Fidelity National Financial, UCC Risk Management Program White Paper

UCC INSURANCE FOR SECURED LENDERS

Improved Risk Management in a Fragile Economy

FIDELITY NATIONAL FINANCIAL™

A White Paper Prepared for Financial Institutions, Corporate Borrowers, Commercial Finance Lawyers, Investors, Industry Analyst, Regulators, Bank Examiners and Public Policy Makers

WHITE PAPER
UCC Insurance
Collateral Protection for Secured Lenders

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EXECUTIVE SUMMARY

Although the fourth quarter 2009 has shown modest signs of stabilization in *consumer sectors*, the nation's economy remains fragile, with many indicators suggesting a broadening of the credit crisis to *commercial and corporate sectors* of the economy. Particularly exposed is the credit quality and capital of secured lenders, the reliability of traditional underwriting tools employed by secured lenders, the quality and creditworthiness of their corporate borrowers, the fund adequacy of the FDIC and potential liability to taxpayers.

Large and small banks electing to not utilize contemporary underwriting and risk mitigation tools now offered by the private sector, and the failure of secured lenders to properly perfect their security interest in reliance collateral, or to maintain their collateral lien priorities in the face of rising corporate defaults, can be expected to experience an adverse affect on bank loan recoveries.

Diminished loan recoveries on defaulted loans will deplete regulatory bank capital. Depleted bank capital may result in institutional insolvency. Bank insolvency may result in FDIC intervention. Too many FDIC interventions can be anticipated to adversely impact the FDIC insurance fund, potentially leading to Treasury assistance. Treasury assistance is referred to by many as a "taxpayer bail-out".

The private sector has developed a proven, simple, effective and low-cost risk mitigation program to contribute to bank underwriting processes. It is a valuable new tool that secured lenders, credit executives, risk management officers, equity investors, shareholders, bondholders, regulators, bank examiners, rating agencies, industry analysts and public policy makers may come to embrace as an effective

collateral lien priority insurance program with which financial institutions and the nation's fragile economy can be protected.

BACKGROUND

This white paper will remind readers that, despite the availability of modern risk management tools such as UCC insurance, tradition-bound bankers continue to inadequately mitigate risks associated with commercial loans secured by personal property as defined by Article 9 of the Uniform Commercial Code, particularly in a dramatically unstable economic environment. Has the banking industry prepared for what could be a cascade of defaults on non-performing commercial loans? It seems clear such defaults will drain capital from the nation's banks, thereby further imperiling the fragile national economy. Though many economists are predicting a slow economic recovery in consumer sectors beginning in the fourth quarter of 2009, the nation can ill afford another credit shock.

Earlier this decade, a stable, robust economy masked defects in commercial loan documentation that in today's unstable market significantly exposes lender's reliance collateral securing commercial and corporate loans. But the devastated economy is beginning to reveal a shocking number of documentation defects related to the attachment, perfection and priority of a lender's security interest. And they can be expected to directly impact balance sheet value and recoverability of commercial loans secured by personal property collateral.

Reports that 30% of commercial loans suffer documentation defects that could result in the bank's loss of collateral reflect needless exposure to bank capital and liquidity upon loan default. The *Wall Street Journal* reports that corporate bankruptcy rates for commercial loans secured by non-real estate collateral have quadrupled in the past two quarters. And, that this trend appears to be continuing into the 4th quarter 2009 and 1st quarter 2010.

There is significant risk to the nation's financial sector associated with the rising tide of corporate bankruptcies. Tremendous pressure is mounting on banks to avoid mark-to-market write downs, charges to an already battered income statement and the recognition of under-collateralized "rolling" loans with little chance of repayment. Some loans may be in technical default, some in monetary default and some in so-called "maturity default".

Many of debtors whom are responsible for these loans will file for bankruptcy. In many cases there will be a contest for control of collateral. More importantly, the lender's lien perfection and/or priority will be set aside as a result of multiple challenges uncovering documentation defects. The banks failure to properly perfect and obtain a first priority security interest on reliance collateral will adversely affect recoveries. Diminished loan recoveries on defaulted loans will deplete bank capital. Depleted bank capital may result in institutional insolvency.

