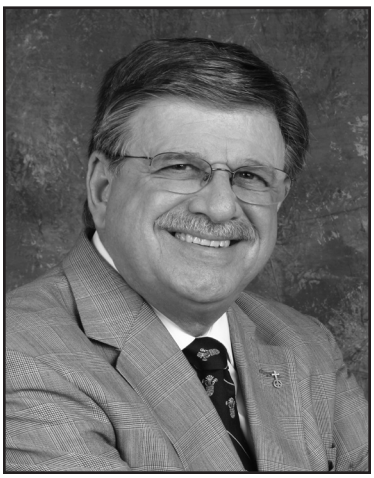
Secured Real Estate Mezzanine Lending (With Form)

James D. Prendergast

There really is a right way to do it!



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THE PURPOSE OF this article is to consider real estate mezzanine lending as a secured transaction under Article 9 of the U.C.C. and to suggest that, from the perspective of the secured creditor, there is a "right" way to structure secured real estate mezzanine lending. This article is based on the premise that the superior bargaining power in the mezzanine transaction is with the lender, and that the right way is from the perspective of the lender. There are situations, which will be touched on in this article, in which the borrower and borrower's counsel will control the structure; this is by no means "wrong"—just an alternative that bears some discussion.

WHY IS THE "RIGHT" WAY IMPORTANT?
• Given the complexity of Article 9, to say nothing of the interplay between Article 9 and Article 8, a question needs to be asked: "Should the 'average' real estate practitioner structure secured real estate mezzanine lending transactions without the assistance of a qualified commercial lawyer?" The national uniformity of Article 9—all 175,000 words, including comments—forces recognition of a resulting national standard of professional competence for malpractice determination. As stated in the *Special Report of the TriBar Opinion Committee: U.C.C. Security Interest Opinions—Revised Article 9*, security interest opinions under Article 9 call for a significant familiarity with Article 9. (References to the TriBar Report are to the published report which can be found at 58 Bus. Law. 1449

(2003).) This should not come as any big surprise. The Tribar Report goes on to advise that "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 the U.C.C. security interest opinion."

A National Standard Of Care For A National Statute

A person who is engaged in the general practice of law (or who is engaged as a specialist in a given area of law) represents that he or she has the degree of knowledge and skill ordinarily possessed and used by others engaged in the general practice of law (or as a specialist, as the case may be). The required knowledge and skill must be judged by the standard legal practice in the geographic area of the attorney's practice at the time the attorney represented the client. The relevant geographic area, given a nationally uniform statute, is probably the nation as a whole and requires a national standard of expertise. An attorney who undertakes to attend to the legal needs of a client represents also that he or she will use such knowledge, skill, and care that attorneys of ordinary ability and skill possess and exercise. The law, therefore, imposes upon an attorney the duty or obligation to have and to use that degree of knowledge and skill that attorneys of ordinary ability and skill possess and exercise in the representation of a client. This is the standard by which to judge malpractice.

Rules For The Generalist

The law does not require that an attorney guarantee a favorable result. The law recognizes that the practice of law according to standard legal practice will not necessarily prevent an unfavorable result. If the attorney has acted with the appropriate degree of knowledge and skill, he or she is not liable simply because the result was not a good one for the client. The attorney is not an insurer, nor is he or she liable for every error in judgment or mistake. Likewise, he or she is not to be held accountable for the consequences of every act that may be held to be an error by a court. On the other hand, he or she is not immune from responsibility if he or she fails to employ in the work he or she undertakes that degree of reasonable knowledge and skill exercised by attorneys of ordinary ability and skill.

Rules For The Specialist

A specialist in a given area of law is one who devotes special study and attention to the practice of a particular field of the law. An attorney who holds him- or herself out as a specialist in a particular field of law represents that, with regard to his or her specialty, he or she has and will employ not merely the knowledge and skill of a general practitioner but that he or she has and will employ that special degree of knowledge and skill ordinarily or normally possessed and used by the average specialist in his or her field. Accordingly, when an attorney holds him- or herself out as a specialist and undertakes work as such for a client, the law imposes the duty upon that attorney to have and to use that degree of knowledge and skill that is normally or ordinarily possessed and used by the average attorney who specializes in the practice of that particular field of law. (This discussion on the general parameters of legal malpractice is taken from the *Model Civil Jury Charges* of the New Jersey Judiciary, www.judiciary.state.nj.us/civil/civindx/.htm.)

If You Try It, You're Apt To Be Considered A Specialist

Given this general discussion, if we connect the dots to the TriBar Report, clearly the report is advising that, in its opinion, an attorney who ventures into the area of providing a security interest opinion under Article 9 is assuming the mantle of a specialist in the U.C.C., or at least to Article 9 and related sections of other Articles, such as Article 1 on scope and choice of law, Article 3 on instruments and Article 8 on securities and the relationship of Article

8 to the issue of perfection and priority of security interests in investment property. This national standard of care, and the related level of expertise, in providing a legal opinion as to matters of commercial law is, to state the obvious, no different than the standard of care that is required in the representation of a client, lender or borrower, in negotiating a commercial loan transaction. A lawyer, who represents either a lender or a borrower in a commercial loan transaction, at least as to matters involving the U.C.C., is to be held to the standard of a specialist in commercial law, and that standard is national, not local.

Hopefully, this article will assist its readers in meeting this "national" standard of care. Structuring the secured transaction aspects of a real estate mezzanine financing is complex and sophisticated, and there is a right way to do it. This article will show the reader the way.

U.C.C. INSURANCE POLICIES • U.C.C. insurance will also be mentioned throughout this article and a few introductory comments are appropriate. First of all, U.C.C. insurance is a proven and effective risk-management tool in the context of secured real estate mezzanine lending. Second, all the major land title companies offer U.C.C. insurance in one form or another. These variations are important to remember as we discuss U.C.C. insurance throughout this article. Unfortunately for the practitioner, there is no "standard" form of a lender's policy of U.C.C. insurance, as there are standard American Land Title Association ("ALTA") forms of land title insurance. All of the U.C.C. insurance lender policy forms have similarities but they also have differences, and often these differences are significant.

