

Commercial Lending Review

Volume 24, Number 4 July–August 2009

3

Contingent Liquidity Pricing

13

Analytical Pricing for Commercial Loans

17

Acquisitions and Their Effect on Loan Covenants

Departments

Asset-Based Market Review.....	21
Loan Documentation.....	27
Real Estate Workouts.....	31
Accounting.....	37
Secured Lending.....	41



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Article 9 Collateral Insurance Shifts Risk for Lenders

By Theodore H. Sprink

UCC insurance insures the commercial lender's security interest in non-real estate collateral.

Traditionally, commercial and residential real estate lenders and investors have used title insurance to minimize documentation errors and to perform processes associated with perfecting lien priority. Title insurance protects credit quality, secondary market value and liquidity.

As late as the mid-1950s, real estate title insurance was not universally accepted or used by lenders. Lawyers' legal opinions and abstracts were widely used in the nation's real estate markets. Standard real property title policy forms of coverage, endorsed by the American Land Title Association (ALTA), were still a decade away. Today, title insurance is a cornerstone of traditional real estate lending.

Title Insurance for Non-Real Estate Loans

Over the last few years, a new concept of title insurance has evolved primarily within the private equity space. This new insurance is available to lenders for which "reliance collateral" is personal property as defined by Article 9 of the Uniform Commercial Code (UCC), that is, title insurance for non-real estate loans.

Non-real estate assets are often called personal property, or Article 9 collateral. Personal property includes inventory, furniture, fixtures, equipment, accounts receivables, deposit accounts, general intangibles, securities and pledges (often crucial to the mezzanine loan transaction).

The title industry has essentially adapted the standard ALTA real estate title insurance policy form to provide the benefits of title insurance to commercial lenders securing loans with non-real estate collateral. These UCC insurance policies currently cover an estimated \$450 billion in secured lending.

UCC insurance insures the commercial lender's security interest in non-real estate collateral for validity, enforceability, attachment, perfection and priority. Policies include UCC search and filing services and are frequently issued on a postclosing basis. In addition, UCC insurance protects commercial lenders against fraud, forgery, documentation defects, search office errors and omissions, indexing problems and financing statement inaccuracies.

UCC insurance provides cost-of-defense coverage in the event of a third-party challenge to the lender's security interest and lien priority. Loans that are insured tend to have greater value in the secondary market than loans that are not insured. Policies are for the life of the loan and assignable.

Pitfalls of UCC Search Vendor Indemnification

UCC insurance overcomes limited UCC search vendor indemnification in connection to search office errors and omissions, indexing inconsistencies and financing statement inaccuracies. Without UCC insurance, a lender's recourse to an inaccurate search or filing function from leading search and filing vendors is limited to the cost of the service rendered by the vendor.

Millions of dollars of collateral could be lost due to a search, filing or clerical error by the vendor, and the lender's recourse could be limited to, for example, \$100 dollars, that is, the cost of the search or filing service.

Theodore H. Sprink is Senior Vice President and National Marketing Director for the UCC Risk Management Program of the Fidelity National Financial Family of Companies, Jacksonville, Florida. Contact him at tsprink@fnf.com.

paragraphs 38–76, in the codification. The inclusion of TIS Section 5100 may result in an accounting change for nonpublic entities that had not previously applied that guidance. The proposed FAS defines a nonpublic entity as any entity that does not meet any of the following conditions:

- Its debt or equity securities trade in a public market either on a stock exchange (domestic or foreign) or in an over-the-counter market, including securities quoted only locally or regionally.
- It is a conduit bond obligor for conduit debt securities that are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local or regional markets).
- It files with a regulatory agency in preparation for the sale of any class of debt or equity securities in a public market.
- It is required to file financial statements with the SEC.
- It is controlled by an entity covered by the above criteria.

The FASB states in the proposed FAS that it understands that some nonpublic entities may not have previously followed the guidance contained in TIS Section 5100, paragraphs 38–76, because it was labeled nonauthoritative; however, many nonpublic entities considered that guidance to be pervasive industry practice and, therefore, within level (d) GAAP. Because the guidance was labeled nonauthoritative, the FASB decided to provide specific transition provisions in the proposed FAS for those nonpublic entities that had not previously applied the guidance. The FASB notes that it sought to reduce the cost of applying that guidance by requiring it to be applied prospectively.

Authoritative vs. Nonauthoritative Literature

The FASB states that if the guidance for a transaction or event is not specified within a source of authoritative GAAP for an entity, an entity is required to first consider accounting principles for similar transactions or events within a source of authoritative GAAP for that entity and then consider nonauthoritative guidance from other sources. The FASB notes that an entity should not follow the accounting treatment

specified in accounting guidance for similar transactions or events in cases in which those accounting principles either (a) prohibit the application of the accounting treatment to the particular transaction or event or (b) indicate that the accounting treatment should not be applied by analogy.

The FASB clarifies that sources of nonauthoritative accounting guidance and literature include, for example, practices that are widely recognized and prevalent either generally or in the industry; FASB Concepts Statements; AICPA Issues Papers; International Financial Reporting Standards (IFRS) of the IASB; pronouncements of other professional associations or regulatory agencies; Technical Information Service Inquiries and Replies included in AICPA Technical Practice Aids (except as noted above); and accounting textbooks, handbooks and articles.

The FASB concludes that the appropriateness of other sources of accounting guidance depends on the sources' relevance to particular circumstances, the specificity of the guidance and the general recognition of the issuer or author as an authority. For example, FASB Concepts Statements would normally be more influential than other sources in this category.

Grandfathered Guidance

The FASB states that FAS-162 contains a description of the categories of the GAAP hierarchy that exists before the proposed FAS will become effective. The FASB notes that an entity that has followed, and continues to follow, an accounting treatment that was previously in category (c) or category (d) of that GAAP hierarchy as of March 15, 1992, need not change to an accounting treatment in a higher category ([b] or [c]) of that hierarchy (now included in the codification in accordance with the proposed FAS) if its effective date was before March 15, 1992. For example, a nongovernmental entity that followed a prevalent industry practice (category [d]) as of March 15, 1992, does not have to change to an accounting treatment included in a pronouncement that was in category (b) or category (c) (such as an accounting principle in a cleared AICPA Statement of Position [SOP] or Accounting Standards Executive Committee Practice Bulletin [PB] that is now included in the codification in accordance with

continued on page 44