The Utility of UCC IN$URANCE

by James D. Prendergast

By describing actual transactions in which UCC insurance has played a part, this article will discuss its utility to providers of secured debt and buyers of assets. UCC insurance generally insures the attachment, perfection and priority of security interests in personal property. All of the larger land-title insurance companies now offer various versions of UCC insurance. The policies contain significant differences, but tend to serve the same purpose.

Personal property — the subject of UCC insurance — is generally anything that is not real property. This coverage includes movable collateral like equipment or inventory; intellectual property, including patents and trademarks and copyrightable matters (but not copyrighted matters which are excluded from the UCC); software and software embedded in goods; general intangibles like contract rights; payment intangibles; and investment property like common stock in corporations. Also covered is personal property that has become so affixed to the real property that an interest in the personal property arises under real property law. Unless you are just dealing with something like a commercial building, a transaction probably involves personal property. If the personal property is reliance collateral, then UCC lien-priority insurance will solve risk problems facing lenders or buyers of the assets.

In addition to the basic lien-priority coverage, UCC insurance covers many of the risks associated with the perfection of a security interest through the central state filing system, such as the authorized execution of the lien-granting document by the debtor, misindexed filings, unauthorized termination statements filed against the record, the correctness of the debtor name, filing in the appropriate jurisdictions, and similar matters. Additionally, the coverage insures the gap between the search report and the date of filing. This coverage is especially useful to asset-based lenders who traditionally will not advance until

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they receive a search.

Asset-based lending was considered an especially promising market segment at the inception of UCC insurance. It has not turned out to be especially fruitful, perhaps for the wrong reason. When UCC insurance was first introduced in late 2000, it was believed that a prime market would be a large asset-based transaction — the $100,000,000 agented credit. As it turns out, these transactions are usually well staffed with competent lawyers for lender and borrower, and insurance to cover priority of the lien of the lender did not seem worth the premium. As one lender noted, "We'll just sue our lawyer if there's a priority problem."

The lender's comment raises two points that demonstrate the importance of UCC insurance for the larger asset-based lending transaction. First, the lender's lawyers should want the insurance because they provide the priority legal opinion, albeit verbally at the closing. No one ever argues over the loan agreement — the billable-hour producer for the lender's lawyer. The agreement provides a great fee opportunity for waiving borrower defaults and any good loan agreement has the borrower in default immediately upon execution. However, in a bankruptcy no one usually cares about the agreement and the hours put in to crafting financial covenants. The issue in bankruptcy is perfection, and then priority. That turns on the appropriate filing of the financing statement and review of the searches by, usually, a paralegal. It is akin to an upside-down pyramid, with malpractice resting at the lowest point.

Second, lenders still think they are getting value from a legal opinion from counsel for the borrower. The opinion usually does not address priority, and is fundamentally circular concerning perfection (if you file the right form in the right place, then all is well). And the last 15 pages of exceptions and exclusions from the opinion usually gut whatever of value remains in the body of the opinion. Despite the hours of legal time spent in negotiating the opinion, it has minimal value to the lender. Lender's counsel should bring this to the attention of their clients. The lender would then see the utility of true priority-indemnity coverage and, in the process, take its own counsel off the hook for the real priority opinion.

The principal UCC insurance policy discussed in this article is a "lender's" policy. This policy is for the typical situation where the insured is the lender and the policy insures the priority of the lender's security interest in the collateral of the debtor. Another type of a UCC insurance policy is a "buyer's" policy. This is akin to an "owner's" land-title policy. It is not called an owner's policy because UCC insurance is lien-priority insurance and not ownership insurance. The buyer's policy covers the lien status of assets being acquired by a buyer, such as in an asset acquisition, merger and the like. If a lender provides the financing for an asset acquisition, it will want a lender's policy coupled with a "seller's lien" endorsement to insure the lien status of the assets being acquired. The buyer may want its own UCC policy regarding the status of the acquired assets and would use the buyer's policy.