U.C.C. Insurance Basics

Generally speaking, U.C.C. insurance falls into the category of insurance categorized as "risk-elimination" insurance, such as land title insurance. Assuming a perfect world and no human or computer error, U.C.C. insurance coverage, consisting of the searching of the U.C.C. filing offices for existing priming security interests against stated collateral of the debtor and ensuring the accuracy of the results of the search, should never result in a claim. That is the reason the typical premium structure for U.C.C. and land title insurance is generally low compared to property and casualty ("P&C") lines of coverage, categorized as "risk-shifting" insurance, such as fire insurance. Fire insurance, or other P&C lines of coverage, insure against the occurrence of a known risk that will in fact, based on an actuarial model, occur regardless of the diligence of the insurance company. Some houses will burn down. The P&C policy premium is usually an annual payment, based on actuarial models of occurrence. U.C.C. insurance typically carries a single premium for the life of the indebtedness covered by the policy.

Which Segment Of The Industry Is The Policy Intended For?

Different policies are tailored to the needs of different segments of the industry, so knowing which one to choose is crucial. As an example, the First American lender's policy jacket is directed across all market segments of commercial lending, from secured mezzanine lending to the factoring of accounts receivable. Hence, it contains a number of exclusions that do no always appear in policies directed at more limited commercial lending markets. For secured real estate mezzanine lending, a significant exclusion in the First American form excludes coverage in the event that the debtor does not have rights in the collateral. Rights in the collateral are important in the secured personal property lending context because they are necessary for the attachment of a security interest when the security interest becomes enforceable against the debtor. In real estate mezzanine lending, the collateral is primarily the equity interest of the debtor held direct-

ly or indirectly in the entity that owns the subject real property. In the typical secured mezzanine real estate lending transaction, collateral may include more that just the bundle of rights encased in the equity interest as a matter of the appropriate entity law. The collateral may also include a broad brush of rights between the debtor and the owning entity, such as contract rights, that are general intangibles under Article 9.

Varying Kinds Of Collateral Mean Varying Risks For The Insurer

This assumption of the debtor having rights in the collateral has less significance or underwriting risk for the insurance company in the context of secured mezzanine lending because, typically, a newly formed special purpose entity ("SPE"), often structured as bankruptcy remote, owns the underlying real property, and the equity holders are often also newly formed SPEs. This is a very different situation in which to analyze possible adverse claims to the equity than the situation in which the issuer and the equity holders are operating entities with significant history.

The issue of the debtor's rights in the collateral becomes even more difficult to determine when the collateral is something other than investment property. For example, consider an asset-based lender lending to an operating company that has been in business 20 years and makes widgets. Significant collateral of the debtor probably would include equipment, inventory, and accounts. There are no registries for determining title or other ownership rights in inventory, equipment, or accounts (except for specialized registries such as for vehicles at the DMV). Add to this operating risk of the issuer the individual shareholders who have held the equity for a significant period of time and may have encumbered or sold the equity. It is beyond the intended purpose of U.C.C. insurance, and certainly beyond its premium pricing model, for the insurance company to take a pure risk on adverse claims against the typical categories of the personal property collateral of a debtor in asset-based lending, such as inventory of an operating company consisting of used computer monitors. U.C.C. insurance is designed generally to insure the priority of the lender's security interest in whatever the debtor owns in the warehouse, not that the debtor actually owns, or has any rights in, the computer monitors actually located in the warehouse. There is no registry to determine "ownership" of computer monitors.

Why The Insurer Assumes That The Debtor Has Rights In The Collateral

The necessity of the assumption that the debtor has rights in the collateral stems from the commercial law premise of *nemo dat quod non habet*: "He who hath not cannot give." A debtor, except for a few exceptions, one of which will be discussed below, cannot convey greater rights in property than it has in the property. If the computer monitors in the warehouse are stolen property, the debtor cannot grant the lender a valid security interest in the monitors—they belong to someone else. There being no registry to track ownership of most categories of personal property, it is beyond the purpose and scope of U.C.C. insurance to insure debtor ownership of the collateral.

However, in the secured real estate mezzanine lending market, with respect to pledged equity that is either a general intangible under Article 9 (but limited to the context of a newly formed SPE and reliable transaction parties where the risk of fraud is remote), or a security under Article 8 (and therefore investment property under Article 9 and usually in the context in which the lender satisfies the requirements to be a protected purchaser under Article 8), the U.C.C. insurance company will insure the "ownership" of the pledged equity collateral. Secured mezzanine lending is, therefore, a significant exception to the limitation on U.C.C. insurance covering "ownership" because of the *nemo dat* principle.

Comparison: Collateral Rights Assumed vs. Collateral Rights Not Assumed

That being said, one widely used form of U.C.C. lender's policy, such as the policy used by First American, contains the assumption as to the debtor's rights in the collateral, because it is designed for use across all market segments of commercial lending. The other basic form, used, for example, by the Chicago/Fidelity family of companies, does not contain the assumption as to the debtor's rights in the collateral because this form of U.C.C. lender's policy is designed for use without modification only in secured real estate mezzanine lending. But this comparison of policy forms is only the beginning of the policy comparison.

Assumption Of Rights Added/Deleted By Endorsement

In the secured real estate mezzanine lending market, those underwriters using the assumption of rights model, such as First American, will delete the assumption by endorsement whether or not the pledged equity is categorized as a general intangible or investment property under Article 9. In asset-based lending, factoring, and other forms of commercial lending, those underwriters using the no-assumption model, such as Chicago/Fidelity, will add the assumption of rights in the collateral into their policy by exclusion in Part II of the schedules to the policy because of the added factual uncertainty and risk. Therefore, for the same transaction, through deletion or addition of the assumption that the debtor has rights in the collateral, the underwriters using the different basic forms end up in the same place.