One recent study by Deutche Bank suggests that there may be $3-5 trillion in commercial real estate and corporate loan defaults through 2013. These defaults, many of which result in bankruptcy filings, are to a large degree the result of frozen, or crippled credit markets in which permanent financing or re-financing is unavailable. Many of these loans, originated when credit was "too loose", are now the victims of initially unrealistic asset values and loan-to-value ratios. As a result, the borrower has little "skin in the game" (in terms of equity), and therefore little motivation to work out the problem for the benefit of the lender.

Banks are *lenders not partners*, with the responsibility to their shareholders to protect bank assets, maximize recoveries and (common in today's parlance) avoid further government and taxpayer intervention. Banks are charged with the responsibility to operate in a safe and sound manner, utilizing all risk management tools available to identify measure and manage risk. The forthcoming wave of corporate bankruptcy filings will tend to make the banks look like partners. With no alternative sources of capital, banks will be forced to protect their collateral, to

recognize capital-depleting charge-offs, or enter into a series of short term modifications that will likely reduce principal, interest rates, principal balance. Defaults, workouts, bankruptcies, receiverships, foreclosures, liquidations, ultimately write-offs and litigation over collateral are coming. There will be significant challenges by debtors, trustees in bankruptcy and/or unsecured creditors committees to the bank's assertion that they have a properly perfected security interest. Banks would be well advised to seek new and contemporary tools for the tool kit.

In September 2009 the AP wire reported concerns with the FDIC's anticipated funding requirements (to rescue insolvent banks). This was the result of significant bank failures, driven by increasing loan defaults. The FDIC identified 305 "troubled" banks during the 1st quarter, referred to as "surging bank failures". 81 banks have failed, and been seized by the FDIC so far this year…approximately a 300% increase over last year. These failures are the result of violation of regulatory capital requirements, usually the result of defaulted loans, failed work-outs and write--offs.

Camden Fine, the president of the Independent Community Bankers of America is quoted, as expressing concern that "significantly increased assessments on the banks to keep the FDIC solvent are likely". Gerrard Cassidy, a banking analyst for RBC Capital Markets predicted that up to 1,000 banks, or 1 in 8, could disappear within 3 years (as the recession deepens and broadens).

The FDIC may need $70 Billion to cover bank failures projected thought 2013. The FDIC recorded $19 Billion in losses in the 1st quarter 2009. While the FDIC is dealing with banks that are dealing with the fall-out of bad consumer and residential real estate loans, it appears that the commercial loans secured by personal property collateral remain on a back-burner and beneath the surface.

The Wall Street Journal reported on September 14, 2009 that "sick banks" now top 400 in number with the banking industry continuing to "slide as bad loans pile up". According to the Wall Street Journal, the banking industry continues to deteriorate

with regulators adding 111 lenders to their list of endangered banks in the last quarter, even as the economy shows signs of stabilizing". The article goes on to refer to government reports (concerning bank capital and liquidity) spotlighting potential risk to the broader economy. The report refers to banks "socking away cash" leaving them less capital to lend, thus constricting credit just as the economy appears poised to revive. FDIC Chairman Sheila Bair acknowledged "credit problems will outlast the recession by at least a couple of quarters". And, many of these problems reside at the nation's leading financial institutions, which appear to be relying on risk management practices that were designed for "normal" economic circumstances…not a severe recession with a weak and prolonged recovery.

A Shared National Credit Program Report, compiled by the FDIC, OTS, OCC and Federal Reserve as reported on September 25, 2009, stated that U.S regulators say"…*losses* from loans facing banks and other financial institutions tripled to $53 Billion in 2009 due *to poor underwriting standards* and the continued weakness in economic conditions". The report was critical that soaring "assets rated special mention, substandard, doubtful and loss" touched $642 Billion representing 22.3% percent of the bank loans reviewed in the regulatory report, compared to 13.4% just one year ago. Classified assets as "doubtful and loss" loan categories reached a staggering $447 Billion*, rising almost fourteen fold from the prior year.*

On September 3, 2009 the U.S. Department of Treasury issued a report concerning "Stronger Capital and Liquidity Standards for Banking Firms" and the safety and soundness of individual banking firms. In this report, the Treasury states that the existing "regulatory framework has failed to prevent the build-up of risk in the financial system in the years leading up to the recent crises. Major financial institutions had reserves and capital and buffers that were too low…". The Treasury goes on to state "capital requirements should be designed to protect the stability of the financial system…and that capital requirements for all banking firms should be increased, and capital requirements for firms that pose a threat (those whom have accepted government TARP funds) to overall financial stability should be higher than those for other banking firms". The report goes on to state "the rules used to

measure risk embedded in bank's portfolios and the capital required to protect against them must be improved".

