GETTING REAL ABOUT UCC INSURANCE FOR REAL ESTATE TRANSACTIONS

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Imagine a world where real estate transactions are closed without title insurance. Title insurance has become such a common fixture of real estate transactions in the United States that it is difficult to imagine a world without. We take title insurance for granted, but many of our real estate colleagues from the baby boom generation can recall a time when it was common to rely on opinions of title prepared by closing attorneys instead of purchasing title insurance policies. History repeats itself, and we now find ourselves in a similar phase with Uniform Commercial Code (UCC) insurance. We are more likely to rely on opinions of closing attorneys instead of buying UCC insurance when pledging members interests in entities that own real estate.

Also, in more recent times, one of the authors of this article has personally experienced the difficulties of closing real estate transactions in China where there is no title insurance industry and title insurance is not available. After living through the adventures of recording transfer deeds and mortgages in various jurisdictions in China and dealing with the gaps between funding and recording, the author can easily see why the modern form of title insurance in the United States became so popular. Title insurance is here to stay and for good reason.

WHY TITLE INSURANCE BUT NOT UCC INSURANCE

Why is title insurance so prevalent in real estate transactions, but UCC insurance is not? A lack of understanding about the benefits of UCC insurance is the primary reason.

History of Title Insurance

According to American Land Title Association (ALTA), the first title insurance company was formed in Philadelphia in 1876 to insure purchasers of real estate and lenders against losses from defective title, liens, and encumbrances with the goal of making transactions more secure and efficient. The use of title insurance became more widespread after World War II, when returning service members began buying homes in large numbers. When banks thereafter started requiring loan policies, title insurance policies became ubiquitous in real estate transactions, starting more in the western portions of the country before moving eastward. Title insurance is now a critical component of preserving the free and efficient flow of real estate transactions. For the most part, government review and approval of real estate transfers (unlike in parts of Europe and China) is not required, which greatly speeds up real estate transactions, but also leaves real estate transactions more prone to security threats, challenges, and disputes. Title insurance serves as a useful tool to help effectively manage the risks posed by such risks.

History of UCC Insurance

Although real estate laws are ancient, the UCC's governance of commercial transactions is a relatively modern invention, and UCC insurance even more so. According to First American, it was the architect of the first UCC insurance policy (the Eagle 9 Lender's policy) in 2001.[1] Now every major title insurance company offers a UCC insurance product. But being only 24 years in, many practitioners in the real estate community are not fully familiar with the benefits of UCC insurance. Pledges of membership interests are routinely accepted without requiring UCC insurance. This creates a significant and avoidable gap in insurance protection for real estate transactions.

UCC INSURANCE BENEFITS

The primary benefits of UCC insurance are:

- Insuring the attachment, perfection, and priority of the secured party's security interest in personal property collateral;
- Protecting a lender from mis-indexed UCCs and fraudulently filed terminations and amendments;
- Covering transfers to the successor and assigns of the insured;
- Applying to all types of Article 9 collateral under the UCC; and
- Having a relatively stable, well capitalized, and regulated title insurance company pay the costs, legal fees, and expenses incurred in defense of the insured security interest.

FACILITATING THE CLOSING

Furthermore, just as real estate practitioners enjoy multiple sets of eyes reviewing mortgages and legal descriptions in real estate transactions, a UCC insurance policy provides another set of eyes to review the collateral descriptions in security agreements and the UCC-1 and to review the precise legal names of the entities for the UCC filing. Finally, UCC insurance covers the gap period between funding and the filing of the UCC to perfect the security interest.

REAL ESTATE TRANSACTIONS THAT BENEFIT THE MOST FROM UCC INSURANCE

The two most common real estate transactions which benefit the most from UCC insurance policies are mezzanine loan transactions and preferred equity transactions. Both types of transactions often involve a pledge of direct equity interests in an entity that owns real estate. Almost all such real estate transactions exceeding $100 million in deal size require a UCC insurance policy, but many smaller transactions do not. In larger transactions, the stakes are too high not to require a UCC policy. As most readers know, the UCC is very unforgiving of mistakes and has strict rules regarding filing locations, the debtor's name, and collateral descriptions, among other items. A mis-indexed UCC or mistake in the search process, along with other common simple errors, can wipe out a secured lender's perfected security interest or even the security interest itself, effectively making its collateral disappear. The question really is why would a lawyer not require UCC insurance for all real estate transactions involving pledges of equity collateral? According to James D. Prendergast, the former Vice President and Special UCC Counsel to the UCC Division of The First

American Corporation and now General Counsel Emeritus:

> [i]n a commercial finance transaction … the greatest malpractice exposure to a lender's counsel is not in the negotiation and drafting of the primary loan documents (services requiring senior associate or partner attention), but rather in the ordering and review of existing financing statements relating to personal property of the borrower.[2]

A simple mistake can have dire consequences to such secured real estate transactions.