Mezzanine lending

Mezzanine lending has found significant utility from UCC insurance. By way of background, the typical UCC insurance policy contains an exclusion from coverage that assumes that the debtor "has rights in the collateral." UCC insurance is fundamentally lien-priority insurance and not collateral-ownership insurance. It does not insure that the debtor owns the computers in the warehouse. Rather, it insures the security interest of the lender in whatever the debtor may own in the warehouse. In the typical mezzanine transaction, the lender to the property-owner borrower does not want a second encumbrance on the property. Therefore, to capture equity value given the loan-to-value ratio of the lender to the property owner, the mezzanine lender lends on this equity value to the equity holders of the owner borrower, the members of the property owner LLC, or the partners of the property-owner partnership. The loan to the member(s) is secured by the equity in the property-owner borrower.

There is an interplay between Article 8 and Article 9 of the UCC, if the lender to the mezzanine borrower can attain the status of a "protected purchaser" under Article 8 (gives value, is unaware of adverse claims to the equity, and obtains a security interest in the investment property by control), then the UCC insurance company will remove the requirement that the debtor has rights in the equity collateral. This effectively insures that the mezzanine borrower "in fact" owns the equity interest in the property-owner borrower. The result is equity-title insurance and this

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coverage has found wide acceptance in mezzanine lending, and with good reason. The real estate attorney is familiar with title insurance and its utility, unlike the commercial attorney, and is therefore readily accepted. Title to the real-property collateral is insured at the property-owner lending transaction level; title to the equity collateral is insured at the mezzanine-borrower level.

Mezzanine UCC insurance has utility in any transaction where equity collateral is involved, not just in mezzanine real estate transactions. Consider a transaction where the borrower has nonassignable contract rights, or intellectual property, or leases, or other such rights where direct foreclosure against the collateral of the borrower is not economically feasible. If the lender wants to capture the “going concern value” represented by these contract rights and other general intangibles, the lender may require the guaranty of the owners of the borrower. Such guaranties are secured by the equity in the borrower. The lender could then obtain a UCC lender’s policy covering its priority security interest in the borrower and add the guarantors as additional debtors. The lender could then obtain an endorsement to the policy removing the assumption that the guarantor debtors have rights in the equity collateral, thereby insuring that the guarantors in fact own the primary obligor debtor.

Given the utility of equity-ownership UCC insurance, such coverage is now an accepted and required part of mezzanine lending. The utility is clear, especially to those involved in real estate transactions where land-title insurance is routine. The commercial lawyer, not familiar with insurance, should consider the coverage in any transaction involving equity collateral.

An endorsement similar to the mezzanine or pledged equity endorsement is available in conjunction with the buyer’s UCC policy. If the buyer meets the status of a “protected purchaser” under Article 8 of the UCC, an endorsement can be added, deleting the assumption that the buyer has rights in the acquired equity. This insures that the buyer has acquired the equity interest in the issuer as described in the buyer’s policy. This endorsement, like the mezzanine and pledged-equity endorsements, effectively insures the buyer’s ownership interest in the acquired equity.

Mixed collateral transactions

In transactions involving both real and personal property — the hotel, hospital, power plant and so on — using both land-title and UCC policies in combination, can prove useful. If the lender can allocate loan value between the real and personal property collateral, along with both UCC policies and land-title policies, the combined premium may be less than if the entire loan value was insured under a land-title policy. The premium per thousand dollars of coverage is less for UCC insurance in most jurisdictions than the premium per thousand dollars of coverage for land-title insurance coverage. Coverage is much more effective and broader under the UCC policy than endorsements to the land-title policy. Finally, a number of the land-title companies provide an additional discount against their UCC policy premium if the insured used the land-title company for the land-title insurance.

