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UCC Mezzanine Loan Policies

Title Tenets Webinar Series

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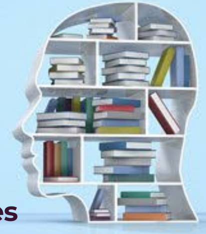
What we will cover today

Help you better understand the risks and protections needed on mezzanine loans, as well as provide detailed answers to questions such as:

- what is mezzanine financing
- why are mezzanine loans becoming more common
- what's the difference between a traditional real estate loan and a mezzanine loan
- how does the outcome of a mezzanine loan foreclosure differ
- what title insurance products are available to mezzanine lenders



What is Mezzanine Financing

A Mezzanine Loan is an equity loan secured by pledges of the ownership interests in the titleholder. Focus is on equity collateral -- a general intangible or a certificated or uncertificated security that is taken as collateral in a mezzanine finance transaction.

The Mezzanine Lender does not secure a mortgage on the land, or an ALTA Loan Policy, but can be insured by:

1. **Mezzanine Endorsement to the Owner's Policy and**
2. **UCC Title Insurance Policy**

Moody's describes it as "lending to a borrowing entity or group of entities that directly or indirectly own a real property-owning entity, which debt is secured by a *perfected first security interest* in the mezzanine borrower's pledges ownership interest in the property owner".

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What is Mezzanine Financing

- Generally a grant of security interest or pledge by the debtor of its interest in the property-owning entity (the “issuer”) which is most commonly a limited liability company or limited partnership. The property-owning entity is commonly referred to as the Issuer.

- The issuer is typically a newly formed bankruptcy remote/SPE/Delaware LLC.

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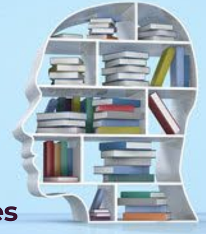
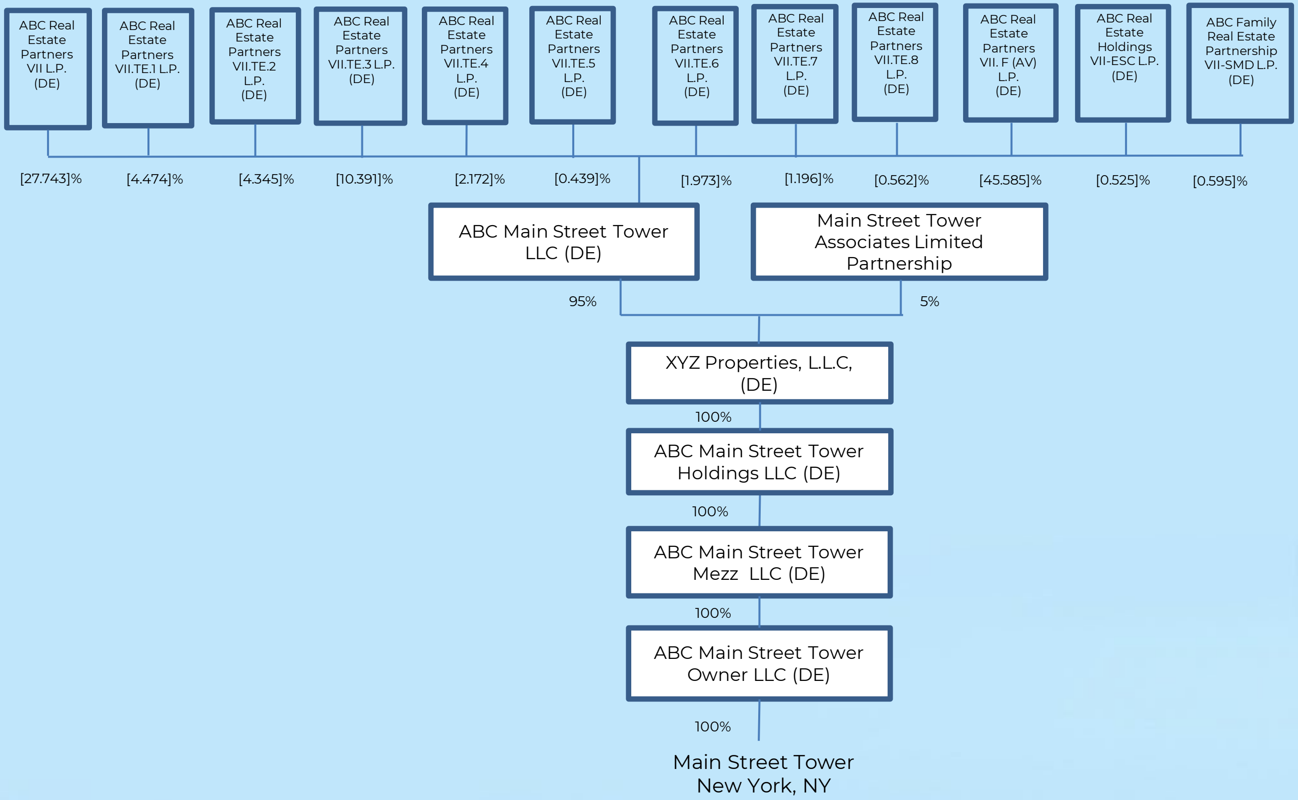
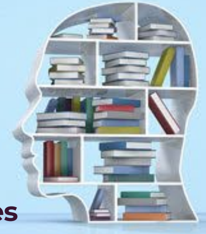
History and Origin of UCC Title Insurance

