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LAND TITLE TRENDS

Title Insurance Options for Mezzanine Lenders

Ordinary Coverage Is Not Available Because Collateral Is Not Considered Real Property

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PRESENT-DAY real estate financing is significantly more complex than traditional financing. Sobered by borrower bankruptcies and compelled by rating agency requirements in the modern day era of mortgage securitizations, lenders are now looking to “mezzanine loans” to bridge the gap between senior debt and borrower equity. A mezzanine loan will often cover 50 percent to 90 percent of the equity required to acquire a property.¹ In order to secure the repayment of a mezzanine loan, a lender customarily requires a pledge of the partnership or membership interests of the property-owning entity.

In traditional mortgage transactions the borrower is required to obtain title insurance insuring the lender’s mortgage lien on the real property. Ordinary title insurance is not available to the mezzanine lender because the collateral is not considered real property but rather a general intangible or investment property.²

The focus of this article is an exploration of the evolution of mezzanine financing and the various title insurance products available to the mezzanine lender in the current mar-

ketplace. Specifically, we will look at the following forms of title insurance coverage: (1) the New York Insurance Rate and Service (TIRSA) Fairway Endorsement; (2) the TIRSA Non-Imputation Endorsement; (3) the TIRSA Mezzanine

amount of approximately 65 to 75 percent of the appraised value of a property and a first mortgage lien. In order to reduce the equity contribution to acquire real property, borrowers have historically sought subordinate financing in the form of a second mortgage.

The use of a second mortgage as a means of subordinate financing has gradually declined over the past decade, a decline that can be largely attributed to two factors: (1) the downturn in the real estate market in the early 1990s and (2) the securitization of mortgage loans.

As the real estate market began to decline in the early '90s, the number of mortgage foreclosure actions began to increase. Many of the delays and challenges experienced in these actions were initiated not by the borrower but by the subordinate lien holder.³

In addition, senior lenders were faced with bankruptcy risks that were compounded by subordinate financing on the property. For instance, in the event of a borrower bankruptcy, the senior lender faced the risk of equitable subordination claims by the subordinate lender and in the event of a subordinate lender bankruptcy, the senior lender

was stayed from taking any enforcement action with respect to the senior debt.⁴ Since a mezzanine loan is structured as a loan to an entity other than the property owner, the risk that the bankruptcy of the property owner will trigger the bankruptcy of the mezzanine borrower is significantly



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Financing Endorsement; and (4) the UCC Article 9 Insurance Policy.

Evolution of Mezzanine Financing

A typical mortgage loan involves a loan

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reduced (and vice versa).

In securitized loan transactions, the rating agencies have developed a comprehensive set of guidelines designed in part to avoid the bankruptcy risks associated with subordinate financing. For example, the rating agencies will in all likelihood require the mezzanine borrower to be structured as a bankruptcy-remote entity. Similarly, the rating agencies will require an "independent director" or like official with control over bankruptcy decisions of the borrower.⁵

Structuring a Mezzanine Loan

As mentioned above, a mezzanine loan is often structured as a loan to the partners or members of a borrower and the loan is usually secured by a pledge of the respective partnership or membership interests.

In the alternative, a lender may take a "preferred equity" position in the borrower in exchange for making a capital contribution. This interest is usually coupled with a right to a preferred return and/or other form of equity kicker as well as the right to approve certain major operating decisions.

However, if a lender is an equity participant in the borrower, an issue may arise as to whether the loan should be considered debt or equity.⁶ A loan that is determined to be equity could lead to equitable subordination claims by other lenders or a claim by the borrower that the lender's equity position clogs the equity of redemption. If a preferred equity position is viewed as debt, there is a possibility that lender liability claims could arise in a foreclosure action if the participating lender is found to have exercised excessive control over the management of the mezzanine borrower.