Another recent Wall Street Journal report concerns shrinking loan portfolios at major banks, indicating that most lending is the renewal of old loans, not the providing of capital to businesses in the form of new loans. In the article Rep. Spencer Bachus pressed the Treasury Secretary as to why TARP money has failed to deliver the "multiplier effect" as advertised. 15 banks hold 47 percent of the TARP funds, and loan portfolios have declined at 13 of the banks. Based on the article, it appears that banks continue to add to loan-loss reserves rather than originate new commercial loans.

A recent article published in USA Today reported on growing concerns with credit quality, loan delinquencies and defaults resulting in an increasing number of banks failing to pay the quarterly TARP "dividend" to the government. According to USA today, banks are preserving capital by defaulting to the Treasury (taxpayers) The article calls into question which banks are deemed "healthy" by the Treasury. This article provided the example that due to credit quality, capital and liquidity problems, CIT is involved in finalizing a pre-packaged bankruptcy which will eliminate $2.33 Billion owed to taxpayers. Yet, it appears that CIT and other major lenders, who have benefited from TARP/Taxpayer assistance, are not utilizing all of the contemporary risk management tools available in the private sector toolbox to improve credit quality in their own underwriting.

A private sector Risk Management Program could serve to give the banks a greater degree of confidence in their corporate lending, with a new level of insurance protection available to protect their secured-lending documentation and related secured collateral.

MARKET CONDITIONS

Historically, real estate title insurance has played an important role in loan transactions by insuring proper perfection and priority of collateral, and by protecting lenders from fraud, forgery and documentation defects. UCC insurance for non-real estate collateral is the natural evolution of this concept in light of the growing need to protect and enhance the strength and quality of commercial loan reliance collateral.

Escalating commercial loan delinquencies, defaults, charge-offs and bankruptcy filings are anticipated to result in substantial pressure on reliance collateral. Many of the nation's lending institutions are failing to implement basic, low-cost and readily available collateral protection, thereby failing to insure against defects and documentation errors that could, in the event of a third party challenge to the lender's perfection or lien priority, result in the bank's security interest being set aside. This loss of collateral position would severely reduce recoveries in the event of a loan default, eroding the capital and liquidity in an already fragile banking system.

UCC insurance, available from the nation's leading real estate title insurance companies, is a relatively new program for the financial markets. Similar in many respects to traditional real estate title insurance, UCC insurance was introduced specifically to insure the commercial lender's security interest in personal property collateral for validity, enforceability, attachment, perfection and priority.

A tradition of relying on legal opinions offered by the borrower's lawyers appears to be the primary reason the commercial lending industry does not yet require UCC insurance as a matter of course for non-real estate secured commercial loans. As detailed below, a legal opinion is not uniform across the country. No claims reserves stand behind the legal opinion, and no cost of defense is included in the legal opinion.

This is clearly a time of economic uncertainty and instability in which the best practice-risk management of balance sheet liability, and protection of reliance collateral, are becoming increasingly important in the secured lending segment.

Bank analysts, bond holders, stockholders, rating agencies, regulators and public policy makers expect the bank to utilize *all the tools available in their "risk management tool box"* to protect credit quality, capital, liquidity, shareholder investment and, by extension, the FDIC and taxpayers.

At some time in the near future, it is likely that the "old school" practice of the nation's financial institutions *not insuring* their lien perfection and priority on reliance collateral, in a manner similar to what is required in the real estate loan segment, will be considered a glaring deficiency to the stakeholders mentioned above.

As we saw in the real estate markets several decades ago, it is likely that the banks' outside counsel would prefer low cost insurance for the bank's lien priority as a very attractive alternative to the liability associated with the lender being "*secured but not insured".*

Clearly, the failure to rely on tradition, and not utilize contemporary "best practice" risk management tools could have a grave effect on the health of the commercial lenders and the nation's economic recovery.