Another benefit of tying land title and UCC policies together: the issue of what a “fixture” is goes away. Whether an item of personal property has become so affixed to the real property that an interest in the personal property arises under real property law is a question of state law. However, the bankruptcy trustee likely will decide against the “secured” creditor. Tying the real property and the UCC policies together avoids the entire issue. Further, tying the policies avoids the cost and heartache of trying to get borrower’s counsel to play insurance company and provide an opinion on what the personal property may be. UCC insurance in this context, when tied to the related land-title policy, solves a real problem.

Any transaction involving real-property collateral with a significant personal property component is a candidate for this combined coverage. Consider a hospital with MRI and other such equipment, or a newspaper or other publisher with large presses embedded in the floor, or a hydroelectric or co-gen facility, or a restaurant with refrigerators and ranges. Let your imagination be your guide. The end result is the avoidance of hassle over legal opinions and a fight over priority with a trustee in bankruptcy. The insurance cost is no more and, often less, than insuring only under a land-title policy.

Co-ops, timeshares and houseboats

This category demonstrates the utility of UCC insurance to cover different categories of collateral and linkage of UCC insurance to land-title insurance. If we consider co-operative housing arrangements, the collateral involved may not be fee ownership of the realty, but interrelated collateral of a ground lease coupled with equity ownership in a co-operative association. The ground lease is real

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property and outside the scope of UCC insurance (except in New York), but equity ownership is what UCC insurance does best. The equity-ownership endorsement discussed earlier can insure that the borrower — the owner of the equity interest in the co-operative association — in fact owns the equity-ownership interest. Functionally there is no difference between a guarantor securing his or her guaranty with the equity-ownership interest in the primary obligor borrower, and the pledge of the co-op equity interest by the owner thereof securing the loan to acquire the co-op interest and the ground lease. The ground-lease interest can then be covered by a land-title policy or by an endorsement to the UCC policy.

For New York, certain land-title companies have fashioned custom policies to take advantage of the unique co-op provisions to Article 9 of the New York UCC. New York has unique filing and perfection rules which make it easier to encumber the equity and ground-lease interests. The New York policies take advantage of these provisions and, as such, are applicable only to interests in New York co-ops. Time-share interests are still another issue. Deeded interests are straightforward and are interests in real property, the ownership of which is to be covered by land-title insurance. Nondeeded interests are another matter. Many developers prefer nondeeded interests because in the event of buyer-payment default they can terminate the transactions for breach and recapture the sold "points" and thus avoid a judicial or nonjudicial real property foreclosure. Consider two scenarios: 1) lending to the developer who secures its repayment obligation with its accounts receivable from the point purchasers; and 2) lending directly to the purchaser of the points and the collateral is the points. UCC insurance provides an answer to each scenario.

If lending to the ultimate purchaser, a UCC lender's insurance policy does the trick. The points are within the UCC collateral type of general intangible and the UCC policy will insure the lender has a first-perfected priority security interest in the general intangibles of the purchaser, including whatever interest the purchaser has in the points. As discussed above, UCC insurance, aside from the equity-ownership endorsement, does not insure that the collateral is there, only the lender's interest in whatever is first.

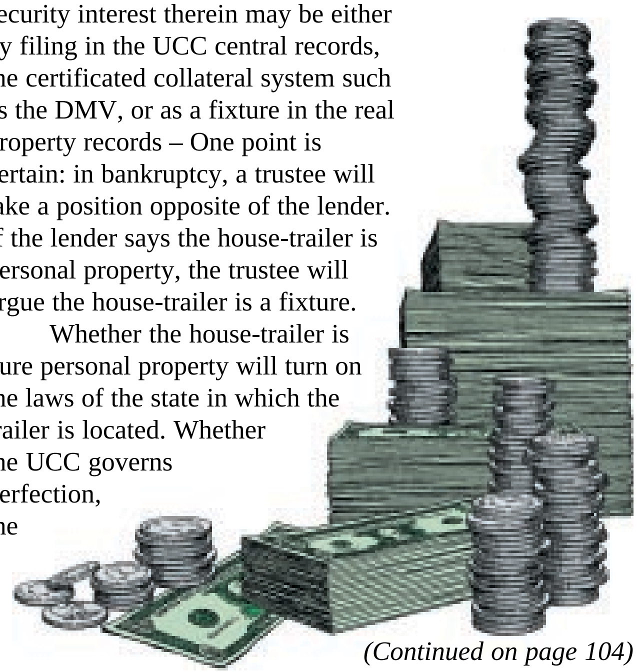
If lending to the developer, the collateral is accounts receivable, the payment obligation of the points purchaser for the purchase price for the points. The UCC lender's policy will insure that the lender has a first priority position in the accounts of the developer.