Look Under The Jacket

As noted previously, it is important to remember that the forms of U.C.C. insurance are different in structure and are not standardized like ALTA land title insurance forms. Further, the policy jacket displays only part of the whole of the insurance coverage contract. Coverage comparison can be effectively done only when comparing the policy forms, related schedules, and any endorsements to coverage. Also keep in mind that the factual matters set forth in the schedules typically constitute representations of the insured and coverage may be affected if the statements are untrue at the date of policy or subsequently become untrue. Be careful to review exactly what the underwriter is requesting in the way of factual statements from the insured, such as a description of covered collateral.

IS PLEDGED EQUITY COLLATERAL A GENERAL INTANGIBLE OR INVESTMENT PROPERTY? • The next significant issue that needs to be addressed is whether the pledged equity collateral in the secured real estate mezzanine loan transaction constitutes a general intangible or investment property under Article 9. As we will see, much turns on this determination, including the effective structural security of the lender's security interest in the pledged equity collateral.

Perfecting The Interest

There are three methods of perfecting a security interest in pledged equity collateral constituting securities under Article 8 and investment property under Article 9: filing, possession, and control. These three methods trump each other in reverse order, control prevailing over possession, and both control and possession prevailing over filing perfection. This becomes important, as we will see below, when one converts an equity interest that is a general intangible into investment property. This ability raises all sorts of very serious questions for the secured lender.

Perfection When The Equity Is A General Intangible vs. When It Is Investment Property

If the pledged equity collateral is a general intangible under Article 9, the only way to perfect a

security interest in the general intangible is through the filing of a financing statement. However, if the pledged equity collateral is investment property under Article 9, perfection may be effected not only through the filing of a financing statement, but also through "possession" of a certificated security or "control" of either a certificated security or an uncertificated security as provided in U.C.C. section 8-106. One needs also to keep in mind the priority rules of Article 9 which provide as the baseline rule that the first to file or perfect prevails ("FTFOP"). However, there are significant exceptions to this baseline rule. Section 9-328(1) provides that a security interest held by a secured party having control of investment property under section 9-106 has priority over a security interest held by a secured party that does not have control of the investment property. Section 9-328(5) provides that a security interest in a certificated security in registered form which is perfected by taking delivery under section 9-313(a) and not by control under section 9-314 has priority over a conflicting security interest perfected by a method other than control, i.e., filing.

One final observation before we make a few preliminary conclusions: all U.C.C. underwriters will insure general intangibles comprising pledged equity collateral. Obviously, the underwriters will insure the priority of the lender's security interest in the pledged equity collateral as general intangibles. However, U.C.C. underwriters will also, in the appropriate context, insure the actual ownership by the pledgor of the general intangible pledged equity collateral. Those underwriters using the Chicago/Fidelity form need do nothing more. Those underwriters using the First American model will issue an endorsement deleting the exclusion that assumes that the debtor has rights in the collateral, as discussed above. However, all underwriters, in the context of general intangibles, will not delete certain other policy exclusions, such as the secured party being primed by a later purchaser obtaining possession or control of certificated securities or a subsequent "protected purchaser." But much more on this later.

Preliminary Conclusions

At this point, some preliminary conclusions are in order:

- Practitioners should compare U.C.C. insurance policies only by comparing the entire contract of insurance—the policy jacket and all schedules and all endorsements thereto. Comparing only the policy jackets can lead to a grave misconception as to the scope of U.C.C. insurance coverage. Notwithstanding the fact that both basic forms of U.C.C. lender's policies can insure the ownership of pledged equity collateral, the forms of policies do contain significant differences. One form in use, for example, reduces the amount of insurance provided by the policy in an amount equal to any reduction in outstanding indebtedness, thereby making the policy thoroughly useless for revolving credit facilities. Further, this same policy provides, in mixed collateral transactions involving both real and personal property which could include secured real estate mezzanine lending, that there can be no claim against the U.C.C. policy covering lien priority in the personal property collateral, the pledged equity, until there has been a combined loss in all collateral in the aggregate. Assuming excess collateral coverage on the land side of the transaction, there may not be a claim under the U.C.C. policy even if the security interest of the lender in the pledged equity collateral is avoided, say, by a trustee in bankruptcy. The moral is to carefully read and compare policies, schedules, and endorsements;
- Remember that factual statements in the schedules to the U.C.C. policies most often constitute representations of the insured and

this can be very troublesome to the scope of coverage if one of the representations is a description of the covered collateral;

- If the pledged equity collateral consists of general intangibles, you can only perfect by filing a financing statement in the appropriate filing office in the location of the debtor. The practitioner who types up a beautiful certificate for the pledged membership interest evidencing the percentage ownership in the limited liability company that holds the real property may have certain rights in the membership interest under applicable limited liability company law, but a perfected security interest is not one of them. You cannot perfect a security interest in a general intangible by either possession or control; and
- If you have a choice as to the method of perfection, elect control over possession, and control or possession over the filing of a financing statement. But also remember that possession or control are available methods of perfection only if the pledged equity collateral is classified under Article 9 as investment property.

WHEN IS PLEDGED EQUITY INVESTMENT PROPERTY? • Assuming that it is better to perfect by control than by filing a financing statement, the question to be resolved is, "When is pledged equity collateral a general intangible, and when is it investment property under Article 9?" For the answer to this question, we again return to Article 8 of the U.C.C.

What Types Of Collateral Constitute Investment Property?