- Introduction of real estate mezzanine financing 20 years ago
- Desire for mezzanine lenders to securitize their mezzanine loans
- A new opportunity for title insurance companies to expand their portfolio of offerings
- Many of the large title insurance companies have offered Uniform Commercial Code (UCC) title insurance policies for the past 18 years



Post-Closing Structure





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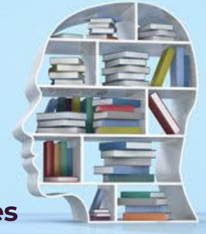
Moody's Recommendations to Rating Commercial Real Estate Mezzanine Loans

- Pledge of 100% of the beneficial ownership interests of the issuer
- Borrower will irrevocably opt-in to Article 8
- Perfection by certificating the membership interests
- File a financing statement
- Organizational documents should prohibit issuance of additional certificates and from opting-out of Article 8 without consent of lender
- Obtain a UCC Insurance Policy where available

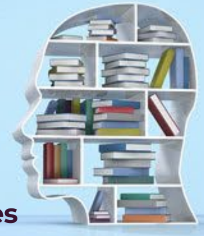


Benefits of Mezzanine Financing for Buyers

In commercial real estate, the primary source of financing is often limited to no more than 60% of the value of the property.

The potential buyer must obtain additional financing if they are unable or unwilling to put up the rest of the funding to complete the purchase. Mezzanine financing is one way to make up this shortfall and ensure the deal goes through.

Mezzanine loans can also help the owner obtain a greater return on equity in the property, since they are required to invest less of their own money. These loans are unsecured and can be obtained quickly by owners with a record of successful investments.

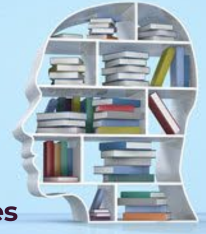


Benefits of Mezzanine Financing for Investors

This sort of investment is an inherently risky position. But with great risk can come great reward, so investors are often willing to put up mezzanine financing for real estate transactions. Investors can expect high interest rates, well above the prime rate.

They can also structure their investment as a hybrid of debt and equity, so that in the event of property owner default, the mezzanine investor will have a share of equity in the property.

The repayment period for a mezzanine loan is also far shorter than even a commercial mortgage (which is shorter than a residential mortgage). Therefore the investor can expect to receive those high returns within a relatively brief period of time.



