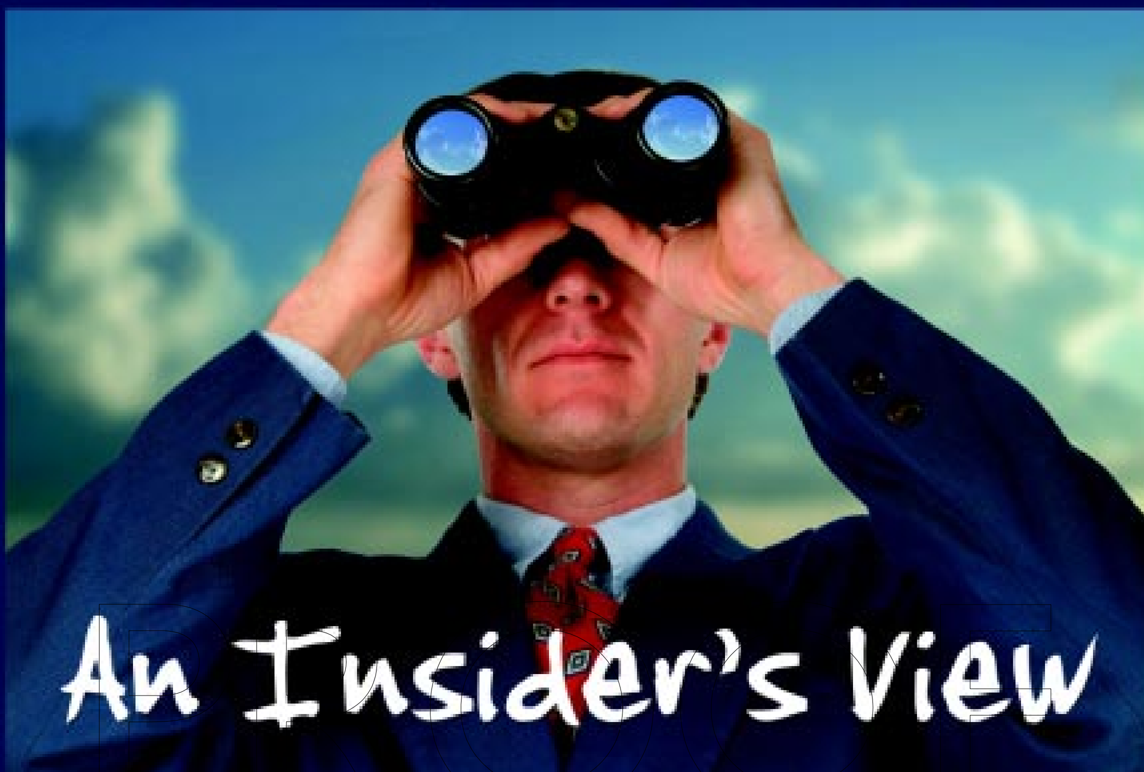
THE SECURED LENDER
January/February 2006

The story of UCC Insurance



An Insider's View

by Theodore H. Sprink

UCC insurance has become a checklist item for most major mezzanine investors and lenders, oftentimes driven by secondary market considerations. Asset-based loans were originally targeted during the early product development, and asset-backed securitizations are a logical extension for the value of UCC insurance.

The initial concept

How does a new product, conceived by seasoned title insurance underwriters, generate in the estimated range of $70-80 billion in lenders' orders in four short years? The original concept was simple: If virtually every bank in the United States funding real estate secured loans requires real estate title insurance, wouldn't those same lenders enjoy the same benefits of "title insurance" for their commercial loans secured by non-real estate collateral?

Similar in many respects to traditional real estate title insurance, UCC insurance was developed specifically to insure the lender's security interest in non-real estate collateral, rather than the chain of title of real property. The non-real estate loan origination market was estimated to exceed $1 trillion annually. For the title insurance industry, adapting this new UCC insurance concept to the fundamentals of a proven real estate title insurance product suggested a new source of potential annual revenue of perhaps $4-5 billion.

The marketing of Revised Article 9

Significantly, the program was in development during 2000, a time of change and uncertainty for the commercial finance industry. Revisions to Article 9 of the Uniform Commercial Code were looming, scheduled to become effective in most states in July 2001. The substantial revisions represented uncertainty and risk to lenders and their outside counsel in the granting, perfecting and enforcing of their security interests.