The first inquiry is, "What types of collateral comprise investment property under Article 9?" Section 9-102(a)(49) includes within the collateral category of investment property a "security," whether certificated or uncertificated, security entitlement, securities account, commodity contract, or commodity account. Therefore, a "security" as defined in Article 8 is included within the definition of investment property in Article 9.

That should resolve the issue, one might say, because is not any entity equity pledged in a secured real estate mezzanine loan transaction a "security"? In layperson's terms, maybe; but not under the U.C.C.

Factors To Consider

Section 8-103 sets forth the rules for determining whether certain obligations and interests are securities or financial assets. A "security" includes, in part, for our purposes:

- A share or similar equity interest issued by a corporation, business trust, joint stock company, or similar entity;
- An interest in a partnership or limited liability company is not a security unless it is dealt in or traded on securities exchanges or in securities markets, its terms expressly provide that it is a security governed by this Article, or it is an investment company security;
- A writing that is a security certificate is governed by this Article and not by Article 3, even though it also meets the requirements of Article 3. However, a negotiable instrument governed by Article 3 is a financial asset if it is held in a securities account.

Stock Is Investment Property

What this all means is that common stock or preferred stock in a corporation is a security for Article 8 purposes without further action and therefore is investment property under Article 9. However, membership interests in a limited liability company or partnership interests in a partnership (general or limited) are not, except for rare exceptions, securities a fortiori under Article 8 and are not investment property under Article 9 without some additional action. This is the famous or infa-

mous "opting-in" to Article 8. Although this matter mesmerizes certain practitioners, the conversion of the pledged equity collateral from a general intangible to investment property is really quite simple as provided in section 8-103. All that needs to be done is for the entity involved to take appropriate action to "expressly provide" that its securities are to be governed by Article 8 of the U.C.C. The act to affect the opt-in can occur in the original organizational documents or in an amendment thereto done at the time of the mezzanine financing. (The Appendix at the end of the article contains a form of resolution of members of an LLC to opt-in to Article 8.)

With First American's Buyer's policy that insures the lien status of acquired assets including equity in entities, the opting-in can occur at the closing table, provided the opt-in occurs before the transfer of ownership in the equity, and the buyer is purchasing a "security." First American's Equity Ownership Endorsement to its Buyer's Policy accomplishes the same deletion of the "rights" exclusion as its Mezzanine Endorsement to the Lender's Policy. The Buyer's Policy has been used in this manner to insure the sale of equity in the entity that owns the underlying real property to avoid transfer tax that would otherwise be incurred if the real property itself changed hands.

Additionally, and perhaps "belt and suspenders," if the equity is certificated, a legend should be set forth on the face of the certificate stating that the equity interest evidenced by the certificate is governed by Article 8 of the U.C.C. This apparent duplication results from the language of section 8-103(c) requiring that the "terms [of the security] expressly provide that it is a security governed by this Article." The certificate "evidences" the security so on goes the legend.

HAVING OPTED-IN TO ARTICLE 8 • Now that the issuer has opted-in to Article 8 by appropriate organizational action (and please consult your local corporate, LLC, or partnership lawyer about how to do this in a specific jurisdiction), that may seem to be the end of the matter. Well not quite. We need to now consider the whole issue of using "opting-in" to convert a general intangible equity interest into an equity interest that is investment property and what that means for the secured creditor.

But before we do, let's address a concern often expressed by practitioners less experienced in this area of the law. The concern goes something like this: "Well, if I opt-in to Article 8 and convert the general intangible to a security under Article 8 and investment property under Article 9, won't I have a problem with the SEC?" The answer to this question is, "Well, no greater problem than you may already have before you opted in to Article 8." The federal and state securities laws operate separately from the U.C.C. If the equity interest being sold is a security, for example, under the applicable tests under the Securities Act of 1933, then the equity interest is a security for state or federal securities law purposes, regardless of whether you opt-in to Article 8 or not. Whether one is investing in a common enterprise to profit from the efforts of another has nothing to do with either Article 8 or Article 9. Opting-in will have no effect on whether and to what extent the securities laws apply to the transaction.

So It's A Security. How Does That Affect Perfection?

That being said, we need to consider the ability to convert a general intangible into a security for Article 8 purposes and therefore investment property for Article 9 purposes, and the relationship of that reality to the hierarchy of the methods of perfection for investment property discussed above. To highlight the issues involved, let us consider the lender that lacks transaction bargaining power as against the borrower and, to keep the transaction alive, agrees not to require the issuer of the pledged equity collateral to opt-in to Article 8. The lender accepts filing perfection against the general intan-

gible pledged equity as sufficient perfection status for its "prudent" lending. The lender, our secured party number one ("SP1"), is relatively happy in its belief that it has a first priority security interest in the pledged equity because of the filing of a financing statement.

Let's further say that the borrower and the limited liability company SPE that it controls as sole member are not the most reputable of characters, or they just have a very good bankruptcy adviser, and sometime after the close of the mezzanine financing the member elects that the equity interests of the issuer LLC are to be governed by Article 8 of the U.C.C. Poof!!! The general intangible is now a security for Article 8 purposes and investment property for Article 9 purposes. To make matters worse, as we shall see, let's say the issuer certificates the equity interest of the sole member borrower. So far the filing priority of the security interest of the lender is probably still in first position.

But now along comes either lender number two or a bona fide purchaser for value without notice. Now what happens? Let's say secured party number two ("SP2") advances new funds to the borrower and perfects by taking control of the equity now evidenced by a certificate and achieves the status of a "protected purchaser," a status any lender should want, as discussed below. As we have seen, control trumps filing perfection. So what is our conclusion? SP1 either has no collateral at all because the pledged equity collateral has morphed from a general intangible to investment property, or, best case for SP1, SP1 has a security interest by filing in the investment property pledged equity which is, arguably, proceeds of the general intangible equity as "property arising out of the collateral." §9-102(a)(64)(C). All well and good to have proceeds, but SP2 has a perfected security interest by control in the pledged equity as original collateral and is a protected purchaser under Article 8. SP2 trumps the filing security interest of SP1. Not a good result for SP1. No, a very bad result for SP1!