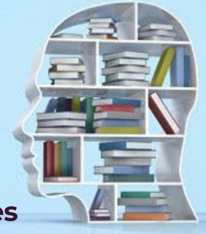
Comparison – Article 9 Security vs Mortgage Loan

Regular Mortgage Loan:

- Collateral is real property
- Promissory Note, Mortgage
- Mortgage is recorded in real property records

Mezzanine Loan secured via Article 9:

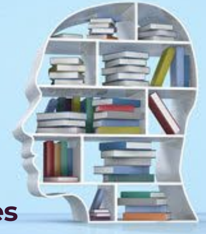
- Collateral is personal property
- Promissory Note, Pledge and Security Agreement
- UCC-1 Financing Statement filed with secretary of state



Article 9 Perfection Problems

Searching and filing is complex and detailed:

- Search logic varies from state to state
- Errors and omissions via secretary of state and search vendors
- Indexing inconsistencies
- Human error, typographical mistakes can result in perfection failure



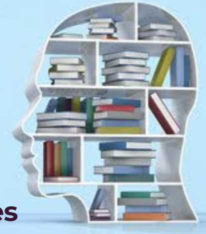
Article 8 and Certificated Securities

- An equity interest can be represented by a certificated “security”, where the issuer has opted in to Article 8.
- Such a certificate, in possession of the secured party, trumps a secured party under Article 9.
- Mezzanine Lenders typically opt to be secured both ways: via Article 9 and Article 8.

Perfection With Respect to an Equity Pledge: Opting-In, Opting-Out

How does one opt-in to Article 8:

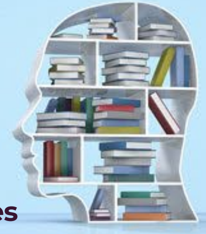
- In the organic document that controls the entity whose equity interest is being pledged
- Only in the Limited Liability Company Agreement, Limited Partnership Agreement
- Not the pledge agreement or any other document!



Perfection With Respect to an Equity Pledge: Opting-In, Opting-Out

Sample opt-in language:

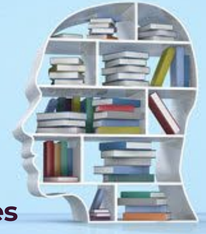
> Each limited liability company interest in the Company shall constitute and shall remain a "security" within the meaning of (i) Section 8-102(a)(15) of the Uniform Commercial Code as in effect from time to time in the State of Delaware and (ii) the Uniform Commercial Code of any other applicable jurisdiction that now or hereafter substantially includes the 1994 revisions to Article 8 thereof as adopted by the American Law Institute and the National Conference of Commissioners on Uniform State Laws and approved by the American Bar Association on February 14, 1995. Notwithstanding any provision of this Agreement to the contrary, to the extent that any provision of this Agreement is inconsistent with any non-waivable provision of Article 8 of the Uniform Commercial Code as in effect in the State of Delaware (6 Del C. Â§ 8-101, et seq.) (the "UCC"), such provision of Article 8 of the UCC shall be controlling.



Perfection With Respect to an Equity Pledge: Opting-In, Opting-Out

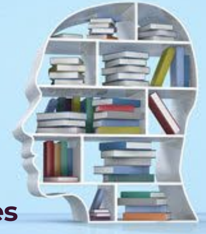
- The ultimate goal of the mezzanine lender: Be a Protected Purchaser Under Article 8

- Definition of a protected purchaser:
  1. Gives value
  2. Does not have notice of any adverse claims to the security
  3. Obtains control of the security



Post Mezzanine Loan Closing Perfection Problems

- Downside to perfection by filing: After mezzanine loan closes, issuer "opts-in" and tenders a certificate and power to a second lender who becomes a protected purchaser
- Downside to perfection by possession of certificate and power under Article 8: lost certificates



UCC Policy

1. Stewart's UCC Lender's Policy insures and indemnifies the lender's attachment, perfection and first priority security interest in personal property taken by the lender as collateral for a loan

2. The functional equivalent to a real estate lenders title insurance lender's policy

3. Insures against fraud and forgery

4. Provides for defense cost and indemnification

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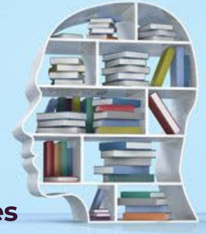
Major Benefits in Obtaining a UCC Title Insurance Policy

What could go wrong?

