VENABLE LLP

white paper

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UCC INSURANCE

PROTECTING A LENDER'S RIGHTS TO COLLATERAL

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UCC Insurance

A lender may only exercise its rights to collateral if a borrower is in default on a loan. and issues undermining the attachment, perfection and priority of security interests generally only become apparent once the loan is in default, often long after the loan has been made. The current economic situation and the resulting increase in charge-offs and delinquency rates have many lenders scrambling to assess the guality of their commercial loans and to reexamine their policies and practices regarding protection of the collateral securing such loans.. This newsletter reminds lenders how easy it is inadequately to secure an interest in collateral, summarizes relevant regulatory guidance , and examines certain third-party tools to mitigate risks associated with commercial lending, including the use of legal opinions and UCC insurance. UCC Insurance is a new form of insurance in the marketplace modeled after traditional real estate title insurance, and is relied on to insure against defects in title to personal property (*i.e*. accounts, chattel paper, inventory, equipment, fixtures, *etc*.) used to secure commercial loans.[i]

The Current Economic Situation

During 2007 and 2008, the United State's economy entered into a significant economic downturn. The rate of change in the gross domestic product fell from positive 4.8% in 2007 to negative 6.3% by the end of 2008. The Federal Reserve Board reports that during this same time, the charge-off and delinquency rates for banks' commercial and industry loans not secured by real estate quintupled from 0.31% to 1.57%. This increase in delinquencies will logically result in a significant increase in problems associated with collateralized commercial loans.

Problems Common to Security Interests

The American Bar Association's Section of Business Law publishes an annual survey of relevant cases and emerging issues regarding transactions secured by non-real estate collateral.[ii] A review of the most recent survey provides some

excellent examples of the many ways lenders may lose or seriously compromise their secured interests.

Attachment

In order for a security interest to attach to collateral, the borrower has to have rights in the collateral, there must be an authorized security agreement, and value must be given. However, there are many ways a lender can fail to satisfy these requirements.

In one recent case, a lender's security interest failed due to the borrower's lack of rights in the collateral.[iii] In this case, the borrower pledged its interest in a limited liability company and a limited partnership to secure a loan. However, the lender did not realize that the operating and management agreements for the entities prohibited the transfer of any interest without consent. Consequently, the court ruled that the borrower lacked sufficient ownership interest in the collateral and the $620,000 loan was deemed unsecured.

In another recent case, the lender's security interest failed because the security agreement was inaccurate.[iv] While the financing statement for perfecting the loan accurately listed all of the agreed upon collateral, the security agreement required for attachment did not. Consequently, the lender's interest was unsecured with regard to the collateral listed in the financing statement but not listed in the security agreement.

Perfection

Still another way for a lender to lose its secured position is by failing to perfect its interest in the collateral. The most common way of perfecting an interest in collateral is by filing a financing statement. But here again a lender can make a number of errors that may result in the failure of the interest to perfect.

In a recent case, a financing statement was deemed ineffective because one letter and a comma were omitted from the debtor's name.[v] The financing statement listed the debtor as "Jim Ross Tire Inc.," while the debtor's real name was "Jim Ross Tires, Inc." The court ruled the financing statement was inaccurate and the security interest for the $63,033.56 loan was therefore unperfected.

Priority

Finally, recent case law shows that issues regarding the priority of interests also continue to hamper lenders. In a case recently decided, a lender made a secured loan and filed a financing statement.[vi] Another lender also made a secured loan perfected

by a subsequent financing statement. The first lender then made a second loan perfected by the original financing statement. The court ruled that both loans by the first lender had priority over the second lender's $72,500 loan because of the original statement. This example demonstrates once again how a lender that believes it has taken all necessary steps to secure its interests in collateral can fall victim to the rules for determining the priority of interests in collateral.

Relevant Regulatory Guidance

These recent examples illustrate how easy it is for an interest in collateral to fail for any number of reasons. Lenders can reduce their risk of this happening by following applicable regulatory guidance and by taking other prudential steps. The following current regulatory guidance offers useful advice on (1) developing formal systems for conducting secured lending, and (2) implementing adequate review processes.

Internal Policies and Control Systems

Key to managing risk in secured lending is developing and implementing internal policies that require establishment of a formal lending system.[vii] Such policies should address the types and amounts of loans that will be made, the acceptable collateral and terms for loans, and the processes for approving and issuing loans.[viii] The process for approving and issuing loans must ensure that all steps necessary to secure an interest in collateral are performed and appropriate records maintained.[ix]

Adequate Review Processes

Lenders should also have an adequate review process in place to ensure compliance with internal policies and control systems.[x] This process should also monitor compliance with legal and regulatory requirements.[xi] Finally, this process needs to regularly examine changing or emerging risks to analyze whether existing internal lending policies and system are adequate.[xii]

This review process should also ensure that personnel are adequately trained and that no single individual presents excessive risk to the lender.[xiii] Personnel need to be familiar with internal lending policies, as well as external legal and regulatory requirements.[xiv] Further, no single individual should be authorized or able to complete every step in making a loan and/or releasing a borrower or collateral from its legal obligation.[xv]

Tools to Help Manage Risk

Sometimes, however, internal polices and procedures, of themselves, cannot adequately protect lenders. For this reason, regulators sometimes recommend the assistance of third-parties to help manage risks associated with collateralized loans.[xvi] For example, third-party services for managing the risk of commercial loans secured by non-real estate may include obtaining external legal opinions. Another form or protection beginning to emerge in the marketplace is UCC insurance.

