Expert Analysis

A Breakdown Of Title Insurance For Mezzanine Financing

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Mezzanine financing is commonly used in commercial real estate transactions because it offers borrowers a mechanism to increase loan proceeds available to finance their acquisition or development of real property while providing lenders with a relative streamlined process if they need to foreclose on the loan. Because mezzanine financing is secured by a pledge of the borrower's equity in the entity owning the real property, rather than an interest in the real property itself, traditional title insurance is not available for these loans. This article explains basic mezzanine debt structure and discusses the title insurance options available to mezzanine lenders, including a rundown of the requirements and necessary documentation for insuring a mezzanine loan and a discussion of issues related to the refinancing of mezzanine loans.

What Is Mezzanine Financing?

Mezzanine financing fills the gap between first mortgage financing, which usually has a loan-to-value ratio of 40 percent to 75 percent, and the equity participation of the borrower's principals, which is usually no more than 10 percent of the cost of the project. Typically, the mezzanine lender extends credit to the members or other equity holders of the borrower (the current equity owners) and takes a pledge of 100 percent of such parties' equity interests (including the right to distributions of income) in the entity that holds title to the subject real property (the titleholding entity). Additionally, the mezzanine lender enters into an intercreditor agreement with the mortgage lender.

The increased securitization of real estate, the packaging of loan pools for sale into the secondary market and the resistance of first mortgage lenders to subordinate mortgages on secured properties has popularized mezzanine financing in recent years. Mezzanine financing is attractive to both borrowers and lenders:

- *Borrower's benefits*. For borrowers, it is a simple way to add to the capital stack. As most loan to values are about 70 percent of the purchase price, mezzanine financing can increase that stack to 80 percent or even 90 percent. Mezzanine loans are also appealing because they are easier to assign or sell than mortgage loans. Finally, where applicable, mezzanine loans do not require the payment of mortgage recording tax, which can be prohibitive in states like New York and Florida.

- *Lender's benefits*. For lenders, the mezzanine loan foreclosure process is faster and less complicated than a real property loan foreclosure. If a real property borrower defaults under its mortgage, a real property lender may bring a foreclosure action under the laws of the jurisdiction where the real property is located. It is usually a complex and lengthy process. If a mezzanine borrower defaults under its security agreement, the mezzanine lender may bring a foreclosure action under Article 9 of the UCC, a relatively quick and straightforward process which begins with notice by publication and ends with a public auction of the pledged collateral. Upon foreclosure, the mezzanine lender has the right to succeed to the ownership and control of the borrower's equity interest. This enables the mezzanine lender to (at least theoretically) prevent a bankruptcy filing by the borrower and enables it to immediately collect and possess the cash flow without having to foreclose on the real property.

Collateral — Creation, Attachment, Perfection and Priority of the Mezzanine Lender's Security Interest

The collateral for a real property loan is comprised of the real estate together with any improvements thereon. It is secured by a mortgage recorded in the real property records where the real estate is located. Sometimes the mortgage will include an assignment of leases and rents.

In contrast, the collateral for a mezzanine loan is the equity in the titleholding entity, which is personal property. The lien on the personal property collateral is created by a pledge and security agreement between the mezzanine lender and the current equity owners. The mezzanine lender generally requires that the security interest be perfected (known as opting in) under Article 8 of the Uniform Commercial Code, and that the mezzanine borrower's ownership interest in the fee owner be certificated. Opting in under Article 8 and certificating the ownership interest permit the mezzanine lender to take physical possession of the membership certificates (for a limited liability company) and protect against potential bona fide purchaser claims.

Moody's Opinion and Rating — 2007

The importance of these protections is seen in Moody's approach to rating mezzanine financing. In 2007, Moody's issued a release entitled "Moody's Approach to Rating Commercial Real Estate Mezzanine Loans," stating that, in its review process:

Moody's expects that the overall substance of a mezzanine loan agreement will be comparable to that of a CRE mortgage loan agreement. It will have most of the same terms, conditions precedent, affirmative and negative covenants, events of default and representations and warranties — altered, of course, to reflect the nature of collateral — to those obtained by mortgage lenders.

The basic requirements Moody's is looking for in a mezzanine transaction are:

- Pledge of 100 percent of the equity
- Opt in to Article 8
- Certificate the equity
- Filing of a financing statement
- Controlling the ability to out-out — hardwire or proxy
- UCC insurance

Opting in to UCC Article 8 gives the mezzanine lender protected purchaser status by perfecting under Article 8 by control rather than under Article 9 by merely filing. Article 8 perfection will prime any filing made under Article 9. The rationale was explained as follows: The mezzanine lender then can obtain priority and perfection of its security interest merely by taking control or physical delivery of the LLC or partnership certificates and can take advantage of so-called protected purchaser status. Thus, Moody's expects that mezzanine loan borrowers will irrevocably opt in to Article 8 of the UCC and will certificate the partnership or LLC membership interests that will be pledged to the mezzanine lender.