1. Not getting the debtor’s exact legal name correct
2. Not conducting a proper UCC search
3. Not utilizing proper search logic
4. Not filling out the financing statement correctly
5. Not filing the financing statement at the right time
6. Hoping the search results from the search company are correct
7. Hoping that another secured party didn’t file in the gap period
8. Hoping that all the loan/security documents are drafted correctly
9. Hoping that the loan/security documents are properly executed
10. Hoping that if anything goes wrong, the loss suffered by the lender won’t be too great



Insured Collateral

- 100% of the parent's membership interest in the titleholder
- General Intangible under Article 9
- Perfected by filing a UCC-1 in the debtor's state of formation

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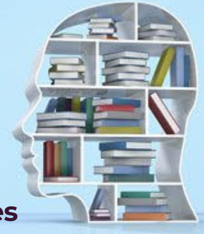
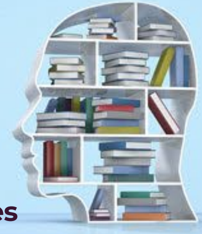
Financing Documentation

- Mezzanine Loan Agreement
- Mezzanine Promissory Note
- Mezzanine Pledge and Security Agreement
- UCC-1 Financing Statement



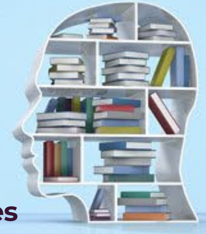
UCC-1 Financing Statement

- Debtor's name must match organizational documents
- Description of collateral must match pledge agreement



Underwriting Requirements

- Organizational/transaction chart
- Certificate of Formation
- Operating Agreement with all amendments (Art. 8 opt-in)
- Consent of Members authorizing the secured transaction
- Certificates of Good Standing
- Mezzanine Pledge and Security Agreement
- Mezzanine Promissory Note
- Mezzanine Loan Agreement
- Delivery and indorsement of certificate (Art. 8 opt-in)



Additional Options

Mezzanine Endorsement

Modifies Article 8 Exclusion for Coverage

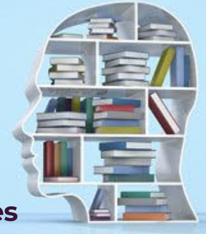
Always request when secured interests are certificated

Tracking Letter

Stewart will alert you prior to lapse of UCC-1 filing

Co-insurance Endorsement

UCC policies can be co-insured among multiple companies

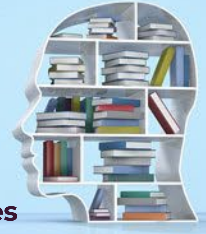


Mezzanine Endorsement to Owner's Policy

(1) <u>Assignment of payments</u> under the Owner's Policy not to exceed the debt owed to the Mezzanine Lender

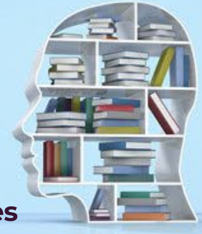
(2) <u>Non-Imputation coverage</u> to the Mezzanine Lender

(3) <u>"Fairway" coverage</u>, acknowledging that coverage will not be adversely affected because of transfer of ownership interests (direct or indirect) in the insured



Requirements

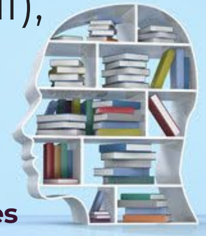
- Stewart Mezzanine Affidavit
- Financial disclosures
- Consent of the insured by signature on the endorsement or by separate letter
- Name the Mezzanine Lender in paragraph 1 of the Endorsement
- Secure the signature of the Mezzanine Lender on the Endorsement



Mezzanine Foreclosure vs Standard Foreclosure

- A mezzanine loan is secured by a pledge of the equity of the entity (such as a limited liability company) that owns the mortgaged real estate. If the mezzanine borrower defaults, **the mezzanine lender forecloses and becomes the new owner of the pledged entity**.

- The mezzanine lender not only becomes the 100% owner of the mortgage borrower, it also effectively becomes the owner of the underlying real property. It should be noted that the underlying real property will remain subject to all liens and encumbrances (including the mortgage loan itself), which, by contrast, would have been extinguished in a mortgage loan foreclosure process.



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Thank you

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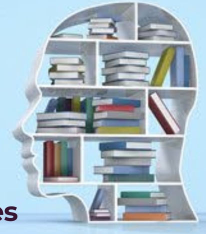

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