Title Insurance For Mezzanine Loan Financing in New York

By Michael J. Berey
Senior Underwriting Counsel and Senior Vice-President
First American Title Insurance Company of New York

Published in the "Real Estate Update" section of the
New York Law Journal on June 13, 2001 as
"Article 9 Products -Covering Mezzanine Loan Financing in New York"

The New York State Insurance Department has recently authorized the issuance in New York of two title insurance products which can benefit a lender making available what is commonly known as mezzanine financing.

A mezzanine loan is made when, in addition to a real estate mortgage being made to an entity such as a limited liability company or a limited partnership and in lieu of a second mortgage on such real property interest, a loan is made to the partners or members of the mortgagor, secured by a pledge of their interests in the mortgagor under the Uniform Commercial Code. The lender making the mezzanine loan, which may be other than the mortgage lender, has as its primary collateral for the mezzanine loan only a claim against equity interests in the mortgagor.[1]

For example, assume that a limited liability company owning a commerical buiding in Manhattan executes a mortgage on its property to secure a loan for $100,000,000. The LLC intended to obtain a mortgage loan of $120,000,000 but loan to value ratios limited the amount of that loan and the conditions of the first mortgage prohibited secondary mortgage financing. As an alternative, the members of the LLC borrowed the additional amount from a Mezzanine Lender which is secured not by a mortgage but by the pledge of the members' interests in the LLC.

On April 24, 2001 the Insurance Department approved a Mezzanine Financing Endorsement which had been filed by the Title Rate Service Association of New York, Inc. ("TIRSA") on behalf of the title insurance companies in New York. On April 23, 2001 the Insurance Department approved the Eagle 9 UCC™Insurance Policy filedby the First American Title Insurance Company of New York. The author is an employee of First American.

Each of these title insurance products afford separate and distinct protections to a Mezzanine Lender.

Althougth TIRSA's Mezzanine Financing Endorsement is solely for the benefit of the Mezzanine Lender, it is part of an Owner's title insurance policy insuring the fee or leasehold estate of the entity borrowing the loan secured by a real estate mortgage (the "Insured Owner").The Insured Owner executes the TIRSA Endorsement to confirm that payment of a title claim under the Owner's policy is to be paid to the Mezzanine Lender as provided in the endorsement.

Under the TIRSA Endorsement, payment for a title loss under an Owner's policy prior to the Mezzanine Lender foreclosing on the pledge of an interest in the Insured Owner will be made to the Mezzanine Lender. The amount payable will not, however, exceed, as of the date of the title loss, the aggregate of the outstanding principal balance of the mezzanine loan, together with related accrued interest, fees and costs, as well as the amount of any protective advances made by the Mezzanine Lender.

In the event a title loss payable under the Owner's policy occurs after the Mezzanine Lender acquires some or all of the pledged interests in the Insured Owner, the amount of the payment to the Mezzanine Lender will be determined based on the amount of the actual title loss multiplied by the percentage interest in the Insured Owner acquired by the Mezzanine Lender pursuant to a pledge at the time the loss is paid.

If there is a title loss payable under the Owner's policy prior to the Mezzanine Lender acquiring an interest in the Insured Owner pursuant to a pledge, the Mezzanine Lender is not required to pursue its remedies against other collateral. This is similar to the coverage provided in New York under the TIRSA "First Loss" endorsement. The Mezzanine Financing Endorsement also provides that the title insurance company will not deny liability to the Insured Owner on the ground that any of the ownership interests in the Insured Owner were acquired by the Mezzanine Lender pursuant to a pledge. This is similar to the coverage provided in New York by the TIRSA " Fairway" endorsement.

When there is a title loss under an Owner's policy after a Mezzanine Lender acquires a pledged interest, the title insurer will not impute to the lender as a defense to payment knowledge of a title defect not excepted in the Owner's policy of which the Mezzanine Lender had no actual knowledge on the policy date, even though the title defect was known to any of the Insured Owner, a mezzanine loan borrower, or the holder of any interest in, or an affiliate of, the mezzanine loan borrower. This is similar to the coverage provided in New York under the TIRSA "Non-Imputation" endorsement.

The charge to issue a Mezzanine Financing Endorsement is thirty percent of the premium payable for the related Owner's policy.[2]

This endorsement does not, however, insure the validity, priority, form, sufficiency or enforceability of the pledge to the lender. This scope of coverage is available in New York only by use of the new UCC Policy.

The Eagle 9™UCC Policy (the "UCC Policy") takes an approach different from the Mezzanine Financing Endorsement. The UCC Policy is more than a "loss payee" endorsement to an Owner's title insurance policy. It is a separate and distinct policy of title insurance which assures a lender that its security interest complies with the requirments of New York's present Uniform Commercial Code's Article 9 on "Secured Transactions". The UCC Policy will also insure compliance with the revision to Article 9 (the "Revised Article 9") when it is effective in New York. Revised Article 9, drafted under the supervision of the American Law Institute and and National Conference of

Commissioners on Uniform State Laws, is expected to be enacted in New York State and to be effective in most all states and the District of Columbia on July 1, 2001. [3]

The prospect of complying with Revised Article 9 is generating a great deal of concern among lenders and their counsel, whether the collateral will be a pledge of an interest in a deposit account or a security interest in equipment, inventory, or rights under a letter of credit. This concern is due, in part, to the its change in the rules governing the place for the filing of a financing statement. Instead of the place of filing being determined by the location of the collateral, the state where the Debtor is located, determined by applying the provisions of Revised Article 9, will now generally control. Instead of dual filing in state and local filing offices, financing statements will generally be filed in the office of the Secretary of State of the jurisdiction in which the debtor has its location. [4] The location of the debtor will be determined with reference to whether the debtor is an entity or an individual and, if the debtor is an entity, the type of the entity involved.