Another common scenario for which UCC insurance would be very helpful is insuring that a UCC financing statement filed against a foreign entity is filed in the correct jurisdiction. In cross-border financing transactions involving real estate in the United States, practitioners routinely encounter foreign entities and often file UCC financing statements against such entities in the District of Columbia thinking that is enough. However, due to some nuances under the UCC, it is not always clear if such filings should be made elsewhere as well (especially in foreign jurisdictions which have a public filing system similar to the UCC). Unfortunately, coverage for such matters is expressly excluded under First American's UCC insurance policy, but perhaps First American will offer an endorsement to cover such matters in the future.

TYPICAL EXCLUSIONS

Similar to title insurance policies for mortgage loans, UCC insurance policies have exclusions from coverage. Many of the exclusions track specific rules of the UCC and use terms as defined in the UCC. Some typical exclusions include the following (some of which are also excluded in title insurance policies):

- The failure of the security interest to attach to the collateral by reason of: (i) the debtor not having rights in the collateral at or following the date of the policy; or (ii) the collateral being solely the proceeds of other collateral, where the proceeds are not identifiable;
- The failure of the insured security interest to be perfected with respect to any collateral by reason of perfection by any method other than perfection upon: (i) attachment under the Uniform Commercial Code; (ii) the filing of a financing statement; (iii) by possession of possessory collateral; or (iv) by control of with a control agreement;
- The failure of the insured security interest to have priority over the rights or interest of a purchaser of the collateral as a result of: (i) various matters to which the insured had knowledge; (ii) basing its priority on the lapse after the date of the policy of any financing statement made to perfect the security interest (this serves as an important reminder to file UCC-1 continuations every five years for certain UCC-1 filings); and (iii) a third party holding a purchase money security interest or interest of a consignor, to the extent in each instance certain filing and notice requirements of the Uniform Commercial Code were met;
- A purchaser of any of the collateral taking its interest in the collateral free of the insured security interest by reason of the purchaser having the status of a person to whom a negotiable document had been duly negotiated or is a holder in due course;
- A purchaser of any collateral having priority over the insured security interest, where the insured security interest is only perfected by the filing of a financing statement, where such purchaser has purchased a certificated security, if the purchaser has control or possession of the certificated security;
- Any change after the date of policy in any of the facts giving rise to any information provided in Schedule A of the policy;
- Any claim resulting from a change in law effective after the date of policy or the application of any law of a country other than the United States of America;
- Certain bankruptcy exclusions;

- The inability or failure of the insured to comply with applicable doing business laws at for following the date of the policy;
- A lien or a security interest or other matters created, suffered, assumed, or agreed to by the insured;
- Applicable usury, interest rate limitation, truth-in-lending, and consumer protection laws.

The above list of exclusions is not exhaustive. There are more exclusions set forth in the "jacket" of the UCC policy, which should be carefully reviewed by an attorney who is well versed in UCC and secured transactions law. Similar to title insurance policies, endorsements can be obtained which override certain exclusions to effectively receive the specific coverage desired.

COMMON ENDORSEMENTS TO UCC INSURANCE POLICIES

Similar to title insurance policies, UCC policies come with a variety of endorsements (though not as many). Common endorsements include the following: Mezzanine, Pledged Equity, Seller's Lien, Tax Lien, Lender's Aggregation, Post Policy Tax Lien, Borrower's Status, and Waiver of Attorney Subrogation.[3]

The Waiver of Attorney Subrogation endorsement should be of particular interest to readers of this article. This endorsement helps mitigate the liability that counsel for borrower or lender would incur if such counsel were to make a mistake that triggered a loss under the UCC policy. Specifically, according to First American, such endorsement waives any rights it may have against either lender or borrower's counsel as a result of paying a claim and thereby being subrogated to the rights of the insured against counsel.[4] With such endorsement coverage, counsel for the borrower or the lender can effectively benefit from the UCC insurance coverage as well, even if it was such counsel's mistake that led to the loss in question.

CONCLUSION

If more practitioners understood the benefits of UCC insurance, more would recommend its purchase to clients. Of course, UCC insurance is no substitute for good lawyering but is a useful tool for any real estate transaction involving the financing of membership interests. UCC insurance removes the avoidable insurance gap in financing such transactions. Perhaps 20 years from now, we will struggle to imagine a world where the transfer of membership interests were financed without UCC insurance. Finally, despite its usefulness, UCC insurance is not for the uninitiated lender. Unlike title insurance policies, UCC policies are not uniform across the industry. Exceptions and coverages differ among insurance providers. It is critically important to work with an experienced and trustworthy finance lawyer to help ensure optimal coverage is obtained.

Notes

1 UCC Insurance, First Am. Title, https://www.firstam.com/title/commercial/ucc-insurance/.

2 James D. Prendergast, Guide to the Eagle 9 TM UCC Insurance Program, 17 CEB Cal. Bus. L. Prac. 1, 4 (Winter 2002) (quoted in John C. Murray, Attorney Malpractice Liability for Failure to File UCC Financing Statement, 30 Mich. Real Prop. Rev. 137, 139 (2003)).

3 A description of each such endorsement as offered by First American Title can be found at https://www.firstam.com/title/ucc/products/eagle9-ucc-insurance-endorsements/lenders-endorsements/.

4 See Lenders' Endorsements, First Am. Title, https://www.firstam.com/title/ucc/products/eagle9-ucc-insurance-endorsements/lenders-endorsements/.