THE CURRENT ECONOMIC MILIEU

Most economists believe the current economic downturn originated in the residential real estate market and its associated effect on capital and liquidity in the banking industry. An avalanche of poorly underwritten real estate loans put many of the nation's largest banks on unsteady footing. Seemingly overnight, credit dried up as banks directed cash toward shoring up their delicate balance sheets. A collapse in housing prices damped consumer spending. Personal default rates soared, and repercussions rippled out from the housing market to nearly every corner of the national economy.

Although residential real estate markets in many regions appear to be stabilizing, according to the Federal Reserve, commercial loan charge-offs and delinquency rates are escalating at a rate faster than the decline in the residential real estate market. By the end of the second quarter of 2009, the Fed reported that charge-off and delinquency rates for non-real estate commercial loans had hit 2.31% -- nearly a 300% increase of the level of just one year before.[1] Clearly, an increase in delinquencies signals a concurrent and significant increase in problems associated with commercial loans secured by personal property collateral.

WHEN THINGS GO WRONG

Personal property secured transactions under Articles 8 and 9 of the Uniform Commercial Code is one of the most heavily litigated areas of commercial law. Small wonder: Recent court cases, as compiled by the American Bar Association's Section of Business Law, suggest that seemingly clerical flaws in documentation and/or perfecting can carry significant negative repercussions for lenders caught unaware.[2] Cases in which the security interest of a secured lender has been challenged or set aside are generally in one of four categories:

1. Failure to file/continue the financing statement
2. Incorrect/ambiguous financing statement
3. Defective description of collateral
4. Incorrect filing jurisdiction

Many commercial loan documentation defects that lead to a lender's security interest being jeopardized are either clerical in nature or are the result of a lack of detailed knowledge regarding the Uniform Commercial Code: Examples include

[1] Federal Reserve Statistical Release: Chargeoffs and Delinquency Rates on Loans and Leases at Commercial Banks 2009:2

[2] Steve O. Weise, U.C.C. Article 9: *Personal Property Secured Transactions,* in The Business Lawyer 1353 (American Bar Association, Aug. 2008).
*See addendum for broad cites

incorrect name of borrower, search of the wrong jurisdiction, wrong state of filing, the lack of filing the appropriate documents, an error in the collateral description and the like.* Moreover, it is often junior staff at either the bank or the law firm that are responsible for perhaps the greatest risk to the lender: the loss of perfection and priority on reliance collateral.

What follows is a general description of common problems that can surface, followed by real-world examples.

Attachment (9-303 of the UCC)

For a security interest to attach to collateral, a borrower must have rights in the collateral, sign the appropriate security agreement granting the lender a security interest and the lender must have given or committed to give value. Too often, however, lenders fail to satisfy even these most basic requirements.

In one recent case in the 5th Circuit Court, for example, an individual signed a security agreement granting a security interest in collateral to secure a loan. It later proved to be unclear if the individual, a sole proprietorship, or a limited liability company actually owned the assets. The matter had to be litigated in court to determine if the individual had the appropriate rights in the collateral in the first place that would be required to grant a security interest.[3]

Perfection (9-308 to 9-316 of the UCC)

Common sense would dictate that a bank should pay careful attention to all steps required to properly perfect its interest in the collateral securing a loan. Lenders need to avoid financing statement inaccuracies, search office and omissions, and indexing inconsistencies. But recent jurisprudence suggests that lenders need to do this with the skill of a surgeon if it is to properly establish and maintain a security interest in a loan secured by personal property.

[3] *Id.* at 1357 (citing *Peoples Bank v. Bryan Brothers Cattle Co.,* 504 F.3d 549, 552 (5th Cir. 2007)).

A 2007 case in South Dakota provides a classic cautionary tale. Here, a financing statement was deemed ineffective because one letter and a comma were omitted from the debtor's name. But for want of a perfect typist, the debtor listed as "Jim Ross Tire Inc.," was in fact "Jim Ross Tires, Inc." The court ruled that the financing statement was inaccurate, and a $63,033.56 loan was subsequently deemed unperfected.[4]

Priority (9-317 to 9-342 of the UCC)

The other common pitfall lenders must avoid is to ensure that they have a first priority security interest in the collateral that secures their loan. Documents perfecting their security interest must be crafted without errors, and filed on a timely basis in the correct jurisdiction. As was the case in the previous examples, the courts tend to punish lenders who demonstrate less-than-perfect due diligence.