For example, if a debtor is an individual, the place to file a financing statement will be in the Department of State of the state of the debtor's principal residence. For an organization that is a "registered organization", the definition of which encompasses both a corporation and a limited liability company, the debtor's location will be the state of its incorporation or formation and, accordingly, the proper filing office will be in the Department of State of that state. For foreign registered organizations, the filing will most likely occur in the District of Columbia. When the entity is not a registered organization, such as in the case of a general partnership, the debtor's location, which will dictate the applicable state's filing office, will be determined by whether the entity has one place of business or, if more than one, where its chief executive office is located.

Also creating confusion for lenders and their counsel are "transitional rules", the provisions under Revised Article 9 which govern the change over from "old" Article 9. For example, a security interest perfected by the filing of a financing statement under "old" Article 9 based on the location of the collateral may need a transitional filing in a different filing office determined based on the location of the debtor to remain perfected. If necessary, the security interest will remain perfected only if the lender complies with the new filing requirments before the earlier of (i) the date on which the existing financing statement lapses and (ii) five years after Revised Article 9's effective date. Security interests perfected under the "old" Article 9 without filing but now required to be perfected by filing or in another, different manner, will need to comply with the new requirments within one year of Revised Article 9's effective date.

Changing over to the new filing requirments may be done by (i) a "true" continuation statement, if there is no change in the filing office, (ii) an initial financing statement filed after the effective date of Revised Article 9, or (iii) the filing (even prior to the effective date) of a continuation statement filed "in lieu" of a financing statement. To make matters even worse, warns a Comment to Section 9-701 of the Uniform Act, "horrendous complications may arise" if less than all states have adopted the revision by July 1, 2001.

A Mezzanine Lender , and all other personal property lenders dealing with Revised Article 9, must determine how to properly obtain and perfect security interests in pledged interests and other personal propety collateral. Will the filing of a financing statement suffice to adequately perfect its security interest or must it also, or alternatively, take possession or control of the collateral? If filing a financing statement is necessary, what is the proper office in which to make the filing? If pledges in which security interests are to be perfected are being made by organizations, some of which are registered and others of which are not, or by individual debtors, lender's counsel will need to perform an extensive analysis to ensure compliance with Revised Article 9.

Recourse to the UCC Policy may be a safe-harbor for the lender needing assurance that its security interest complies with the rules under Revised Article 9. First, the policy insures the lender, as of the policy date, against actual loss or damage sustained due to the failure of the insured security interest to "attach", or be effective as against the debtor. Within the scope of this coverage is protection against claims against lack of authority and capacity and against other challenges to the effectiveness of the security agreement. This coverage will be increasingly important to lenders as secured transactions, encouraged by the more liberal requirments of Revised Article 9, take place electronically without the use of actual signatures. Note that Revised Article 9 requires only that a "Record" be "Authenticated" which allows, for example, a security agreement to be entirely in an electronic format without an acutal, physical signature.

The UCC Policy further insures that the lender's security interest is properly "perfected", assuring the lender that its financing statement (i) meets the requirements of Revised Article 9 as to form and content, (ii) that the financing statement was (if a filing is required) filed in the proper filing office, and (iii) that the insured lender's security interest is not subject to, and is enforceable against, other secured parties, lien creditors[5] and post-policy interests. For example, under Revised Article 9, a financing statement with an incorrect debtor's name or an improper collateral description will be defective and as a result the lender's position may be rendered unsecured.

The UCC Policy also protects against loss incurred by the insured lender if a claim is asserted in a case filed by or against the debtor in an adversary proceeding is brought under the Bankruptcy Code contending that the insured security interest is not valid or enforceable or does not have the priority as insured. The title insurer will pay the costs, legal fees and expenses incurred by its insured in defending the insured security interest and loss covered by the UCC Policy.

[1]Due to recent actions by the New York State Insurance Department, a Mezzanine Lender in New York now has available two alternative title insurance products. The Mezzanine Financing Endorsement makes the Mezzanine Lender a "loss payee" in the event of a real estate title loss under an Owner's policy issued to insure the property owning entity. The UCC Policy directly affords the Mezzanine Lender assurance that it is in compliance with the requirments of Article 9 of the Uniform Commerical Code, and insures the enforceability and priority of its security interest.[1] See Horowitz and Mor⁶ [3]row, "What You Need to Know About Mezzanine Financing", The Practical Real Estate Lawyer, May 2000.

[2]By way of example, the charge for the Mezzanine Financing Endorsement in downstate New York would be $17,890 with an Owner's policy of title insurance for $20,000,000, $40,840 for a policy of $50,000,000, and $79,090 for a policy of $100,000,000. This is in addition to the premium payable for the Owner's policy.

[3]As of May 1, 2001, Revised Article 9 had been enacted in thirty-five states and the Distrct of Columbia. The effective date in all but Mississippi is July 1, 2001. Legislation pending in New York is expected to be enacted effective July 1.

[4]It is anticipated that, in New York under Revised Article 9, financing statements as to cooperative unit loans, timber to be cut, as-extracted collateral, and fixtures will continue to be filed in the county in which the collateral is located. As to such collateral, however, the lender must comply with rules governing the form of financing statements and the transition requirements of Revised Article 9.

[5]A "Federal and State Tax Lien Endorsement" to the UCC Policy is available after the performance of additional lien searches.

[6]By way of example, the premium payable for the UCC Policy would be $13,000 for a policy of $20,000,000, $28,000 for a policy of $50,000,000 and $50,500 for a policy of $100,000,000. Filing and search fees are not included in these charges.