Can't happen, you say? SP1 had filed a financing statement and therefore SP2 took its security interest with notice of the claim of SP1 thereby defeating the priority of SP2. Good try, but this situation is one of those analogies to real property law that does not apply to U.C.C. transactions. Section 9-331(c), and section 8-105(e) both provide that the filing of a financing statement itself is not notice of an adverse claim in the context of an Article 9 perfected secured creditor or an Article 8 "protected purchaser," a status the lender should want as discussed below. As stated in section 9-331(a), a protected purchaser of a security takes priority over an earlier security interest, even if perfected, to the extent provided in Article 8. Therefore, filing will not sustain the security interest of SP1 against a protected purchaser SP2.

What Can The Lender Do About The Opting-In Problem?

So how does a lender who wants to perfect only by filing in a general intangible protect itself from this "opting-in" problem? One suggestion is a covenant in the loan agreement that the borrower will not vote to elect opt-in. However, this approach will probably only result in one more default in a transaction that most likely, at the time in question in the life of the loan, has a plethora of defaults. Collecting defaults is not the desired goal, stopping opt-in is. No medal to the lender for having the greatest number of debtor contractual defaults. The only effective way to stop opting-in is to hardwire the prohibition into the organic documents of the entity and preclude amendment without the consent of SP1. Any effort to opt-in would therefore arguably be ultra vires and beyond the power of the entity.

Now, what if the lender wants the heightened level of perfection by control and has the issuer opt-in and takes control of the pledged equity. Great, that's the way to do it—but what if the entity then opts-out of Article 8? Can the entity do this? This

author doesn't know for sure, as there are no cases on this issue (or much of Article 8 for that matter). The best argument is that opting back out of Article 8 cannot affect already issued and outstanding equity, as one cannot unilaterally defease the property interest of another. A better approach is to require an irrevocable proxy from the debtor/pledgor granting the lender the right to vote the pledged membership interest on all matters related to Article 8. See the Appendix at the end of the article for a Model Article 8 Matters Proxy.

PROTECTED PURCHASER • So, what is this status of "protected purchaser" and why does the lender want this status? Protected purchaser is defined in section 8-303 as a purchaser who, in addition to acquiring the rights of a purchaser, also acquires its interest in the security free of any adverse claim. ("Purchaser" in this context is broadly defined in the U.C.C. to mean a person that takes by "purchase" (§1-201(b)(30); and "purchase" is defined to mean "taking by sale, lease, discount, negotiation, mortgage, pledge, lien, security interest, issue or reissue, gift, or any other voluntary transaction creating an interest in property" (§1-201(b)(29).) By being able to cut off adverse claims, a protected purchaser of a security may acquire greater rights in the transferred security than the transferor has to convey. Therefore, a lender should do what is necessary, again assuming the bargaining power in the transaction so permits, to attain the status of a protected purchaser under Article 8.

How To Become A Protected Purchaser

Section 8-303(a) provides the criteria for a purchaser to attain the status of a protected purchaser. "Protected purchaser" means a purchaser of a certificated or uncertificated security, or of an interest therein, who:

- Gives value;
- Does not have notice of any adverse claim to the security; and
- Obtains control of the certificated or uncertificated security.

Giving value is usually not an issue and we have discussed the methods of obtaining "control" over certificated and uncertificated securities above. The significant remaining criterion is whether the lender, in our context, has "notice of an adverse claim." If the lender has notice, then the lender cannot attain the status of a protected purchaser. As stated in Official Comment 2 to section 8-303, "there must be a time at which all of the requirements are satisfied." So, what is an adverse claim and what constitutes notice of such a claim?

Adverse Claim

"Adverse Claim" is defined in section 8-102(a)(1) to mean "a claim that a claimant has a property interest in a financial asset and that it is a violation of the rights of the claimant for another person to hold, transfer, or deal with the financial asset." For example, our SP2 would have notice of an adverse claim if it knew that SP1 had taken a security interest in the pledged equity collateral, being a financial asset, and if it knew that the security interest of SP1 violated a covenant in SP2's mezzanine loan agreement wherein the borrower had agreed to not further encumber or otherwise transfer any rights in the pledged equity without the consent of SP2. However, if SP2 was in its position junior to the position of SP1 through a consensual subordination agreement between SP1 and SP2, the security interest of SP1 would not constitute a claim adverse to the interest of SP2, although it constitutes a claim senior in the pledged equity collateral. Remember, section 8-102(a)(1) requires that the adverse claim be in violation of the rights of the claimant, not a consensual senior or junior position.

Notice

Given the meaning of adverse claim, how does a purchaser obtain notice so that its ability to attain protected purchaser status is defeated? First of all, a person has notice of an adverse claim under section 8-105(a) if:

- The person knows of the adverse claim;
- The person is aware of facts sufficient to indicate that there is a significant probability that the adverse claim exists and deliberately avoids information that would establish the existence of the adverse claim; or
- The person has a duty, imposed by statute or regulation, to investigate whether an adverse claim exists, and the investigation so required would establish the existence of the adverse claim.

Knowledge

"Knowledge" is defined in section 1-202(b) as "actual" knowledge. (This is another interesting point by which to compare U.C.C. insurance policies. One type of policy in wide use changes the meaning from "actual" knowledge to some other form of knowledge, say, "constructive," seriously altering the risk balance between underwriter and insured, by using the word "Knowledge" in lower case, resulting in a change from the definition of "Knowledge" in section 1-202(b).) Since knowledge is defined as "actual," section 8-105(a)(1) is of little real concern. Section 8-105(a)(3) probably is also of minimal concern in our context unless someone more expert than this author in the federal and state regulations of financial institutions reaches the conclusion that "prudent" banking standards or other statute or regulation could bring section 8-105(a)(3) into play. However, let's finesse section 8-105(a)(3) and take a closer look at section 8-105(a)(2).