In a 2007 case out of New Jersey, a prospective buyer of accounts searched under an incorrect name of a debtor prior to purchase. Because of this error, the buyer did not discover a prior financing statement by a previous secured party. When the buyer later went to collect on some of these accounts, a priority dispute arose between the original secured party and the buyer, resulting in a protracted legal situation.[5]

All of these examples offer a vivid reminder that “almost perfect” simply isn’t good enough when it comes to properly documenting commercial loans secured by personal property. With the courts demanding such precision, even the most diligent banker is exposed to losses based on documentation defects or omissions when originating or modifying commercial loans.

OPERATIONAL RISK

[4] *Id.* at 1362 (citing *In re Jim Ross Tires, Inc.*, 379 B.R. 670, 673 (Bankr. S.D. Tex. 2007)).
[5] *Id* at 1364 (citing *Wawel Sav. Bank v. Jersey Tractor Trailer Training, Inc.,* 2007 WL 2892956

Given the current credit environment there can be no margin for error in evaluating loan quality, the proper perfecting of a security interest or accessing of secured collateral in the event of a default.

Many institutions have become increasingly dependent on highly complex, untested financial instruments as they seek alternative sources of revenue. This path led banks to enter new businesses, new markets or introduce new services within existing lines of business in an attempt to drive significantly higher levels of activity and more complex financial products through increasingly sophisticated analytical systems.

In the face of this innovation, the exposure to operational risk has escalated substantially and has made many institutions more vulnerable to losses from "failed or inadequate internal processes, people and systems."*

From the perspective of risk managers, bank credit officers, shareholders and investors, the consequences of such failures are severe. Insured collateral protection represents an ideal risk mitigation tool by transferring operational risk exposures for commercial loan transactions from the lender to an insured product. An insured collateral position permits bank's credit and risk management officers to shift the risks of loss due to documentation defects, lien attachment, perfection and priority.

*Basel Committee on Banking Supervision, Consultative Document on Operational Risk

REGULATORY CONSIDERATIONS

A brief review of the seriousness of bank capital requirements is helpful, and underscores that both regulators and banks need to be extremely sensitive to asset and collateral values in a highly unstable economic environment. As commercial loan quality deteriorates, and reliance collateral becomes increasingly important to banks, it raises the question, are uninsured capital and reserve requirements from past "normal" credit markets adequate to protect banks in "abnormal" market conditions?

- Tier 1 Capital: Tier 1 is the bank's core equity capital {Book value of bank's stock (common plus preferred that is irredeemable/non-cumulative) plus retained earnings}...it is the bank's net worth---the difference between assets and liabilities, related to its risk-weighted assets. Under Basel I, the highest risk weight is for Commercial & Industrial, CRE credits etc at 1.0. The minimum Tier 1 ratio must be 4% of risk-weighted assets.

- Tier 2 Capital: Tier 2 includes Tier 1 capital plus subordinated debt, provisions for loss and revaluation reserves. The minimum for the combined Tier 1 and Tier 2 Total Capital ratio must be 8% of risk-weighted assets.

- Basel I : Basel I is the current system of bank capital standards adopted in 1988 that resulted in higher capital requirements internationally and introduced the link between a bank's capital and the bank's risk taking appetite. It established risk weights with different assets ie: grouping assets according to perceived credit risks -the greater the asset risk weighting, the higher the capital required. For example, cash is considered risk-free and has a capital requirement of zero. It had various limitations. For example it was not sensitive to changes in the economy and required banks to hold the same amount of capital in good times and in bad.

- Basel II: Basel II was proposed to remedy deficiencies within the Basel I accord. For example, Basel I viewed all C&I loans as of the same quality and assigned a uniform risk weight of 1.0; it did not take into account the specific risk profile of the bank's C&I portfolio, deterioration in asset quality, risks of off-balance sheet transactions, or fee based activities or actions taken to mitigate the risks. Basel II builds on risk management and risk measurement practices of each individual bank and links risk taking to capital adequacy.

