Mitigating The Risk Of A Loan Portfolio Acquisition With UCC Insurance

James D. Prendergast is Senior Vice President and the General Counsel of the UCC Division of First American Title Insurance Company. He is Co-Chair of the ABA Joint Task Force on Filing Office Operations and Search Logic, an Official Observer to the ALI/ULC Review Committee on Article 9, a Fellow of the American College of Commercial Finance Lawyers, Past Co-Chair of the Programs Subcommittee of the Commercial Finance Committee of the Business Law Section of the American Bar Association, Past President of the Financial Lawyers Conference, Past Chair of the Commercial Law and Bankruptcy Section of the Los Angeles County Bar Association, a former member of the UCC Committee of the Business Law Section of the State Bar of California, and Adjunct Professor of Commercial Law - Secured Transactions at Pepperdine University School of Law.

Jill Sharif is Vice President and National Sales Director of the UCC Division of First American Title Insurance Company. Ms. Sharif is responsible for sales, marketing, and business development for The First American Title Insurance Company's array of UCC products and services. As such, she has provided numerous presentations on the application of the EAGLE 9® UCC Insurance Policy for Lenders and Buyers, as well as, Article 9 of the Uniform Commercial Code, and title insurance for real estate mezzanine loan transactions. Ms. Sharif is currently serving her second term as a Board Member for the Northeast TMA Chapter and currently serves as their Treasurer and Membership Co-Chair. She can be reached at jsharif@firstam.com.

James D. Prendergast and Jill Sharif

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WE HAVE, on many occasions, written about the utility of UCC insurance as it relates to specific market segments. Whether in connection with real estate mezzanine lending, asset-based lending, factoring, mixed real and personal property transactions, flooring arrangements with vehicle or equipment dealers, mining and other mineral extraction, or in other types of financial transactions, UCC insurance has demonstrated its risk management utility when personal property is the reliance collateral. Over $350 billion of UCC insurance coverage has been placed since Revised Article 9 became effective on July 1, 2001.

Now that the economy is under extreme stress, market conditions are requiring the recapitalization of financial institutions or the purchase of, or participation in, financial transactions and instruments. Financial institutions are disposing of loan portfolios and other financial assets to bolster their balance sheets. Problem assets are now targets of opportunity for financial speculators. With respect to any financial transaction in which personal property is reliance collateral or in which financial assets are being acquired, either directly through purchase or indirectly

through participation in some manner, UCC insurance can be an effective and efficient risk management tool to mitigate the legal and financial risks inherent in such transactions. Up until the current credit crisis, the financial stability of the originating lender or seller of financial assets has been a sufficient hedge to inherent risk. Further, legal opinions were thought to be sufficient to satisfy any due diligence requirement demanded by prudent lending. This may no longer be the case.

LOAN SYNDICATIONS, ASSIGNMENTS, AND SYNDICATIONS • Because the structure of a transaction will determine the appropriate UCC insurance product to use, we need to agree on some definitions.

Loan Syndication

The first term to be defined is "Loan Syndication." Loan Syndication is the process of involving different lenders in providing various portions of a loan at the inception. It is used primarily in large loan situations. Syndication allows any one lender to provide a large loan to its customer while at the same time maintaining a more prudent and manageable credit exposure because it is not the only creditor. A syndicated loan is in contrast to a "Bilateral Loan" which only involves one lender.

After the loan transaction has been established, either as a Bilateral Loan or a Loan Syndication, the initial loan may be further fractionalized, either through a "Loan Assignment," or a "Loan Participation." People often use the term "Participation" to mean either a "Loan Assignment" or a "Loan Participation." Often they mean a "Loan Assignment" and often they don't understand the difference.

Loan Assignment

A "Loan Assignment" is the transfer or acquisition of a fractionalized portion of the lender's interest in the loan. *Loan Participation: Getting It Right,* by R. Kymn Harp, available at http://www.imakenews.com/iln/e_article000404223.cfm?x=b11,0,w. Typically, the interest transferred or acquired will be less than 100 percent, with the originating bank retaining a percentage interest in the loan and, often, retaining responsibility for servicing the loan and maintaining direct interaction with the borrower as the "lead bank." The acquiring bank, often referred to as the "participant," will become an "owner" of a portion of the loan with all benefits of full performance and all associated risks of loss, as if the participant had originated the loan itself. This assignment effects a novation between the assigning lender and the assignee. As a result, the assignee is obligated with respect to the remaining commitments and the assigning lender is relieved of any further obligations (with respect to the portion of the loan assigned). This type of "Participation" is identical in legal structure to a "Syndication," except that the "Participant" was not involved in the initial structuring, negotiation, and placement of the loan but is entering into the loan transaction after the fact to "buy" a portion of the loan from the originating lender. For purposes of this article, this type of participation will be called a "Co-Lender Assignment."

Loan Participation

Another application of the term "Participation," this time correctly, is a financing transaction in which the Participant is purchasing an interest in the loan from the lead lender but the lead lender remains obligated to the borrower to make any committed extensions of credit and there is no privity of contract between the borrower and the participant. For purposes of this article, this type of participation will be called a "Loan Participation."

Another distinction between a Co-Lender Assignment and a Loan Participation is that a Co-Lender Assignment usually involves a restatement of the loan documents between the new lenders and the borrower. The new lender coming into

the loan transaction as a co-lender is added to the loan documents as a lender, perhaps an administrative or collateral agency structure is added to the documentation, and if the borrower's obligation is evidenced by a promissory note, the original note will be severed and cancelled and replaced with individual notes to the lenders in their proportional relationship.

