“OPTING IN” TO ARTICLE 8 AND OTHER MEZZANINE FINANCING BEST PRACTICES

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I. Introduction

This paper discusses the issue of perfection of security interests under the Uniform Commercial Code (the “UCC”) in mezzanine-financed real estate transactions. The world of mezzanine finance has expanded dramatically in recent years. This is partly attributable to (i) investors’ desire to maximize the amount of leverage utilized in their real estate transactions (i.e., minimize their own equity), and (ii) the growth overall of the securitization market for mezzanine loans. The increasing influence of rating agencies and title insurance companies in mezzanine transactions has also led to the development of certain “best practices” regarding the manner in which lenders perfect the equity interests typically pledged in mezzanine loan transactions. These practices are discussed in this article.

II. UCC Perfection Methods

When a lender (the “Mezzanine Lender”) extends credit in a mezzanine loan transaction, the borrower is typically a bankruptcy remote special purpose entity (the “Mezzanine Borrower”) formed solely for the purpose of the mezzanine loan transaction. The collateral for the mezzanine loan is usually the Mezzanine Borrower’s interest in a wholly-owned subsidiary that holds title to real property (the “Property Owner”). These Property Owners are typically bankruptcy remote special purpose entities, structured as limited liability companies, general partnerships, or limited partnerships.

Mezzanine Lenders seek to protect themselves in these transactions by perfecting their security interests under the UCC. The question thus becomes how best to perfect the interest in the Property Owner. The UCC classifies equity interests in limited liability companies,
partnerships, and limited partnerships as “general intangibles,”\textsuperscript{3} and not as “investment property,”\textsuperscript{4} unless (i) the equity interests are publicly traded, (ii) the parties “opt in” to Article 8 of the UCC (as will be discussed below), or (iii) the entity in which there is an equity interest is a registered investment company.\textsuperscript{5}

Different types of collateral are afforded different methods of perfection under the UCC, depending on how the collateral is characterized. Article 9 of the UCC governs the perfection of security interests under the UCC. A security interest in a general intangible can only be perfected by filing a financing statement.\textsuperscript{6} A security interest in investment property, however, may be perfected by control,\textsuperscript{7} possession,\textsuperscript{8} or filing.\textsuperscript{9} The UCC defines perfection by control as taking delivery of: (i) a certificated security in bearer form, (ii) an indorsed certificated security that is in registered form, or (iii) an uncertificated security when the issuer has “agreed that it will comply with instructions originated by the purchaser without further consent by the registered owner.”\textsuperscript{10} The UCC defines perfection by possession as taking delivery of a

\textsuperscript{3} “General Intangibles” are defined as “any personal property, including things in action, other than accounts, chattel paper, commercial tort claims, deposit accounts, documents, goods, instruments, investment property, letter-of-credit rights, letters of credit, money, and oil, gas or other minerals before extraction.” U.C.C. §9-102(a)(42) (emphasis added).

\textsuperscript{4} “Investment Property” is defined as “a security, whether certificated or uncertificated, security entitlement, securities account, commodity contract, or commodity account.” U.C.C. §9-102(a)(49) (emphasis added).

\textsuperscript{5} Equity interests in limited liability companies, partnerships, or limited partnerships are not investment property because they do not meet the definition of a security unless they fall within one of the three exceptions listed above. A security is generally defined as “a share or similar equity interest issued by a corporation, business trust, joint stock entity, or similar entity.” U.C.C. §8-103(a). However, “an interest in a partnership or limited liability company is not a security unless it is dealt in or traded on securities exchanges or in securities markets, its terms expressly provide that it is a security governed by this Article, or it is an investment company security.” U.C.C. §8-103(c)(emphasis added). An investment company security is defined as a “share or similar equity interest issued by an entity that is registered as an investment company under the federal investment company laws, an interest in a unit investment that is so registered, or a face-amount certificate issued by a face-amount certificate company that is so registered.” U.C.C. §8-103(b).

\textsuperscript{6} U.C.C. §9-310(a).

\textsuperscript{7} U.C.C. §9-314(a).

\textsuperscript{8} U.C.C. §9-313(a).

\textsuperscript{9} U.C.C. §9-312(a).

\textsuperscript{10} U.C.C. §§8-106(a-c).
certificated security. Finally, a secured party perfects by filing, by actually filing a financing statement in the appropriate state and/or county filing office.

A Mezzanine Lender’s interests may be adversely affected by another creditor depending upon the manner in which the security interest was perfected. A security interest that is perfected by control primes all other security interests, regardless of which party was first to perfect. A security interest that is perfected by possession primes all other security interests except a security interest perfected by control. Therefore, the pecking order is that a security interest perfected by control primes one perfected by possession, which primes one perfected by filing. The comments to Article 9 provide an example that illustrates the concept:

Example 1: Debtor borrows from Alpha and grants Alpha a security interest in a variety of collateral, including all of Debtor’s investment property. At that time Debtor owns 1000 shares of XYZ Co. stock for which Debtor has a certificate. Alpha perfects by filing. Later, Debtor borrows from Beta and grants Beta a security interest in the 1000 shares of XYZ Co. stock. Debtor delivers the certificate, properly indorsed, to Beta. Alpha and Beta both have perfected security interests in the XYZ Co. stock. Beta has control, see Section 8-106(b)(1), and hence has priority over Alpha.

Thus, it is important for a Mezzanine Lender to perfect by possession or control to obtain priority over a competing creditor.