- Basel 1A: Only the largest banks were to be required/choose to adopt the Basel II framework. Basel IA was proposed by the US regulatory authorities for most banks other than the largest banking organizations that have less sophisticated portfolios and less complex activities. The Fed issued the proposed Basel IA capital requirements for those institutions that are not subject to Basel II. Similar to Basel II, it is intended to be more risk sensitive than Basel I but it is less complex than Basel II. Major provisions include the "broader use of external credit ratings", an increase in the number of "risk-weight categories", an expanded "range of collateral and guarantors that may qualify an exposure for lower risk weights" and the elimination of the "50% limit on the risk weight that applies to certain derivatives

Given the significant deterioration in the health and stability of the banking industry and many corporate borrowers; increasing defaults rates and the rising insolvency of commercial borrowers will place substantial new pressure on the availability of properly perfected reliance collateral, which, notwithstanding the asset value, will be

crucial in maximizing bank recoveries. Banks will require a renewed vigor and discipline in implementing underwriting measures to ensure that the bank's collateral position is protected. This will take qualified "boots on the ground," not complicated analytical programs.

THE CASE FOR MANAGING RISK

In today's complex and threatening economic environment, evidenced by the well known and documented melt-down of sub-prime related credit quality and liquidity issues, hazards to a bank's capital have been substantially elevated by the spreading of the recession to other loan segments.

Public policy makers should ask Regulators, what bubble is next for the nation's economy? Regulators and bank examiners may very well ask the same question of their banks. The failure to apply traditional real estate secured loan origination underwriting and risk management practices, for commercial loans secured with personal property collateral, is an outdated and unnecessary practice of holding too much risk.

Most lenders can and do reduce their risks in such transactions by developing and implementing formal internal lending policies that govern the size and type of loans, and the various classes of acceptable collateral to help ensure that loans are made with uniform rigor, based on objective criteria. Stringent loan review procedures that ensure the bank and its employees are in compliance with internal policies and control systems further reduce risk of errors and omissions. Recent history aside, most institutions strive to regularly examine existing economic and regulatory conditions to ensure that emerging risks are identified.

Lenders can also shift risk by engaging third parties. Traditionally, such third parties often include attorneys, who issue legal opinions on matters regarding borrower authority, attachment and ownership. On *behalf of the borrower* they also opine

whether the security agreements are adequate, and whether perfection has been accomplished. Oftentimes the opinions are costly and highly conditioned with exceptions, exclusions and characterizations. They represent risk to the lawyer and his/her law firm, and generally add little to the quality or credit worthiness the proposed transaction.

Lawyers should focus on negotiating and structuring transactions on behalf of their borrower clients, with risk shifted to a qualified and regulated third party to ensure and "insure" that all necessary and appropriate searches have been performed for the appropriate debtor(s) in the appropriate jurisdictions. The qualified and regulated third party, by definition, would insure that all crucial elements of a loan transaction, including the documents, searches and filings, provide for a policy that insures the lender's security interest for validity, enforceability, attachment, perfection and priority. None of these issues are insured by a lawyer representing a borrower. Such risk to the nation's banks, and by extension the taxpayers, is unnecessary, unacceptable and fully avoidable.

THE CASE FOR SHIFTING RISK

There is another path: UCC insurance. Recently introduced as a risk management tool for secured lenders, UCC insurance functions in much the same way that title insurance does in real estate transactions. For a reasonable one-time premium, a qualified and regulated insurance company steps in to indemnify lenders against the many common defects and errors that can occur when attempting to perfect a security interest and achieve first priority in personal property.

Just as title insurance replaced attorney opinions as the standard in real estate transactions, UCC should become the standard for commercial loans secured by Article 8 and Article 9 collateral. For example, the debt rating service Moody's recently began recommending the use of UCC insurance for Article 8 secured mezzanine finance transactions.