The reasons financial institutions fractionalize existing loans are many and varied. For some, the primary motivation is to enable the institution to originate loans that would otherwise exceed the legal lending limit of the institution. By fractionalizing loans to other financial institutions, a lead bank can stay within its legal lending limits while continuing to serve as the primary banking contact for a valuable customer whose borrowing needs are outgrowing the legal limits of the bank. For other financial institutions, purchasing interests, directly or indirectly, in established loans allows them to earn market interest rates for money lent, even when lending opportunities in their own banking community may be limited. In other cases, financial institutions may sell or purchase fractionalized interests in loans as a risk-management vehicle to diversify loan risks among a variety of loans in multiple lending locations.

Direct Loan Transactions

There is another form of transaction that is often confused with either a Co-Lender Assignment or a Loan Participation, and this is a loan made by Lender A to Lender B. The loan may be secured by specific assets of Lender B, including loan transactions that are assets on the books of Lender B. If secured by loan assets, this direct loan has the similarity with a Loan Participation in that Lender A does not have a direct legal relationship or privity of contract with the borrower. However, it is confusing to label this loan transaction as a "Participation," so for purposes of this article, the direct loan will be called a "Direct Loan Transaction."

LOAN PORTFOLIO ACQUISITIONS • In addition to describing the privity relationship between the lenders and borrower, it is useful at this point to add a few definitions, briefly, from the UCC. This article is primarily concerned with a loan portfolio acquisition (from an Article 9 of the UCC perspective) and the use of UCC insurance to mitigate market risk. The asset being acquired will usually be a payment obligation, either an Account, Chattel Paper, a Promissory Note, or a Payment Intangible.

Accounts, Chattel Papers, Promissory Notes, And Payment Intangibles

A promissory note is an Instrument, as defined by UCC section 9-102(a)(47), whether negotiable or not under UCC section 3-104. If there is no note but only a contractual obligation of the borrower to pay amounts outstanding under the loan documents, the asset being acquired or collateralized might constitute a Payment Intangible as defined by UCC section 9-102(a)(61). These terms are useful to remember because Article 9 distinguishes between the sale of or a lien in the various forms of payment obligations. First of all, the sale of Accounts, Chattel Paper, Promissory Notes and Payment Intangibles comes within the scope of Article 9, thereby requiring perfection of a security interest in the payment obligation to defeat other creditors or the trustee in bankruptcy. *See* §9-109(a)(3) as to the scope of Article 9. Further, Article 9 provides for automatic perfection in the case of the sale of a Payment Intangible or a Promissory Note, but requires the filing of a financing statement to perfect a security interest in a Promissory Note (possession will also perfect a security interest in an Instrument and, in a priority contest, will prime perfection by filing) or a Payment Intangible. *See* §9-309 for automatic perfection.

The approach taken with respect to Promissory Notes and Payment Intangibles is to be distinguished from the approach taken with respect to

Accounts and Chattel Paper, for which the filing of a financing statement is needed for either sale or lien (again possession trumping filing perfection in the case of Chattel Paper). *See* §9-310 and §9-312.

Supporting Obligation

Because the payment obligation evidenced by the Promissory Note or Payment Intangible being acquired in some manner may itself be secured, we also need to define a "Supporting Obligation." Section 9-102(a)(77) defines Supporting Obligation as a letter-of-credit right or secondary obligation that supports the payment or performance of an account, chattel paper, a document, a general intangible, an instrument, or investment property. If the Payment Intangible or Promissory Note is secured by either real or personal property, the attachment of a security interest in a right to payment or performance secured by a security interest or other lien on personal or real property is also, automatically and without further effort, the attachment of a security interest, in the security interest, mortgage or other lien. *See* §9-203(g). Therefore, obtaining a security interest in a promissory note automatically gives the attaching creditor a security interest in any real property mortgage or deed of trust securing the repayment obligation of the Account Debtor under the note. The mortgage follows the note! The same functional relationship between the note and a collateral mortgage also applies to perfection. *See* §9-308(e). Finally, a secured party is given the right to proceed against the Account Debtor under the underlying mortgage upon default in the obligation supported even if there is a break in real property recorded title.

Secured Party's Rights Upon Default

Section 9-607 provides in part with respect to collection and enforcement by a secured party that, if so agreed, and in any event after default, a secured party:

- May notify an account debtor or other person obligated on collateral to make payment or otherwise render performance to or for the benefit of the secured party;
- May take any proceeds to which the secured party is entitled under Section 9-315;
- May enforce the obligations of an account debtor or other person obligated on collateral and exercise the rights of the debtor with respect to the obligation of the account debtor or other person obligated on collateral to make payment or otherwise render performance to the debtor, and with respect to any property that secures the obligations of the account debtor or other person obligated on the collateral;
- If it holds a security interest in a deposit account perfected by control under Section 9-104(a)(1), may apply the balance of the deposit account to the obligation secured by the deposit account; and
- If it holds a security interest in a deposit account perfected by control under Section 9-104(a)(2) or (3), may instruct the bank to pay the balance of the deposit account to or for the benefit of the secured party.

Further, If necessary to enable a secured party to exercise under subsection 9-104(a)(3) of the right of a debtor to enforce a mortgage non-judicially, the secured party may record in the office in which a record of the mortgage is recorded:

- A copy of the security agreement that creates or provides for a security interest in the obligation secured by the mortgage; and
- The secured party's sworn affidavit in recordable form stating that a default has occurred and the secured party is entitled to enforce the mortgage non-judicially.

APPLICATIONS OF UCC INSURANCE • With all of that as needed background, let us con-