Lenders often utilize legal opinions by outside counsel to obtain assurances that commercial loans are properly secured. Outside counsel can provide opinions regarding attachment, including whether borrowers have proper ownership in collateral and whether security agreements are adequate. Further, outside counsel can assist in perfecting a security interest by reviewing the contents of filing statements to ensure that they are accurate and complete and can evaluate whether the filing statements are properly filed in the appropriate jurisdiction. Finally, outside counsel can monitor the priority of a lender's security interest and take legal action to protect against other lenders securing superior interests in collateral.

Necessarily, there are certain limitations and qualifications that apply to legal opinions, and human errors sometimes occur in searches conducted and preparation of filing statements. For this reason, some lenders are also utilizing a new tool in the marketplace to manage the risks associated with secured lending – UCC insurance. As noted above, UCC insurance is a form of insurance modeled after traditional real estate title insurance and is used to insure against defects in title to personal property (*i.e.* accounts, chattel paper, inventory, equipment, fixtures, etc.) used to secure commercial loans. While UCC insurance is a relatively new product, a number of major title insurers are currently offering such policies. Further, Moodys recently began recommending UCC insurance in conjunction with Article 8 secured transactions. UCC insurance similarly may eventually become the standard for Article 9 secured transactions as well.[xvii]

UCC insurance addresses all aspects of non-real estate collateral securing a commercial loan. During attachment, insurance shifts the risk of whether a borrower has an ownership interest in the collateral and whether the security agreement is accurate and complete. During perfection, insurance shifts the risk of whether the financing statement is accurate and whether the financing statement is properly filed. Finally, insurance shifts the risk of collateral losing its priority to other lenders. Not only does UCC insurance insure the validity and enforceability of the pledge of reliance collateral on a commercial loan, it also provides an additional external system for reviewing the collateral loan documents and provides a means to protect against financing statement

inaccuracies.

This protection extends beyond the documents and filing process, as well. Insurance can also shift the risk associated with fraud or forgery. Further, such insurance typically covers defense costs associated with, and indemnifies against, challenges to the priority of a secured commercial loan. For these reasons, a lender may want to consider UCC insurance as a new tool for managing the risk associated with commercial lending secured by non-real estate collateral, particularly for larger loans and as a complement to obtaining a legal opinion.

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The current economic situation is resulting in an increasing number of problems for commercial lending secured by non-real estate collateral. A review of recent cases reminds lenders how easily an interest in collateral can fail to attach, perfect or have priority. While it is important to examine and update internal systems, review processes and personnel, lenders should also remember the role that third-party service providers, like outside counsel and UCC insurers, can play. Financial institutions engaged in significant levels of commercial lending need to assess the risks of such lending, develop and implement internal policies, control systems and review processes, obtain legal opinions when necessary and consider the additional protections that may be afforded by a UCC insurance policy.

Please contact us if you have any questions or you would like to discuss how Venable may be able to assist you.

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[i] Venable LLP currently represents a large title company offering this form of insurance

[ii] Steve O. Weise, U.C.C. Article 9: *Personal property Secured Transactions, in* The Business Lawyer 1353 (American Bar Association, Aug. 2008).

[iii] *Id.* at 1356 (citing *In re Weiss*, 376 B.R. 867, 877 (Bankr. N.D. Ill. 2007)).

[iv] *Id.* (citing *Allete, Inc. v. GEC Engineering Inc.*, 726 N.W.2d 520 (Minn. Ct. App. 2007)).

[v] *Id.* at 1362 (citing *In re Jim Ross Tires, Inc.*, 379 B.R. 670, 673 (Bankr. S.D. Tex. 2007)).

[vi] *Id.* at 1364 (citing *Rentenbach Constructors, Inc. v. CM Partnership,* 639 S.E.2d 16, 17 (N.C. Ct. App. 2007)).

[vii] Federal Deposit Insurance Corporation, *Risk Management Manual of Examination Policies: Section 3.2 – Loans* (Feb. 2005); Office of the Thrift Supervision, *Examination Handbook* 214.5 (Jan. 1994)("Systems to monitor portfolio quality and adherence to policies and procedures.").

[viii] Office of the Comptroller of the Currency, *Comptroller's Handbook: Commercial Loans (Section 206)* 22 (Mar. 1998); FDIC *Risk Management Manual of Examination Policies: Section 3.2 – Loans;* OTS *Examination Handbook* at 214.5-214.6.

[ix] OCC *Comptroller's Handbook: Commercial Loans* at 19; FDIC *Risk Management Manual of Examination Policies: Section 3.2 – Loans*.

[x] OCC *Comptroller's Handbook: Commercial Loans* at 24; FDIC *Risk Management Manual of Examination Policies: Section 3.2 – Loans;* OTS *Examination Handbook* at 214.6.

[xi] FDIC *Risk Management Manual of Examination Policies: Section 3.2 – Loans*; OTS *Examination Handbook* at 214.5.

[xii] OCC *Comptroller's Handbook: Commercial Loans* at 24; OTS *Examination Handbook* at 214.5-214.6.

[xiii] FDIC *Risk Management Manual of Examination Policies: Section 3.2 – Loans*; OTS *Examination Handbook* at 214.6.

[xiv] OCC *Comptroller's Handbook: Commercial Loans* at 24; FDIC *Risk Management Manual of Examination Policies: Section 3.2 – Loans.*

[xv] OCC *Comptroller's Handbook: Commercial Loans* at 22;

[xvi] OTS *Examination Handbook* at 214.9.

[xvii] Moody's Investor Service, *US CMBS and CRE CDO: Moody's Approach to Rating Commercial Real Estate Mezzanine Loans* (Mar. 29, 2007).