Major market commercial loan transactions have historically relied on legal opinions. Here are the advantages of UCC insurance over the traditional legal opinion:

1. Supported by published independent financial strength ratings and claims reserves
2. Protections as to legal costs to defend a challenge to a lender's security interest
3. National coverage for multiple jurisdictions
4. Indemnification as to loss occurring due to improper attachment, perfection and priority
5. Coverage as to lender priority, including the "gap period"
6. Coverage as to UCC search report inaccuracies, errors and omissions and financing statement inaccuracies
7. Coverage against documentation defects
8. Protection against fraud and forgery
9. Coverage as to authenticity and authority of document signatories
10. Protection as to proper attachment, perfection and priority
11. Protection for life of loan benefiting original lender and successors-in-interest

UCC insurance, available from the nation's leading title insurance companies, insures the lender's security interest for validity, enforceability, attachment, perfection and priority. Such insurance protecting the lender's reliance collateral is crucial, particularly in an unstable economic environment subject to increasing defaults, bankruptcy filings and related challenges to the bank's lien priority.

UCC insurance delivers an effective private-sector backstop that shifts risk and transfers it to a well-capitalized insurance company, helping in part to thaw frozen commercial credit markets and protect taxpayers from the potential of yet another government funded intervention to protect or restore capital and solvency in the nation's banks.

NEXT STEPS/RECOMMENDATIONS

While the overall economy may be showing some signs of stabilization, absent a significant improvement in broad economic indicators, a robust recovery is not on the immediate horizon, and even a moderate recovery appears fragile. Despite positive signs of the housing market stabilizing, the percentage of defaults for commercial and industrial loans is soaring.

Regulators, bank examiners and rating agencies need to anticipate the next loan segment likely to experience the bursting of the bubble. Numerous recent court cases, suggest that collateral securing loans subject to the trend of defaults may be compromised by documentation defects, which leads to a bank's loss of collateral in the event of third party challenge, foreclosure or liquidation. Reduced recoveries lead to an erosion of bank capital, liquidity and shareholder value

As citizen groups, shareholders, regulators, examiners, equity investors, rating agencies and public policy makers begin to examine the policies and processes that underpin the commercial loan industry in this unsteady economic environment, it is important to examine and update internal systems, test processes and personnel, and ensure all available risk management tools are being employed in the commercial loan underwriting and documentation process.

Regulatory officials should expect their member banks to utilize third-party service providers, including UCC insurers, whose primary function is to minimize and shift risk for the benefit of secured lenders. Commercial lenders, regulators, rating agencies, equity investors, shareholders, bondholders, government lending functions and government loan guarantors should incorporate this relatively new product into the commercial loan industry's best practices, standards and procedures. The safety and soundness of the commercial lending process, and the associated health of the U.S. economy as a whole, would benefit substantially from this effective, low-cost, private sector insurance protection.

In recent years, UCC insurance has often reduced loan origination costs, increased lender and investor transaction protections, eliminated UCC related documentation defects and filing errors, and shifted risk from outside counsel with regard to the legal opinion. It has further served to enhance the strength and value of loans and loan portfolios securitized or otherwise sold into the secondary market.

Perhaps most crucial in today's unstable economic environment is that UCC Insurance allows lenders to improve internal credit quality, which supports appropriate levels of loan loss reserves, consistent with best practices in today's economic environment. Today's market is substantially different from the environment in which many capital and reserve requirements were established. UCC insurance contributes to the demands of today's credit quality requirements as it relates to properly risk-rated regulatory capital requirements.

SUMMATION

The next economic bubble facing the nation's fragile economy is anticipated by many to be the commercial loan market, evidenced by significant increases in delinquencies, defaults, charge-offs and losses which serve to deplete bank capital. This depletion of bank capital may expose lenders, investors, shareholders, bondholders, government lending functions, government guarantors, government insurance agencies and taxpayers to significant liability. Simply put, UCC insurance can mitigate much of the pressure on lending institutions by protecting lien perfection and priority on reliance collateral, with the goal to maximize recoveries in the event of a third party challenge, foreclosure or liquidation.

UCC insurance should be considered as an important "best practices" risk management tool for commercial loans. This is an effective and low-cost tool that should be utilized to identify measure and manage commercial loan related risk.

Bank examiners should be familiar with this private-sector program, and should evaluate the benefits for adoption by all banks, including in particular those banks that are the beneficiary of direct government lending, government guarantees and taxpayer subsidy.