Section 8-105(a)(2) provides that if there are facts sufficient to indicate that there is a significant probability that the adverse claim exists and the purchaser deliberately avoids information that would establish the existence of the adverse claim, then the person would have notice of the adverse claim and could not, therefore, attain the status of a protected purchaser. Section 8-105(a)(2) seems clearly aimed at the intentional ostrich. But recall our example above, in which SP1 filed a financial statement to perfect its security interest in the general intangible pledged equity collateral. Is the filing of a financing statement notice of an adverse claim under Article 8? Remember that under section 9-331(c) the mere filing of a financing statement was not notice of a claim or defense to the purchaser. Article 8 has a similar provision. Section 8-105(e) makes very clear that the filing of a financing statement under Article 9 is not notice of an adverse claim to a financial asset. But section 8-105(e) answers only part of the inquiry.

Although a filed financing statement is not notice of an adverse claim under section 8-105(e) in and of itself, section 8-105(a)(2) probably mandates, in response to notice of the existence of a filed financing statement, further inquiry; and section 8-105(a)(3) may mandate an initial search of the U.C.C. records for a regulated financial institution. Given the context of a commercial financing transaction and the common practice of searching the applicable filing offices to check the U.C.C. record of borrowers, SP2 will have seen the filed financing statement of SP1. (Note that U.C.C. insurance typically insures against the very real problem of filing office error, including mis-indexing and non-indexing of effective financing statements.) Having seen the filed financing statement, is SP2 now aware of "facts sufficient to indicate that there is a significant probability that the adverse claim exists"? If so, SP2 would need to conduct additional inquiry to determine the extent of the interest of SP1 and whether such interest is adverse to the property interest of SP2 in the financial asset. We cannot resolve this issue except to point out the avenue of inquiry and

the obvious fact that the answer will turn on the specific facts and circumstances of the transaction. If SP2 is a lender or a hedge fund buying the equity interest, we get one set of answers. If SP2 is the uncle of the pledgor/debtor who has never made a loan in his life, maybe we get another set of answers.

How The Financing Statement Can Help

However, we can reach one conclusion at this point. It is a very prudent step for a lender to file a financing statement in the context in which the pledged equity collateral constitutes investment property under Article 9 even if the pledged equity collateral is the only collateral and there are no related general intangibles or other collateral types roaming around. The filing of a financing statement, even if not notice of an adverse claim in and of itself, will raise the hurdle of section 8-105(a)(2). It is arguable that in a typical commercial finance transaction, the filing of a financing statement by SP1 may effectively preclude SP2 from attaining the status of a protected purchaser and thereby prevent SP2 from acquiring its interest free of the adverse claim of SP1. (Taking "free" can have two different meanings depending on whether the subsequent protected purchaser is a buyer or a secured party. *See* Official Comment 1 to section 9-331.) So, as an interim moral, always file a financing statement to help prevent a subsequent protected purchaser. However, if you are intent, for whatever reason, on maintaining the pledged equity as a general intangible, the better approach would be to hardwire into the organic documents of the partnership or limited liability company a prohibition on opting-in to Article 8 and a prohibition in the amendment provision from amending the Article 8 opt-in prohibition provision without the consent of the mezzanine lender. Such protective actions should prevent opting-in to Article 8 as an ultra vires action of the entity.

CONFLICT BEWTEEN PROTECTED PURCHASERS • We now come to a discussion of serial protected purchasers, which has a surprising conclusion. Let's begin with the premise that it is much better for a purchaser, whether a secured party or buyer, to attain the status of a protected purchaser. This is because, as we have seen, a protected purchaser will cut off adverse claims. Our first question is whether section 8-303(b) means what it says if SP1 has perfected its security interest in the pledged equity collateral, not only by filing a financing statement but, because the equity is certificated investment property, also by a control agreement between the issuer, pledgor/borrower, and mezzanine lender, thereby attaining the status of a protected purchaser under Article 8. Can SP2 as a subsequent protected purchaser defeat the prior protected purchaser status of SP1?

Let's assume a fact pattern where SP1 perfects a security interest in pledged equity collateral by a control agreement and meets the criteria for the status of protected purchaser. The loan agreement has a default provision against any further pledge or other encumbrance of the pledged equity collateral by pledgor/borrower. Control in this example is through a control agreement between SP1, the pledgor/borrower and the issuer of the certificated pledged equity, and the agreement contains appropriate covenants forbidding the issuer from entering into a control agreement with any third party. The issuer is a Delaware limited liability company that has elected to have its equity governed by Article 8. The pledgor/borrower, as the sole member of the issuer, controls the issuer. SP1, being frugal and not wanting to spend the $50 or so to file a financing statement for its $100 million transaction, as there is no reliance collateral for the secured mezzanine loan other than the equity in the issuer, perfects in the equity only through a control agreement.

Now, the borrower/pledgor falls on difficult times and decides it needs additional funds. So it contacts SP2 for additional funds. SP2 contacts the

issuer about any outstanding control agreements affecting the equity and the issuer. Notwithstanding all of the appropriate covenants of the issuer in the control agreement, the issuer advises SP2 that it has never entered into any control agreement with anyone. SP2 runs a U.C.C. search against the pledgor/borrower and finds no prior filings. So, SP2, in good faith, agrees to lend and enters into an appropriate control agreement with the issuer and the pledgor/borrower and advances new funds. Let us also assume that SP2 meets the criteria for a protected purchaser not having notice of the adverse claim of SP1. Murphy's Law now takes over and there is a fight, in or outside of bankruptcy, between SP1 and SP2. Who should prevail against the pledged equity collateral?