But what if the developer is filing against the points purchaser to secure the purchaser's payment obligation with the points and collaterally assigning its security interest position to its lender? The UCC lender's policy can be endorsed to insure the lender against any loss resulting from the developer not being in first position with respect to the points, and the lender by assignment. A simple endorsement insures the collateral up the chain of assignment to the lender to the developer. But suppose there are no points.

One land-title insurance company has coupled UCC insurance with a points inventory-control system and crafted a unique vacation-interest lender's policy. The policy insures both the lender and the individual purchaser that the liens are in first position and the points actually exist to be sold to the purchaser by the developer. This VIP policy effectively insures the lender against points overselling by the developer. It also gives the developer's lender added confidence since the nondeeded systems do not have the benefit of a real property recording system to police the selling of the points. Regulatory authorities that have seen the VIP policy favor the idea because the inventory-control system provided by the land-title company replaces enforcement dollars that can be more effectively used elsewhere in these times of limited state budgets.

Houseboats, house-trailers and the like pose still more questions. Putting aside documented vessels, houseboats are personal property that may or may not be "certificated" collateral, meaning personal property where perfection is through a lien-recording system apart from the central UCC filing system, such as a Division of Motor Vehicles. Because they are not real property, only a UCC policy will provide lien-priority coverage. By endorsement, the UCC policy can cover perfection in a certificated-collateral filing system, such as a DMV. The same reasoning is true for house-trailers, again putting aside state systems that may allow the morphing of the house-trailer into real property, which would then permit title coverage by a land-title policy. Depending on how the trailer is affixed to the real property, it may be either pure personal property or a fixture. Perfection of the security interest therein may be either by filing in the UCC central records, the certificated collateral system such as the DMV, or as a fixture in the real property records – One point is certain: in bankruptcy, a trustee will take a position opposite of the lender. If the lender says the house-trailer is personal property, the trustee will argue the house-trailer is a fixture.

Whether the house-trailer is pure personal property will turn on the laws of the state in which the trailer is located. Whether the UCC governs perfection, the



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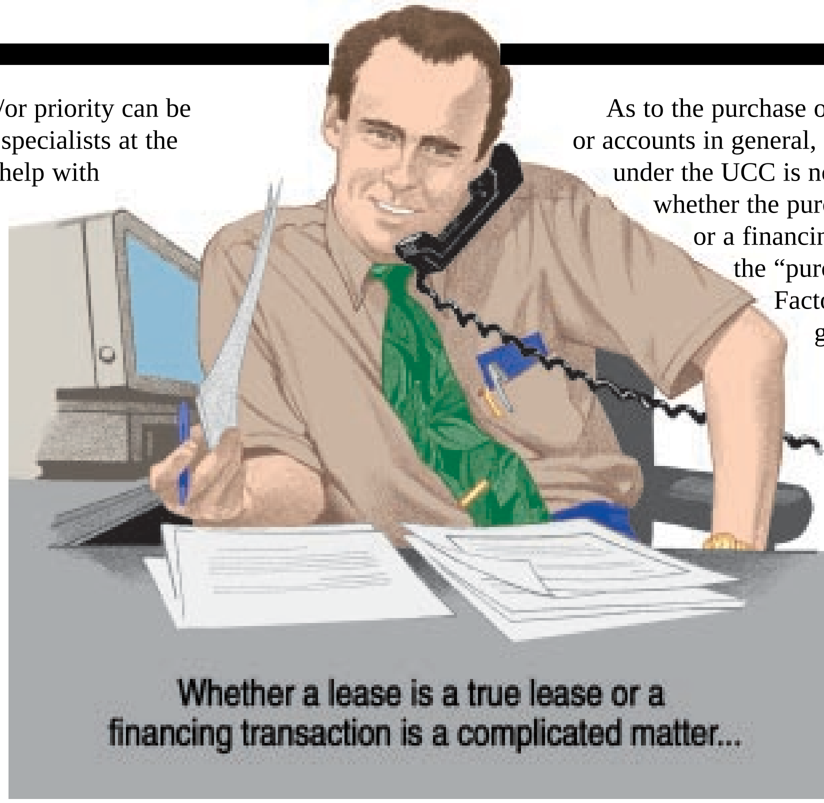