Fidelity National Financial is the nation's largest provider of real estate loan origination, closing and insurance services, operating through the Alamo Title, Chicago Title, Commonwealth Title, Fidelity National Title, Lawyer's Title, Security Union and Ticor Title insurance brands. Fidelity National has an investment portfolio of approximately $5.5 billion and reserves for claims losses that exceeds $2.3 billion. This white paper was prepared by Theodore H. Sprink, (tsprink@fnf.com) Senior Vice President of Fidelity National Financial's UCC Risk Management Program.

Addendum

Exposure to lenders and outside counsel is often revealed in matters involving 1. Failure to file/continue the financing statement, 2. Incorrect/ambiguous financing statement, 3. Defective description of collateral, 4. Incorrect filing jurisdiction. Cases generally fitting into these categories include:

1. **Receivables Purchasing Company** Cite: Georgia Court of Appeals-October 2003

Issue: Debtor's correct name was Network Solutions, Inc. The financing statement was filed against *Net Work Solutions, Inc.* A UCC search on the correct debtor name did not uncover the filing. The court commented that a party filing a financing statement now acts at its peril if it files a financing statement under the wrong name.

Conclusion: The secured party did not perfect properly despite only adding a space in the debtor's name.

2. **Pankratz Implement Company** Cite: Kansas Superior Court-March 2006

Issue: Debtor's Correct Name was Rodger House. The financing statement was filed against *Roger House.* A UCC Search on the correct debtor name did not uncover the filing. The court commented that article 9 had the effect of shifting responsibility of getting the name right on the financing statement to the filing party.

Conclusion: The secured party did not perfect properly despite missing only one letter in the debtor's name.

3. **In Re Tyringham Holdings, Inc.** Cite: United States Bankruptcy Court Virginia-December 2006

Issue: Debtor's correct name was Tyringham Holdings, Inc. The financing statement was filed against *Tyringham Holdings.* A UCC Search on the correct debtor name did not uncover the filing. The Secured Party argued that a private search service using a different search logic would have found the filing. The court ruled that the Virginia search logic did not find the filing and the filing was therefore seriously misleading.

Conclusion: The secured party did not perfect properly despite only missing the Inc. in the debtor's name.

4. **Host America Corporation v Coastline Financial, Inc.** Cite: United States District Court- Central District of Utah-May 2006

Issue: Debtor's correct name was K. W. M. Electronics Corporation. The financing statement was filed against *KWM Electronics Corporation.* A UCC Search on the correct debtor name did not uncover the filing. The court ruled that "given the importance of the debtor's name, it should come as no surprise that a failure to adequately provide the name will render a financing statement, "seriously misleading".

Conclusion: The secured party did not perfect properly despite missing 3 periods and spaces in the Debtor's name

5. **Fuell v MNTC** Cite: United States Bankruptcy Court Idaho-December 2007

Issue: Debtor's correct name was Andrew Fuell. The financing statement was filed against *Andrew Fuel.* The court held that the financing statement was ineffective and that the Debtor's name on the financing statement was seriously misleading.

Conclusion: The secured party did not perfect properly despite missing only one letter in the debtor's name.

Additional Footnotes:

Publicly adjudicated cases illustrate exposure to lender's relying on search vendors and/or outside counsel to assure proper attachment, perfection and priority of its security interest in personal property:

The "Failure to File" a UCC-1 Financing statement by outside counsel led to a legal malpractice judgment against a law firm in an action brought by the client, in Kory vs Parsoff, 745 NY S. 2d 218 (2002).

An "Incorrect/Ambiguous Financing Statement" limited collateral subject to a bank's filing in Shelby County State Bank vs. Van Diest Supply 303 F. 3d 7th Cir (2002).

A "UCC Search Vendor's Liability for Damages" was limited to $25 for the failure/inaccuracy of the vendor's search in identifying prior liens in Puget Sound Financial, LLC vs. Unisearch, Inc. 146 Wn. 2d 428 (2002).

A "Defective Description in Collateral" and "Incorrect Filing Jurisdiction" led to a lender failing to properly perfect its security interest in Fleet National Bank vs. Whippany Venture I 370 B.R. 762 (d. Del 2004).