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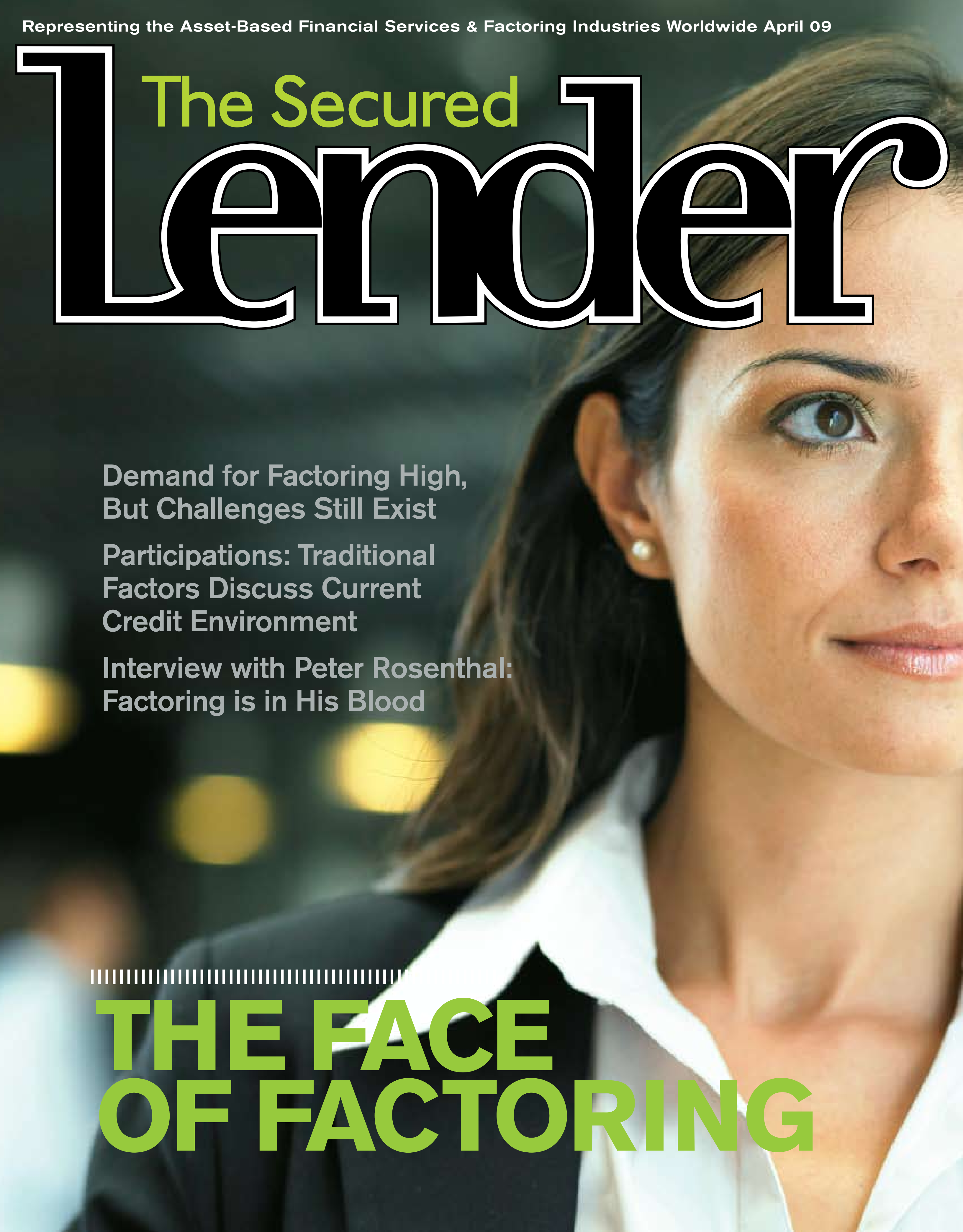
The Secured Lender



Demand for Factoring High, But Challenges Still Exist

Participations: Traditional Factors Discuss Current Credit Environment

Interview with Peter Rosenthal: Factoring is in His Blood

THE FACE OF FACTORING

Practical Strategy for Improved Risk Management

Article 9 Collateral Insurance Shifts Risk for Secured Lenders

The nation's most respected financial reporters, economists and market analysts have made today's recession and federal bailouts seem very complicated. However, to many, devastating economic developments particularly as experienced in the third and fourth quarters of 2008 are a rather simple story of risk management and credit quality.

BY THEODORE H. SPRINK

Frozen credit markets, residential foreclosures, government bailouts of the private sector, Fed Funds rates not seen since the 1930s, the questioning of the SEC and the rating agencies, stock market setbacks, unstable energy prices, interest rates, cap rates, the fear of inflation, deflation, stagflation, recession, depression, increases in business bankruptcy filings, higher unemployment rates, reduced orders for manufactured goods and slipping consumer confidence: these are just some of the issues that suggest commercial-loan default rates may play a more significant role in bank strategies than they have in the past.

In recent years the stable economy has "masked" commercial-loan defects, not linking them directly to defaults, loss-given-default and loan recoveries. Documentation defects that will directly affect value and recoverability of collateral have been kept somewhat below the surface because many of the affected loans are not yet in monetary default. And, in the past, a good loan work-out effort, coupled with alternative sources of capital, could move a defaulted borrower out of the bank. No more.

The existence of technical defaults, repeatedly renewed "PIK" loans, and a swelling emergence of monetary defaults suggest a strong likelihood that many borrowers are headed toward insolvency proceedings. This potential is increasing dramatically each month and is likely to result in frequent challenges to commercial lenders' security interests as competing parties focus on collateral in order to maximize their recoveries.