Title Insurance Products for Mezzanine Lender vs. Insurance Products for Real Property Lender

Mezzanine lenders typically have two title insurance options. Each is explained below.

Owner's Title Insurance Policy With Mezzanine Loan Endorsement

The American Land Title Association 16-06 Mezzanine Financing endorsement is ideally used with a new owner's policy involving a mezzanine lender. (Although it is possible in certain jurisdictions to obtain a mezzanine financing endorsement to an existing prior dated title insurance policy issued by the same title insurer, such an endorsement will only cover the period prior and up to the date of that existing policy. There will be a gap in coverage from the policy date going forward.) The mezzanine financing endorsement provides a partial waiver of exclusions 3(a), 3(b) and 3(e) for loss or damage that would be otherwise excluded as the result of the action, inaction or knowledge of the current equity owners in connection with the insured titleholding entity. This endorsement is intended for situations where the mezzanine lender takes as security a pledge of 100 percent of the equity interest in the insured titleholding entity. The insured titleholding entity also assigns its rights to receive any amounts payable under the policy for any loss compensable under the policy to the mezzanine lender up to the amount of the outstanding debt under the mezzanine loan. In sum, the mezzanine financing endorsement provides the mezzanine lender with nonimputation coverage and direct access to proceeds of a claim.

Eagle 9 or Similar Uniform Commercial Code Insurance Policy/UCC Mezzanine Endorsement

All the major land-title insurance companies offer UCC insurance policies; however, there is no standard form of UCC insurance policy as there are standard ALTA forms of land title insurance. So, while all the forms of the UCC lender policies are similar, they are not exactly the same.

A basic UCC lender's insurance policy insures the creation, attachment, perfection and priority of the mezzanine lender's security interest in personal property collateral. In addition to 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 borrower, misindexed filings, unauthorized termination statements filed against the record, the correctness of the debtor's name, filing in the appropriate jurisdictions and similar matters. Additionally, the coverage insures the gap between the search report and the date of filing.

Additional risks covered by UCC insurance include:

- Federal and state tax liens;

- Matching the description of the covered collateral in the financing statement against the description of the collateral in the lien-granting document, such as the security agreement;

- Whether the security agreement is sufficient to create the security interest.

As noted, there is no single, uniform form of UCC lender's policy. A commonly used form is the EAGLE 9 UCC insurance policy, or Eagle 9 policy, offered by First American Title Insurance Company. First American and other insurers have also promulgated a specialized endorsement for use in connection with mezzanine loans. Where the governing documents of an LLC provide that the membership interests are securities and the lender has taken the proper steps to achieve protected purchaser status (as described above), the Eagle 9 policy when coupled with this endorsement insures not only perfection by possession or control, but also that the pledgor effectively owns the interests being pledged as collateral and that the lender has protected purchaser status under Article 8. Note that though this endorsement is referred to as the mezzanine endorsement, it is not the same as the identically named mezzanine endorsement to a new owner's policy that is discussed above and serves a different purpose.

Requirements for a UCC Lender's Policy and the UCC Mezzanine Endorsement

To begin processing a new order for a UCC lender's policy and UCC mezzanine endorsement, the insurer will need the following information:

- Name and address of the proposed insured (secured party);
- Name, address and jurisdiction of the debtor(s);
- Draft pledge / security agreement(s);
- Collateral description, along with method of perfection (filing, possession, and/or control); and
- Contact information for all parties.

To issue the final policy, the insurer's requirements will include:

- Evidence of payment in full of the loan proceeds;
- Copies of the executed loan documents, for example:
    - Pledge / security agreement;
    - Appropriate control agreement(s) for uncertificated securities or deposit accounts;
    - Copies of certificated securities and related endorsements executed in blank (certificates are to include a legend which states that the interest in the issuer is a security governed by Article 8 of the UCC);

- Sufficient evidence that the proposed insured is in possession of the original certificated securities and endorsements executed in blank;

- Irrevocable proxy (Article 8 matters);

- Loan agreement;

- UCC-1 financing statement;

- Copies of executed formation documents;

- Organizational chart;

- Articles of incorporation, organization or limited partnership for all debtors and issuers, with any amendments thereto;

- By laws, operating agreement or partnership agreement for all debtors and issuers, with any and all amendments thereto (for securities, all issuers must sufficiently opt in to Article 8 of the UCC);

- Document tracing the ownership of the issuer's equity interest back to the date of formation;

- Contribution and/or assignment agreement;

- Appropriate consents or resolutions authorizing this transaction between the debtor and proposed insured;

- Appropriate consents in the event there is a restriction on encumbrance of the issuer's equity;

- Copies of all membership certificates, which have ever been signed or executed, representing the collateral (i.e., replacement certificates, duplicate originals, etc.) marked as cancelled, or a confirmation satisfactory to the company that the only executed originals are those which have been delivered to the proposed insured (note that similar to promissory notes, membership certificates should be signed only one time).