effect of perfection and/or priority can be complicated. The UCC specialists at the land-title company can help with this issue as part of their underwriting process and insure the priority of your security interest whatever the collateral may be. You no longer have to pick the category of your collateral house-trailer. Avoid the fight with the trustee; or let the insurance company fight on your behalf with the trustee. Whatever the house-trailer may be, cover it with UCC insurance.

This same rationale applies to whatever may be affixed to the realty. Take a microwave transmission tower. What are the tower and all the dishes hanging on the tower? Probably the lowest portion of the tower — the part embedded in the concrete, at least up to the first set of connecting bolts — is a fixture and covered by a fixture filing in the real-property records. What about all that's above the first set of connecting bolts? The really valuable part can be disconnected by unfastening four bolts and carried away without any damage to the underlying real property. It's probably personal property to which a lien cannot be perfected by any filing in the real-property records. A UCC-1 financing statement filed in the central UCC records is the only way to perfect an interest in this purely personal property collateral. There is no need to pick or be confused. UCC insurance can eliminate the worry of being unperfected in a debtor bankruptcy.

What if it's not the purchase of receivables or a true lease

This category also covers a "what is it?" issue. The UCC does not cover "true" leases but does cover leases that are "financing transactions." Whether a lease is a true lease or a financing transaction is a complicated matter and the answer depends on many factors including: whether there is a transfer of the economic risk of loss of value, whether there is a purchase option and how the purchase price is determined and similar matters. There is no need to pick whether your lease transaction is a true lease or a financing transaction. UCC insurance will cover the priority of your lien position in the leased goods and avoid a costly, if not also a losing, debate with the trustee in the lessee's bankruptcy.

As to the purchase of accounts receivable, or accounts in general, the issue of coverage under the UCC is not determined by whether the purchase is a true purchase or a financing transaction because the "purchase" is with recourse. Factoring generally is governed by the UCC as if it is a financing transaction. The exceptions are for the sale of accounts as part of the sale of a business, assignment of accounts for the purpose of collection, or assignment of a single account in satisfaction of indebtedness. Therefore, the factor, as secured party, needs to file against the seller of the accounts as debtor. The filing will not change the economic nature of the transaction. The UCC applies as a matter of law and the purchaser needs to perfect its security interest in the accounts. Again, UCC insurance can facilitate the factor in perfecting its security interest and, through the outsourcing feature of UCC insurance, the insurance company can prepare, file and track the financing statement for lapse, generally for no additional cost.

This category of coverage shows the broad utility of UCC insurance. The equipment lessor, the factor, the software distributor, and so on, are faced with complying with a complex new statute, Revised Article 9, in transactions usually of low, individual, dollar value. Because of the outsourcing built in to the premium charge, the UCC insurance company can provide effective lien priority insurance often at a cost equal to or less than the documentation cost currently incurred by the factor or lessor without the added benefit of the insurance coverage.