Available Title Insurance Coverage

The following forms of title insurance coverage are available to mezzanine lenders:

A. The TIRSA Fairway Endorsement. When a mezzanine lender forecloses on a pledge and becomes an equity owner of the insured, there is a risk that the transfer of ownership will trigger a termination of the insured entity's existence and a corresponding termination of the insured's title insurance coverage. While most governing documents of a limited liability company or partnership borrower will specifically state that the admission or withdrawal of a member or partner will not result

*While the Mezzanine
Endorsement provides
a significant level of coverage
to a mezzanine lender,
the lender is not insured
against perfection
or priority claims.*

in the termination or dissolution of the entity, the Fairway Endorsement provides affirmative coverage that the title insurance policy will continue in effect notwithstanding any transfer of an ownership interest to the mezzanine lender pursuant to the pledge.⁷

B. TIRSA Non-Imputation Endorsement. "Matters known to the Insured" are excluded from coverage under a typical policy of title insurance. When the insured is an entity, "knowledge" is imputed to the equity owners of the insured. A mezzanine lender will seek affirmative coverage from the title insurer that upon acquisition of an ownership interest in the insured entity, the lender will not be denied coverage as a result of matters known to equity owners other than the lender.⁸

C. TIRSA Mezzanine Financing Endorsement. As mezzanine financing became more popular, the Fairway Endorsement and the Non-Imputation Endorsement were made part of a single endorsement known as the TIRSA

Mezzanine Financing Endorsement. In addition to Fairway and Non-Imputation coverage, the Mezzanine Financing Endorsement offers certain additional protections to a lender that acquires a pledge.

The endorsement offers a form of coverage known as "Contingent Loan Coverage" and provides that in the event the insured under an owner's policy is entitled to insurance proceeds, such proceeds will be paid directly to the lender whether or not the lender has acquired an ownership interest by realizing on its collateral. This is contrary to the requirement in a typical title insurance policy, where a loss must actually be suffered before insurance proceeds are payable under a policy.

In the event a mezzanine lender acquires an interest in the insured, the amount of proceeds payable to such lender under a Mezzanine Endorsement is equal to the total loss payable under the policy less a percentage of the loss equal to the percentage of partnership or membership interest not owned directly or indirectly by the mezzanine lender at the time of loss. To the extent any portion of a mezzanine loan is repaid to the lender, the lender is required to return any proceeds received from the title company, although the title company may not exercise its subrogation rights until the mezzanine loan is repaid in full.⁹ The cost of a Mezzanine Endorsement is approximately 30 percent of the owner's premium.¹⁰

If a mezzanine lender has a preferred equity interest in the borrower, the lender will require a separate owner's policy with an insured amount equal to the value of its ownership interest. If a mezzanine lender makes its equity contribution after the effective date of the original owner's policy, the effective date of the mezzanine lender's title policy will be the date the contribution is first made. Thus, a borrower can find itself in the position of having to pay a portion of the owner's premium

for a second time in order to satisfy the lender's title insurance requirements.

While the Mezzanine Endorsement provides a significant level of coverage to a mezzanine lender, the lender is not insured against perfection or priority claims. For these matters, mezzanine lenders will look to an opinion of borrower's counsel and/or a UCC-9 Policy of Insurance.

D. The UCC-9 Policy. As mentioned above, a mezzanine loan is often secured by a pledge of the equity interests in the borrower. In order to perfect its lien on pledged collateral under Revised Article 9, the lender has three options: (1) filing a UCC-1 statement; (2) taking possession of the certificates evidencing the equity interest; or (3) taking control in the instance where the collateral is deemed an investment security.¹¹

Pursuant to §9-310 of Revised Article 9, a pledge of an equity interest can be perfected by filing a UCC-1 Statement in the filing office of the state in which the debtor is located. An individual is deemed located at his or her principal place of residence. A debtor that is a registered entity such as a corporation, partnership or limited liability company is deemed to be located in the state of its organization.