Another situation in which a Mezzanine Lender’s interests may be adversely affected is when the Mezzanine Borrower sells the equity interest of the Property Owner to a “protected purchaser.” Under the UCC, a “protected purchaser” is a purchaser of a security that: (i) gave value for a certificated or uncertificated security, (ii) did not have notice of any adverse claims, and (iii) took control of the security. The “protected purchaser” then “acquires an interest in the security free of any adverse claim.” Unlike a traditional real estate transaction, where a mortgage or deed of trust is recorded against the subject property and all future creditors and purchasers are placed on notice, in a UCC transaction, the filing alone does not constitute notice

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11 U.C.C. §9-313(a).
13 U.C.C. §9-328(1).
14 U.C.C. §9-328(5).
16 U.C.C. §8-303(a).
17 U.C.C. §8-303(b).
to a future creditor or purchaser.\textsuperscript{18} Therefore, it is conceivable that a Mezzanine Lender that perfects only by filing could lose its interest in the equity to a “protected purchaser.”

However, a Mezzanine Lender will itself become a “protected purchaser,” if: (i) it extends credit to the Property Owner,\textsuperscript{19} (ii) has no knowledge of any adverse claims, and (iii) requires the Property Owner to “opt in” to Article 8 (as discussed below) and takes control of the resulting certificated security. Therefore a Mezzanine Lender who follows the “best practices” for “opting in” to Article 8 outlined below will become a “protected purchaser,” so long as the Mezzanine Lender does not have knowledge of any adverse claims.\textsuperscript{20}

Because a secured party may only perfect its interest in a “general intangible” by filing a financing statement, a Mezzanine Lender would be better protected if the equity interest in the Property Owner were classified as “investment property,” and best protected if the Mezzanine Lender qualifies as a “protected purchaser.” Fortunately, the UCC allows parties to expressly provide that an equity interest will be governed by Article 8. This is referred to as “opting in” to Article 8. By doing so, an interest may be re-characterized as “investment property,” thereby allowing the additional methods of perfection by possession and control in addition to filing, and allowing the Mezzanine Lender to become a “protected purchaser.”

\textbf{III. How to “Opt In” to Article 8}

To “opt in” to Article 8, the: (i) organizational documents of the Property Owner must expressly provide that the equity interests of the Property Owner shall be governed by Article 8\textsuperscript{21}, and (ii) the Property Owner should issue a certificate for the equity that expressly states that it is governed by Article 8. By “opting in” to Article 8, a secured party may perfect its interest by possession, control, or filing. However, perfecting an interest by possession or control does not preclude the filing of a financing statement in addition thereto. Indeed, perfecting by possession or control and also filing a financing statement should be considered a “belt and suspenders” method. As discussed below, this approach is becoming the “best practice” in the industry.

If a Mezzanine Borrower that had previously “opted in” to Article 8 attempted to “opt out,” that could adversely affect the perfection of the security interest of the Mezzanine Lender.

\begin{itemize}
\item \textsuperscript{18} The UCC provides that the “filing of a financing statement under Article 9 is not notice of an adverse claim to a financial asset.” U.C.C. §8-105(e). However, this has yet to be tested in court.
\item \textsuperscript{19} The UCC provides that an entity has “given value” for an interest if it has received the interest “in return for a binding commitment to extend credit or for the extension of immediately available credit.” U.C.C. §1-204(1).
\item \textsuperscript{20} See U.C.C. §8-303(a) for the requirements to become a protected purchaser.
\item \textsuperscript{21} See U.C.C. §§8-103(c).
\item \textsuperscript{22} A “certificated security” is defined as “a security that is represented by a certificate.” U.C.C. §8-102(a)(4).
\end{itemize}
While it appears that an “opt out” attempt would have no effect on a security interest issued against the prior issued certificated securities, this issue has yet to be tested in the courts. A Mezzanine Lender should require that a covenant be included in the loan agreement, and a provision included in the operating agreement, that would restrict the Mezzanine Borrower’s ability to “opt out” of Article 8. Such a provision would either require the written consent of the Mezzanine Lender to any changes in the borrower’s status under Article 8, or grant to the Mezzanine Lender proxy voting rights on the pledged equity for any changes in the borrower’s status under Article 8.

IV. The Mezzanine Loan Industry

As a result of the rapid growth in the mezzanine loan industry, rating agencies and title insurance companies have begun to exert increased influence over the industry. Among other aspects of their influence, they have promulgated their own underwriting preferences and standards in the mezzanine loan industry, and caused the development of certain “best practices.”

A. Title Insurance Companies

Title insurance companies will insure a Mezzanine Lender’s interests in a mezzanine loan transaction. While there are some differences between the underwriting standards of the various title insurance companies, most prefer, and in some cases mandate, that their insureds cause their borrowers to irrevocably “opt in” to Article 8. This permits the insureds to perfect their security interests by possession or control, in addition to filing.

Mezzanine Lenders have two options for obtaining insurance coverage in a mezzanine loan transaction. As discussed below, these options are not duplicative and it is industry practice to obtain both policies. The first coverage available is an ALTA Endorsement Form 16 to the standard form ALTA owner’s title insurance policy issued at closing to the Property Owner. This endorsement to an owner’s policy provides that the insurance company will insure a Mezzanine Lender as a new owner of the real property in the event of a default on the mezzanine loan and a foreclosure of the equity interest in the Property Owner. Among other affirmative coverages, this endorsement provides non-imputation coverage, so the knowledge of the Property Owner does not affect the Mezzanine Lender upon foreclosure of its collateral.

23 Appreciation is expressed to Gary Zimmerman, Senior Vice President and Manager, UCCPlus Division of Chicago Title Insurance Company, for his comments regarding the “best practices” for UCC insurance and title insurance in the mezzanine loan industry.


25 *Id.*

26 Originally adopted in October 2003, and unchanged in the 2006 version of the ALTA standard policy.