The world of legal opinions

The portion of the "standard" borrower's counsel legal opinion regarding perfection of the lender's security interest is, in this observer's view, generally worthless. It only covers perfection, not priority, covered by UCC insurance. Such opinions tend to be totally circular, in essence saying that if you file the national financing statement form in the appropriate jurisdiction, then you're perfected in the described collateral provided you can perfect by filing in the described collateral.

The real UCC security interest "priority" legal opinion is given verbally by lender's counsel at the closing.

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The lender's representative will look at his or her counsel and ask if everything is ready to go and fund. The lender's counsel will nod. Bingo! — the priority legal opinion.

Given this background, it should be noted that it is not the purpose to replace the legal opinions of borrower's counsel or take lender's counsel off the hook. That may be a useful byproduct, but not the primary goal. However, UCC insurance does offer some of what is provided by a legal opinion and a lot more. The UCC insurance insures the effective grant of the security interest by the debtor. The UCC insurance, at least as to the grant of the security interest, insures the due organization of the debtor if the debtor is a registered organization, and the authorization, execution and delivery of the lien-granting document. As part of its underwriting process, the insurance company will review the articles and bylaws of the debtor, and other documents to reach the underwriting conclusion. This coverage does not provide the insured an enforceability opinion, but the UCC insurance offers lenders some material covered by a borrower's counsel opinion.

> **...how does UCC insurance coverage relate to legal opinions?**

The UCC insurance provides a lot more than is covered by a typical borrower's counsel opinion, including priority insurance and GAP coverage. A lawyer once asked how the insurance company could cover such matters that cannot be factually determined, such as covering the GAP. The answer points out the great difference between UCC insurance and a legal opinion. The latter should be viewed as a due-diligence document and *not* an insurance policy. A lawyer's job is to review the record and reach reasoned conclusions based upon that review, such as whether the borrower is duly formed. An insurance company is just a provider of insurance and makes prudent business judgments with regard to risk based on probability of occurrence. Both the lawyer and the insurance company have their place in a financing transaction, but not the same place. The lawyer determines what can be discovered from the record and the insurance company shifts prudent risks from the lender to the insurance company.

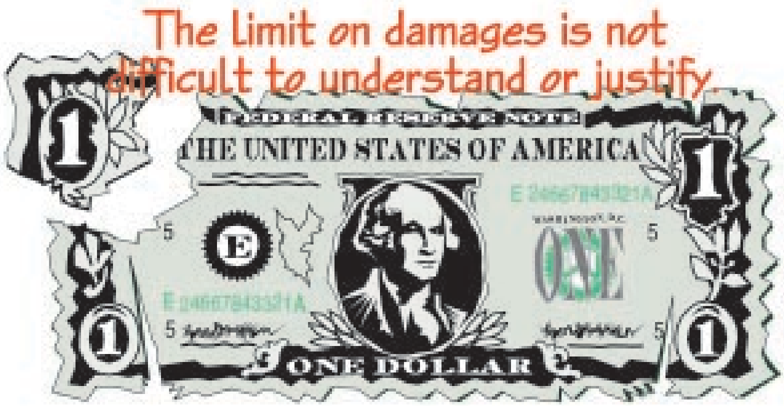
Given the foregoing, how does UCC insurance coverage relate to legal opinions? The answer depends on the size and scope of the transaction and the legal issues involved.

The smaller transaction: In financing transactions below a certain dollar value, which will vary by jurisdiction and lender, there are no legal opinions. The transaction value will not bear the freight of legal opinions. If this is the case, then the issue is not replacing or supplementing a legal opinion with UCC insurance, but replacing or supplementing the representations and warranties of the borrower with UCC insurance. In this context, UCC insurance seems a better option. And, given the low cost of UCC insurance and the outsourcing offered by the insurance companies for the same premium, UCC insurance may even cost less than the lender's current documentation fee to the borrower.

