find the missing certificates.) Moreover, the surety bond companies will require the indemnity of a strong indemnitor before issuing the bond and may even require collateral.

A popular solution is for the UCC insurance company insuring the transaction to take the risk. UCC insurance insures the attachment, perfection, and priority of a secured party's security interest in personal property collateral such as pledged equity. A lost security certificate is not the typical type of risk covered by a UCC

insurance policy. However, under certain circumstances, a UCC insurer may be willing to insure against subsequent protected purchasers, including those with the original certificates. If the policy amount is not too great and if the UCC insurance company is provided satisfactory indemnity, it may become comfortable insuring around the risk. Unfortunately, most UCC insurance

providers are reluctant to enter into such a transaction in which they are being asked to take on additional risk by providing a "free" surety bond.

As mentioned above, another "solution" frequently proposed by counsel for the lender that misplaced the certificates is for the pledged entity to cancel the certificates on its books and records, pay off the loan, and simply refuse to acknowledge the prior certificates should they be presented at a later time. As discussed above, canceling the certificates and refusing to recognize the rights of a protected purchaser will not work under Article 8 and will also subject the issuer to costly litigation. (These are exactly the type of losses to be covered by the surety bond.) Without the posting of a surety bond, this "solution" places the risk of the lost certificates resurfacing firmly on the shoulders of the issuer, not much of an equitable solution.

Looking Forward. Moody's expects to see certificated equity interests when rating mezzanine loans for the placement in the secondary market of collateral debt obligations (CDOs). While Moody's does set the gold standard for mezzanine loan structure, lenders may consider perfecting through a control agreement and not certificating equity interests for deals that are not destined for rating. Perfecting with a control agreement eliminates the risk of lost certificates and most UCC insurance companies can still issue a UCC

policy with a mezzanine endorsement, the highest level of protection. While the control agreement eliminates the risk of lost certificates, it is not without its drawbacks. Should the pledged entity subsequently issue certificates, the secured party that perfected via a control agreement could lose a priority dispute because a secured party cannot perfect a security interest in certificated securities with a control agreement. There is also some argument that the secured party that perfected its security interest with a control agreement could be trumped by a subsequent secured party perfected with another control agreement. Of course, these scenarios

involve borrower fraud and are only “disadvantages” if the collateral still possesses value. If the lender is dealing with a fraudulent borrower, the collateral does not likely hold any real value. After weighing the advantages and disadvantages of certificated and uncertificated securities, a lender may well choose to use a control agreement to perfect its security interest even though it results in a more laborious foreclosure process.

Borrower’s counsel may also want to include provisions in the loan agreement requiring the lender to provide a surety bond if it is unable to produce the original certificates. Perhaps if the lender is

a large, well-known institution, the borrower will accept the lender’s indemnity to reissue any lost certificates.

Conclusion

Given the minimal requirements for and the super priority afforded protected purchasers, it is important for mezzanine lenders to closely guard the certificates representing the collateral. Failure to do so will leave the lender with only expensive and difficult options. Should the lender lose the certificates, it will be left with only expensive solutions.