Just A Priority Fight Or Something More?

The argument in favor of SP1 is that this fight between SP1 and SP2 is only a priority fight between two secured creditors who have both perfected in the pledged equity collateral by control. Thus, section 9-328(2)(A) seems to be dispositive that priority is according to time of obtaining control. The response is that this is an Article 8 debate, not an Article 9 debate. The question is not which secured creditor perfected first by control but whether SP2 as a subsequent protected purchaser takes its security interest in the pledged equity collateral "free" of the adverse security interest of SP1. The real issue is whether SP2, as a protected purchaser, cuts off the adverse claim of SP1 pursuant to section 8-303(b). .

This orientation of the discussion to Article 8 is confirmed by section 9-331, which puts to rest any argument that, because Revised Article 9 followed in time the enactment of Article 8, section 9-328(2)(A) should resolve the question of whether a subsequent protected purchaser prevails over a prior protected purchaser as simply a dispute between two secured parties each perfected by control in investment property. Article 9 does not limit the rights of a protected purchaser under Article 8; nor affect the result that a subsequent protected purchaser takes priority over an earlier perfected security interest, even if held by a protected purchaser as provided in Article 8. Section 9-331 further provides that Article 9 does not limit the rights of or impose liability on a person to the extent that the person is protected against the assertion of an adverse claim under Article 8. We can therefore reach the surprising conclusion that, notwithstanding section 9-328, and because of section 9-331, a subsequent protected purchaser under section 8-303 acquires its interest in the security "free" of any adverse claim of a prior protected purchaser.

The Intent To Protect The Purchaser

Is this really a surprising result? No, not given the relationship of Article 8 to Article 9 and the clear intent of Article 8 to provide a status, similar to the status of a holder in due course of a negotiable instrument, to a subsequent protected purchaser in securities. The intent is to "protect" the subsequent purchaser from adverse claims to facilitate the tradability of securities, whether certificated or uncertificated. The perceived benefits to the securities markets prevailed over the rights of the first perfected secured creditor. SP2 wins! (Insuring against this eventuality is another significant benefit of U.C.C. insurance in the context of secured real estate mezzanine lending; it passes this fraud risk to the U.C.C. insurance underwriter.)

Certification, Perfection, And Appropriate Endorsement

Now, if we accept the foregoing discussion, what can SP1 do to protect its protected purchaser status from a crooked pledgor/borrower who controls the issuer? The collection of contractual defaults by the issuer or the pledgor/borrower for breach of covenants in the loan agreement or control agreement will not alter the result. But there is a way for SP1 to prevent SP2 trumping the protected purchaser

status of SP1. SP1 should insist that the pledged equity collateral be certificated and perfect by control through possession of the certificate coupled with appropriate endorsement. If SP1 requires that the issuer certificate the pledged equity and then perfects therein by control, SP1 has effectively precluded SP2's ability to obtain control perfection of the pledged equity collateral. SP2 cannot perfect its security interest in certificated securities through a control agreement. But what if the bad pledgor/borrower dummies up a phony replacement certificate? This probably is meaningless, because the dummy certificate does not evidence any of the issued and outstanding equity of the issuer. But what if the issuer controlled by the pledgor/issuer issues additional equity interests for value (we will ignore any watered stock problem)? Again, probably nothing happens because, if the first certificate was for 100 percent of the membership interest, the issuer has nothing further to issue and the second certificate is an overissue and a nullity. If the first certificate was denominated as a number of units or similar quantification, the second certificate, assuming not an overissue, could, however, dilute the outstanding equity. But the pie also got larger through the additional issuance for value. In any event, SP2 would clearly have causes of action against the issuer and the pledgor/borrower for breach of the warranties required by Article 8, but would not acquire a perfected security interest in the outstanding certificated equity in which SP1 has a perfected security interest by control.

CONCLUSION • So, what is the "right" way for a secured creditor to structure a real estate mezzanine loan transaction from the perspective of the U.C.C.? Given the interplay between Article 8 and Article 9, and assuming bargaining power is with the lender, we can reach a few conclusions:

- The secured lender should always require that the issuer of pledged equity collateral, consisting of membership interests in limited liability companies or partnership interests, to opt-in to Article 8;
- The secured lender should always file a financing statement against the pledgor/borrower even if the only reliance collateral for the mezzanine loan is the pledged equity interest;
- The secured lender should require that the pledged equity be certificated by the issuer and the lender should perfect by control of the certificated equity—possession plus endorsement;
- The secured lender should require that the inability to issue additional equity or opt-out of Article 8 be hardwired into the organizational documents of the issuer and preclude amendment of these provisions without the consent of the lender;
- The secured lender should require U.C.C. insurance.

These efforts should put the lender in the position of a protected purchaser with less of a chance of being trumped by a subsequent protected purchaser. However, these issues are complex and need to be considered by competent commercial practitioners well versed in the U.C.C. Notwithstanding the fact that a portion of commercial lending may still be local in scope, the relevant law of the transaction is not local. The lawyer's standard of care is that of an expert in a sophisticated area of the law. That is where the U.C.C. underwriters of can be of assistance to the real estate practitioner. We are here to help.

Appendix
U.C.C. Article 8 Opt-In Provision

_____ hereby elects, pursuant to U.C.C. §8-103(c), that its limited liability company interest in _____ is a "security" governed by U.C.C. Article 8, and that any certificate evidencing its limited liability interest in _____ is a "certificated security" within the meaning of U.C.C. §8-102(a)(4). The limited liability company agreement of _____ and any such certificate shall be and are hereby deemed amended in effectuation thereof, and _____ hereby waives any and all preconditions, formalities, or other provisions of the limited liability company agreement which would operate to limit or prevent the effectiveness of the foregoing amendment to the limited liability company agreement and any such certificate. For purposes of this Paragraph, the limited liability company agreement of _____ and any certificate evidencing _____ limited liability interest in _____, the term "U.C.C. Article 8" shall mean 6 Del. C. §8-101, et seq., and Revised Article 8 - Investment Securities, 1994 Official Text.