When you can't get a legal opinion: A recent case involved a significant dollar-value financing transaction where a borrower in current default to its lender had brought in a bankruptcy lawyer to negotiate a standoff with the existing lender. Meanwhile, the borrower negotiated a refinancing. At the closing of the refinancing, the bankruptcy lawyer said he didn't give legal opinions. The new lender said, if that was the case, it didn't give money. UCC insurance broke the logjam.

When the legal opinion is insufficient: In another transaction, the insured provided financing for individuals to make their car insurance payment. The lending transactions were evidenced by a document called an Insurance Premium Finance Agreement. The lender wanted to securitize the transactions and obtained a credit enhancer who would provide a letter of credit to the conduit to cover a portion of cash flow. The obligation of the insured lender to repay the credit enhancer for any draw against the letter of credit was secured by the lender's rights in the agreements. The provider of the letter of credit also wanted an opinion as to what these agreements were. The lawyers were willing to opine that the agreements were either payment intangibles or instruments (the agreements contained an agreement to repay so much per month at a stated interest rate). This did not satisfy the credit enhancer. Because the agreements had to remain at the servicer level for several reasons, including regulatory, the credit enhancer could not take possession of the agreements to perfect its security interest. Therefore, if the agreements were instruments, perfection only by filing left the credit enhancer exposed to a subsequent perfection by possession. An outside insurer was called in and, after its own legal review, agreed to insure the credit enhancer against any loss resulting from a determination that the agreements were instruments.

In nonreliance jurisdictions: A Kansas-based subsidiary of a Canadian borrower was guarantying the obligation of its Canadian parent. The guaranty was to be secured by the assets of the Kansas subsidiary. The Kansas collateral was not reliance collateral, but the Canadian lender was taking a security interest out of an abundance of caution. The issue was whether the transaction warranted local counsel in Kansas for both the lender and the guarantor to opine as to the perfection and priority of the Canadian lender's security interest in the Kansas corporation's assets. UCC insurance could be used in this situation to insure the priority of the security interest, and the outsourcing used to prepare, file and track the financing statement. The cost was significantly less than the cost of retaining local counsel. This same rationale can be applied in any transaction where jurisdictions other than the primary perfection jurisdiction of the debtor are involved. UCC insurance can be used to supplement the primary legal opinion of borrower's counsel, in lieu of the added expense of hiring and training local counsel for a one-time engagement.



To offset other risk

This is the concluding catchall category. UCC insurance is fundamentally different than the role of a search company.

In the recent Washington State Supreme Court case of *Puget Sound Financial, L.L.C., a Washington limited liability company, f/k/a Factors of Puget Sound, L.L.C., Respondent* v. *Unisearch, Inc., a Washington corporation, Petitioner*, 146 Wn. 2d 428 (2002), respondent financial factors filed a lawsuit against petitioner lien search company, alleging negligence and breach of contract. The superior court granted the search company's motion for summary judgment on damages. The factors appealed. The Washington Court of Appeals held that the trial court abused its discretion in granting the motion and remanded the case to proceed on both liability and damages. The search company sought review.

This case arose because the search company failed to report on 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. After 48 transactions, a course of dealing was clearly established. There was no unfair surprise, the liability-limiting clause was not hidden in a maze of fine print and was not inconspicuous. While the absence of negotiations may have weighed in the factor's favor, it had a reasonable opportunity to understand the terms of the clause, which remained unchanged throughout. The liability-limitation clause in the contract for services between the parties was not unconscionable.

The importance of the case 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 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."

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 $50 search fee. 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.

The *Puget Sound* case addresses only one issue in searching: the failure to discover an enforceable filing against a similar name of the debtor. Many other issues under the general theme of sufficiency of search reports 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 misindexed 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 on the secured party's security interest.

The searching party or its lawyer should utilize UCC insurance to provide the protection against search company or state filing office error. The land-title insurance companies offering UCC insurance *are* 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 of a search company. ▲

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