Every transaction is different, and the requirements vary based on the structure of each transaction.

Refinancing of Mezzanine Loans

A significant increase in the refinancing of existing mezzanine loans began in 2017. In many of these transactions, the amount of the outstanding loan was increased. The explanation for this wave of refinancing appears to be a rush to refinance before anticipated interest rate increases in 2018. In addition, borrowers are taking into consideration the increased value of the properties since originally financed.

If a UCC lender's policy was issued at the time of the original transaction and that loan amount is increased, that policy can easily be amended to increase the amount of insurance with little additional documentation. Unlike a mortgage, the perfection under the UCC remains in place. If the same lender is involved with the refinancing, it remains the holder of the certificate representing the pledged equity. If a new lender is involved in the refinancing, that certificate must be transferred to the new lender. (Refinancing of a mezzanine loan by a new lender requires a new UCC lender's policy.) Locating that original certificate is important and can be of considerable concern if it cannot be located.

Lost or Misplaced Certificates

In 2006 and 2007 when mezzanine financing was at its height, over 90 percent of the transactions included opting in to Article 8 of the UCC and having the pledged equity certificated. Those certificates were taken at closing by the lender's representative perfecting the lien. Possession satisfied the statute's control requirement. The certificates were endorsed in blank and then held by the lender throughout the life of the loan.

The certificates with endorsements in blank are easily transferrable, similar to negotiable instruments. As these loans have matured, been assigned, sold and in some cases defaulted, the equities represented by those certificates need to be located and passed to any new secured party. Unfortunately, new lenders and their insurance companies are finding more and more situations in which the certificates cannot be located. Because the certificates are negotiable, it creates a potential liability should those certificates be obtained by a third party without knowing that they had been lost or even stolen. In the UCC, Article 8 specifically addresses what the original secured party needs to do in this situation to protect any new secured party who will accept a replacement certificate. Section 8-405, entitled "Replacement of Lost, Destroyed, or Wrongfully Taken Security Certificate" sets forth the requirements:

- If an owner of a certificated security, whether in registered or bearer form, claims that the certificate has been lost, destroyed or wrongfully taken, the issuer shall issue a new certificate if the owner:
    - so requests before the issuer has notice that the certificate has been acquired by a protected purchaser;
    - files with the issuer a sufficient indemnity bond; and
    - satisfies other reasonable requirements imposed by the issuer.

To overcome the potential liability of a lost or stolen certificate surfacing after a new loan is in place, expensive options are available to the original lender / secured party. The original lender can obtain a bond in the amount of the original loan, but such a bond is a very expensive product that any lender would be reluctant to pursue. Normally, the bond requires payment of upwards of 10 percent of the amount in question, meaning that on a $100 million loan, $10 million would be required to obtain the bond. The alternative is to offer an indemnity should the original certificate surface. Any new lender or any insurance company issuing a UCC policy insuring the transaction would require financial information from the proposed indemnitor to determine if it has sufficient financial assets should a claim arise. Considering the size of most mezzanine deals, considerable assets would be needed to meet this requirement.

Generally speaking, certificates are rarely, if ever, lost. They are usually misplaced. They are taken at the real estate closing and placed in a box and stored along with the other closing documents. The real estate closer may not realize a certificate is negotiable. Situations have occurred where after extensive searches, certificates have turned up on the closing date, thus avoiding the pricey requirements dictated by the UCC.

When handling the closing of a mezzanine financing transaction, it is essential to be aware of the negotiable status of the certificates and carefully maintain them so that they are readily available in the future. If the certificates — which are valuable collateral at the time of the original closing — are put away in a file without documenting their location, it becomes a very costly mistake when they cannot be located later.

Outlook for Mezzanine Financing

Despite pessimism after the recession that mezzanine financing would disappear, its appeal to both lenders and borrowers endures, and mezzanine financing continues to be a part of almost every significant commercial real estate transaction's financing. As business and legislative requirements keep loan to values on average below 70 percent, mezzanine financing will continue to fill the gap required by buyers. And with so much mezzanine financing reaching maturity in the coming years, it appears that it will be around for quite some time.

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