IRREVOCABLE PROXY AGREEMENT

This Irrevocable Proxy Agreement (this "Agreement") is made as of _____, by and among _____ ("Pledgor"), _____ ("Company"), and _____ ("Secured Party").

WHEREAS, the Pledgor is the beneficial and record holder of the [membership interests] in Company set forth on Exhibit A hereto (the "Pledged Interests"); and

WHEREAS, Pledgor desires to grant to Secured Party the proxy granted pursuant hereto; and

WHEREAS, Pledgor and Secured Party intend that the proxy granted pursuant hereto to be irrevocable during the term of this Agreement and that the powers and proxies granted pursuant to this Agreement are given to secure the obligations of Pledgor under that certain [Pledge Agreement, dated as of _____, between Pledgor and Secured Party];

NOW, THEREFORE, in consideration of the mutual promises and covenants herein contained, and other consideration, the receipt and adequacy of which is hereby acknowledged, the parties hereto agree as follows:

Irrevocable Proxy

Pledgor hereby irrevocably constitutes and appoints Secured Party, from the date of this Agreement until the termination of this Agreement in accordance with its terms, as Pledgor's true and lawful proxy, for and in Pledgor's name, place, and stead to vote the Pledged Interests and any and all other equity interests in Company by Pledgor whether directly or indirectly, beneficially or of record, now owned or hereafter acquired (the Pledged Interests together with all such other equity interests, the "Pledgor's Interests"), with respect to any Article 8 Matter (as hereinafter defined). The foregoing proxy shall include the right to sign Pledgor's name (as member of the Company) to any consent, certificate, or other document relating to the Company that applicable law may permit or require, to cause the Pledgor's Interests to be voted in accordance with the preceding sentence. Pledgor hereby revokes all other proxies and powers of attorney with respect to the Pledgor's Interests that Pledgor may have appointed or granted, to the extent such proxies or powers extend to any Article 8 Matter. Pledgor will not give a subsequent proxy or power of attorney

(and if given, will not be effective) or enter into any other voting agreement with respect to the Pledgor's Interests with respect to any Article 8 Matter.

As used herein, "Article 8 Matter" means any action, decision, determination, or election by the Company or its member(s) that its membership interests or other equity interests, or any of them, be, or cease to be, a "security" as defined in and governed by Article 8 of the Uniform Commercial Code, and all other matters related to any such action, decision, determination or election.

THE PROXIES AND POWERS GRANTED BY PLEDGOR PURSUANT TO THIS AGREEMENT ARE COUPLED WITH AN INTEREST AND ARE GIVEN TO SECURE THE PERFORMANCE OF THE PLEDGOR'S OBLIGATIONS UNDER THE PLEDGE AGREEMENT AND UNDER THIS AGREEMENT.

Agreements of Company

Company shall give copies of any notices or other communications that it sends to Pledgor or to any other members of Company related to any Article 8 Matter to Secured Party at the same time as such notices or other communications are sent to Pledgor or any such other member of Company. Company acknowledges the powers and proxies granted herein and agrees that Secured Party shall have the sole right during the term of this Agreement to vote the Pledgor's Interests with respect to any Article 8 Matter.

Termination

This Agreement shall terminate at such time as all of Pledgor's obligations secured hereby have been indefeasibly paid and performed in full and Company shall have received written notice from Secured Party of the termination of this Agreement.

Restrictive Legend

Each certificate, if any, representing any of the Pledgor's Interests shall be marked by the Company with a legend reading as follows:

"THE MEMBERSHIP INTERESTS EVIDENCED HEREBY ARE SUBJECT TO AN IRREVOCABLE PROXY AGREEMENT (A COPY OF WHICH MAY BE OBTAINED FROM THE ISSUER) AND BY ACCEPTING ANY INTEREST IN SUCH MEMBERSHIP INTERESTS THE PERSON HOLDING SUCH INTEREST SHALL BE DEEMED TO AGREE TO AND SHALL BECOME BOUND BY ALL THE PROVISIONS OF SAID AGREEMENT."

The Company agrees that, during the term of this Agreement, it will not remove, and will not permit to be removed (upon registration of transfer, reissuance or otherwise), the legend from any such certificate and will place or cause to be placed the legend on any new certificate issued to represent the Shares theretofore represented by a certificate carrying a legend.

Notices
All notices and other communications required or permitted hereunder shall be in writing and shall be mailed by registered or certified mail, postage prepaid, sent by facsimile or electronic mail or otherwise delivered by hand or by messenger addressed:
if to Pledgor: _____
_____
_____
if to Secured Party: _____
_____
_____
if to Company:
_____
_____

Governing Law
This Agreement and all acts and transactions pursuant hereto shall be governed, construed and interpreted in accordance with the laws of the State of [Delaware] as they apply to contracts entered into and wholly to be performed within such state by residents thereof.

Amendment
Except as expressly provided herein, neither this Agreement nor any term hereof may be amended, waived, discharged, or terminated other than by a written instrument referencing this Agreement and signed by each of the parties to this Agreement.

Counterparts
This Agreement may be executed in any number of counterparts, each of which shall be enforceable against the parties actually executing such counterparts, and all of which together shall constitute one instrument.

Jurisdiction; Venue
With respect to any disputes arising out of or related to this Agreement, the parties consent to the exclusive jurisdiction of, and venue in, the state or federal courts located within the State of _____.

The parties have executed this Agreement as of the date first above written.

[Signatures of Pledgor, Company, and Secured Party]

Exhibit A
Pledged Interests