There was also significant concern on the part of lenders and law firms with respect to compliance to the five-year transition rules to Revised Article 9. A general angst in the marketplace over the possible loss of priority in collateral virtually called out for a shift in risk—the core function of an insurance company, and the basis by which UCC insurance protection would be launched.

Nuts and bolts of UCC insurance

UCC insurance is a lender title-insurance product which insures the security interest in loans secured by non-real estate assets for validity, enforceability, attachment, perfection and priority. UCC insurance covers fraud, forgery, insures the gap and provides cost of defense coverage in the event of a challenge to the lender's security interest. Policies include UCC search and filing services, are life-of-loan and frequently issued on a post-closing basis.

Non-real estate assets are defined by Article 9 of the Uniform Commercial Code, and often referred to as "personal property", or "Article 9 collateral". Personal property includes inventory, furniture, fixtures, equipment, accounts receivables, deposit accounts, general intangibles, securities and pledges (often crucial to the mezzanine loan transaction).

Being introduced by the title industry, dominated by a handful of major, national underwriters serving an industry fully committed to using title insurance for essentially every transaction, provided a unique opportunity to take advantage of existing sales, marketing and distribution channels. For the first time the title industry would be able to insure "both sides" of a mixed-collateral transaction, those deals secured by both real property and personal property.

Thus, a broadening of coverages was available to lenders already familiar with title insurance in transactions involving manufacturing concerns, retail operations, hotels, power plants, casinos, hospitals and the like. Now lenders could outsource UCC search, document preparation and filing functions, while wrapping the entire transaction in an insurance policy offered by a handful of Fortune 500 insurance companies, effectively shifting risk for the proper attachment, perfection and priority of their security interests.

The policy would replace the costly traditional legal opinion rendered by borrower's counsel as a lender requirement, and provide cost of defense in the event something went wrong. And, with regard to high risk-low billable documentation matters, outside counsel would be able to more appropriately focus on negotiating and drafting primary loan documents, letting the UCC insurers worry about UCC matters.

Positioning a new concept

The policy was originally positioned externally to expand coverages available to lenders, while at the same time complementing (if not eventually replacing) the traditional legal opinion, successfully relieving liability to outside counsel in connection to priority and perfection issues.

Internally, the program was positioned as a source of new revenue, while serving as a powerful cross-marketing tool for the core commercial real estate title insurance products. Representatives of the title insurers could market the program directly to existing lender clients, simultaneously familiarizing lawyer clients with the new concept in anticipation of garnering outside counsel's recommendation for lender clients to utilize UCC insurance in appropriate transactions. Such transactions would include Article 9 "reliance collateral".

Product development

In the early days, a series of focus groups were conducted in key geographic markets, with senior representatives of blue chip law firms invited to provide input to the drafting of the coverages and exclusions contemplated in the new UCC policy form. One worry was the potential for outside lawyers to express concern that the policy would serve to reduce billable hours related to providing the legal opinion.

There was almost unanimous support for a new product that could effectively take outside counsel off the hook for delicate and problematic issues involving the portion of the opinion related to perfection and priority. Some believed that replacing the (multi-jurisdictional) opinion with actual (national) insurance coverage would serve to reduce risk to the law firms and, by extension,

perhaps one day to reduce law firm malpractice coverage premiums.

Next, a number of leading national commercial lenders were visited for the purpose of evaluating in an audit environment the condition of their underlying commercial loan documents in connection to targeted loan portfolios. Would loans stand up to a bankruptcy trustee's challenge of the attachment, perfection and priority of their security interests? In other words, what was the extent of the need for UCC insurance?

Since most banks had grown through mergers and acquisitions, there was little consistency in the commercial loan underwriting standards. And the audits determined that up to 40 percent of the loans reviewed were subject to some type of documentation defect that could result in the lender's security interest being set aside.

Market research reflects value

This market research showed that, incredibly, most documentation defects were rather clerical in nature: incorrect name of borrower, wrong jurisdiction searched, wrong state of filing, the lack of filing the appropriate documents, an error in the collateral description and the like. The research indicated that it might be the lowest paid individual at either the bank or the law firm that was responsible for perhaps the greatest risk to the lender: the loss of reliance collateral.

The research also showed perhaps UCC insurance would be viewed by many as similar to the fire insurance we all purchase for our personal homes: You don't really need the fire insurance until the house catches on fire. In short, there was unlikely to be a challenge to the lender's security interest, unless there was a default. However, unlike a home fire (that may not result in a total loss of contents), when a perfection or priority defect occurs, it is often catastrophic to the lender in that it consumes all collateral.