Revised Article 9 §9-313(a) provides for perfection by taking possession of certificated securities pursuant to §8-301 of the UCC. Mezzanine lenders often require a statement in the borrower's organizational documents confirming that the applicable partnership or membership interests of the borrower are deemed to be "securities" governed by Article 8 of the UCC.¹²

Finally, a security interest can be perfected by taking control of the collateral. This mode of perfection is usually used in situations involving a cash management account. In mezzanine financing, a lender will typically require the establishment of an account in its own name for deposit of monthly debt service and all remaining cash flow after payment

of all amounts then due under the senior loan and all operating expenses. In order to perfect an interest in a deposit account, the lender and borrower typically enter into a control agreement with the depository institution.

The general rule under Article 9 is that priority is established by the first to file or perfect. However, if perfection is established both by control and by filing, the creditor who perfects by control will have priority over the creditor who perfects by filing even if the filing occurs prior to the establishment of control. Pursuant to UCC §8-303, if collateral is deemed investment property, a lender can achieve "protected purchaser status" by giving value for the pledged interest (i.e., the loan) without notice of any adverse claim at the time the lender takes control of the investment property. If an equity interest in a borrower is deemed to be a security by the borrower's organizational documents, the borrower is deemed to have opted into Article 8 and a lender is deemed to have a lien on investment property.¹³

The UCC Article 9 Policy covers risks due to lack of (1) attachment; (2) perfection, and (3) priority. The policy covers all three modes of perfection discussed above (i.e. filing, possession and control).

In addition to the property owned by the debtor on the date of issuance, the UCC Policy can also cover after-acquired property of the debtor. The maximum amount recoverable under a UCC Article 9 Policy is the lesser of (1) the face amount of the policy; (2) the indebtedness outstanding under the loan at the time of the loss as reduced by the amount the insured is able to recover on the collateral; and (3) the value of the collateral as reduced by the amount the insured is able to recover on the collateral.¹⁴

Unlike the Mezzanine Endorsement, the insurer is required to make payment of a claim within 30 days after the insured's loss or damage, except that if a litigation is commenced prior to the 30-day period, no

payment shall be made until a final unappealable judicial determination is made.

The cost for a UCC 9 Policy in New York is based on a filed rate using a sliding scale.¹⁵

Conclusion

Challenges in American commerce have historically been met by adaptation. As so, as mezzanine financing developed, title insurance adapted as well, producing the two products now available in New York: the TIRSA Mezzanine Financing Endorsement (comprising in part, the TIRSA Fairway Endorsement and the TIRSA Non-Imputation Endorsement) and the UCC 9 Policy.



1. Calderon, Jeanne A., "Mezzanine Financing and Land Banks: Two Unconventional Methods of Financing Residential Real Estate Projects in the 21st Century," 29 RELJ 283, 287.

2. Murray, John C., "Title and UCC Insurance Endorsements For Mezzanine Financing Transactions," SJ004 ALI-ABA 245, 248 and 249.

3. Ciabarra, Laura and Horowitz, Stephen, "Mezzanine Loan Program Requirements," SH004 ALI-ABA 499, 506.

4. For additional risks raised by subordinate financing see Forte, Joseph P., "Mezzanine Finance: A Legal Background," SJ090 ALI-ABA 437, 441.

5. Ciabarra and Horowitz, supra at 514.

6. McDaniel, K.C., "Intercreeitor Issues in Mezzanine Lending," SD04 ALI-ABA 501, 506.

7. Yarber, Sharon, "Title Insurance Issues in Mezzanine Financing Transactions," 500 PLI/Real 475, 480.

8. Murray, John C., supra at 248.

9. Yarber, Sharon, supra at 481, 482.

10. Many thanks to Nicholas DeMartini, general counsel, Fidelity National Title Insurance Company of New York.

11. Stern, Sandra, "An Analysis of The Secured Lender's UCC Article 9 Insurance Policy," June 28, 2002, New York Law Journal, Vol. 227, Number 124.

12. Ciabarra and Horowitz, supra at 501.

13. Murray, John C., supra at 245.

14. Stern, Sandra, supra.

15. Many thanks to Nicholas DeMartini, general counsel, Fidelity National Title Insurance Company of New York.