So, even loans known by the lender to be defective in documentation, were not an issue until such time as they were in (monetary) default. Naturally, by then, it is often too late. The $25 indemnity furnished by the bank's UCC search vendor, or the right to sue outside counsel, do not represent attractive alternatives to proper perfection and priority to the lender's risk management team.

The economy of UCC

In recent years, the stable economy has "masked" commercial loan defects, not linking them particularly to defaults and loan recovery. Documentation defects that will directly affect value and recoverability of collateral have been kept somewhat below the surface by the simple fact that many of the affected loans are not in monetary default. This, notwithstanding the potential for the borrower being headed toward an insolvency proceeding, which is likely to result in a challenge to the lender's security interest.

Perceived equity cushions and ample alternative sources of capital may have artificially hidden cash flow and management difficulties in core lending segments. Stock market jitters, rising oil prices, increases in interest rates, the fear of inflation, higher unemployment rates, reports of concerns with reduced orders for manufactured goods and slipping consumer confidence suggest that the default rates may play a more significant role in bank strategies in the future.

The case for UCC insurance

Recent cases, recognized by the title industry as publicly adjudicated, illustrate exposure to lenders' rely 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).

The exposure to lenders and outside counsel often takes form in the categories mentioned above, with litigation and loss of collateral supporting the case for UCC insurance. Other cases generally fitting into these categories include:

- *In re Knudson*, 929 F.2d 1280 (8th Cir. 1991), *District of Columbia vs. Thomas Funding*, 15 UCC Rep Serv 2d 242 (D.C.),
- *First National Bank of Lacon vs. Strong*, (663 N.E. 2d 432 (Ill. App 3d 1996),
- *ITT Commercial Finance Corp vs. Bank of the West* 166 F.3d 195 (5th Cir 1999),
- *LaSelle's Bicycle World* (120 B.R. 579 (Bankr. N.D. Okla 1990); *In re Matter of Ellingson Motors* 139 B.R. 919 Bankr D. Neb 1991), *Franklin National Bank vs. Boser,* 972 S.W. 2d 98 (Tex App. 1998), *Avalon Software, Inc*. (209 B.R. 517 D. Ariz. 1997),
- *In re Isringhausen* (20 UCC Rep Serv. 2d 366 Bankr S.D. Ill. 1993), *Banque Worms vs. Davis Construction Co, Inc.* 831 S.W. 2d 921 (Ky. Ct. App 1992),
- *In re Nenko*, Inc. 209 B.R. 588 (Bankr E.D. NY 1997), *Schaheen vs. Allstate Financial Corp.*, 17 UCC Rep. Serv. 2d 1309 (4th Cir. 1992), and
- *Mellon Bank, N.A. vs. Metro Communications, Inc.* 945 F.2d 635 (3rd Cir 1991.).

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UCC insurance today

UCC insurance has in many transactions proven to reduce loan origination costs, increase lender and investor transaction protection, eliminate UCC-related documentation defects and filing errors, and shift risk from outside counsel with regard to the legal opinion. UCC insurance has further served to enhance the strength and value of loans and loan portfolios securitized or otherwise sold into the secondary market.

In this regard, by many measures UCC insurance has become a significant success, in that most Wall Street firms, including Morgan Stanley, Goldman Sachs, Merrill Lynch, Credit Suisse First Boston, Bear Stearns, Greenwich Capital, Deutsche, JP Morgan Chase and a host of other lenders providing access to the capital markets, have embraced UCC insurance.

Future prospects bright for UCC insurance

As late as the mid-1950s, real estate title insurance had not yet become universally accepted or utilized by lenders. Lawyer's legal opinions and abstracts were widely utilized in the nation's real estate markets. Standardized real property title policy forms of coverage, endorsed by the American Land Title Association (ALTA), were still a decade away.

Many believe it is the secondary market, with the advent of Fannie Mae and Freddie Mac and their crucial roles in the American economy, that led to not only the importance of title insurance for individual (retail) transactions, but the investment community's need for enhanced, high-quality, real-estate related "securities".

This quality enhancement was provided by the nation's title industry, based on the industry's ability to deliver, insure and defend "clear title". Although UCC insurance is a relative newcomer to the financial markets, lenders and investors are poised to gain many of the same benefits enjoyed in the real estate markets. ▲

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