Today's Business of Banking: Little Room for Error

Perceived equity cushions, a stable economic environment and plentiful alternative sources of capital have for years artificially hidden problems associated with collateral value, borrower cash flow and management difficulties. Loan concentration, relaxed underwriting standards, declining asset values and increasing defaults in core lending

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segments are causing lenders to seek risk-management tools that protect credit quality and liquidity.

Throughout the late 1990s and 2000s the market was awash in liquidity with far "too much money chasing too few deals." Perhaps, it could be said, too few well-structured deals existed: hedge funds and private equity partnerships in competition with, or financed by banks, were deploying vast sums of money from pension plans, endowment funds and foreign investors. In the wake of this competition, relaxed covenant packages and historically low-risk pricing, there has been very little room for error.

Such relaxed standards have had a significant impact on credit quality, loan loss reserves, regulatory capital requirements, loan pricing, reliance collateral, default rates, potential legal fees and, ultimately, recoveries.

Connecting the Dots

The broadening of the recession is reflected by connecting the dots from subprime and Alt-A loans, generally viewed as entirely toxic, to traditional residential real estate loans, now suffering from plummeting values and skyrocketing default rates; to commercial real estate loans, due to suffer significantly from cap-rate and occupancy issues; to the commercial finance asset-based lending market, anticipated to be a final resting ground for the defaults, collateral contests, bankruptcies and other economic ills generally associated with recession. These ills will likely result in increased loan defaults, which will cause greater reliance on collateral, credit quality and risk-management tools.

Exposure to operational risk for commercial lenders has also escalated substantially and has made many institutions more vulnerable to losses from failed or inadequate internal processes, people and systems. From the perspective of risk managers, shareholders and regulatory authorities, the consequences of such failures are severe.

That's why title insurance has become more important. The Basel Committee on Banking Supervision's Consultative Document on Operational Risk stated: "One growing risk of mitigation technique is the use of insurance to cover certain operational risk exposures." Risk managers have used title insurance to shift risk in past real estate transactions, in what has become an essential component of the real estate-secured loan-origination business.

Traditional Shifting of Risk

Traditionally, real estate lenders for both commercial and residential transactions, as well as investors, have used title insurance to minimize documentation errors and to perform processes associated with perfecting lien priority. Lenders and investors have utilized title insurance to benefit from improved credit quality, secondary market value and liquidity.

As late as the mid-1950s, real estate title insurance had not yet become universally accepted or utilized by lenders. Lawyers' legal opinions and abstracts were widely used in the nation's real estate markets. Standardized real-property title-policy forms of coverage, endorsed by the American Land Title Association (ALTA), were still a decade away. Although title insurance developed into a cornerstone of traditional real estate lending, a new concept of title insurance has evolved over the last few years into an accepted risk-management tool for secured lenders primarily within the private equity space.

However, there is one significant difference: title insurance is now available to lenders in which "reliance collateral" is personal property as defined by Article 9 of the Uniform Commercial Code. Such title insurance for non–real estate loans has been recently been positioned by one major title insurance underwriter as a risk-management tool.

New Risk-Management Tools for a New Regulatory Environment

With regulatory authorities subject to criticism for allowing an excess concentration of subprime and Alt-A loans within certain financial institutions, coupled with relaxed underwriting standards (and loan covenants), regulators can be expected to call for improved identification and management of risk. Both lenders and investors benefit from strengthened collateral positions and the shifting of risk as it relates to lien perfection and priority.

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. In a few short years the nation's leading title insurers have produced new UCC insurance policies covering an estimated $450 billion in secured lending.

The Evolution of Title Insurance

Historically, real estate title insurance played an important role in loan originations by insuring proper perfection and priority of collateral and by protecting lenders from fraud, forgery and documentation defects. UCC insurance for non–real estate collateral is the natural evolution of this concept in light of the growing need to protect and enhance the strength and quality of commercial-loan assets.

The original concept of applying the benefits of real estate title insurance to the commercial finance market segment was simple: if every bank in the United States originating real estate–secured loans requires real estate title insurance, would those lenders originating non–real estate secured loans not also gain from the risk-shifting and protection benefits of title insurance?

UCC insurance, available from the nation's leading real estate title-insurance companies, is a relatively new development in the financial markets. Similar in many respects to traditional real estate title insurance, UCC insurance was introduced specifically to insure 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, are life-of-loan, and are frequently issued on a postclosing basis. Additionally, UCC insurance was developed to protect commercial lenders against fraud, forgery, documentation defects, search-office errors and omissions and indexing problems in the financing statement search and filing process.

Further, UCC insurance was designed to insure the "lending gap" and provide cost-of-defense coverage in the event of a third-party challenge to the lender's security interest and lien priority. From a secondary-market perspective and portfolio-management standpoint, the policies are "life-of-loan" and assignable.

Avoiding the Most Obvious and Most Common Risk

As a significant benefit to the lender, UCC insurance overcomes limited "UCC search vendor" indemnification in connection with search office errors and omissions, indexing inconsistencies and financing-statement inaccuracies. Most commercial-loan documentation defects that jeopardize a lender's security interest are clerical in nature: incorrect name of borrower, search of the wrong jurisdiction, wrong state of filing, the lack of filing the appropriate documents, an error in the collateral description and the like. Moreover, it is often junior staff at either the bank or the law firm that is responsible for perhaps the greatest risk to the lender: the loss of reliance collateral. 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—$100, for example.

Benefits of UCC Insurance as a Risk-Management Tool

Risk management is, of course, everyone's business within a bank. However, risk managers are specifically charged with the responsibility to anticipate, identify, quantify and manage risk across each of their increasingly complicated portfolios of businesses.

Positive economic conditions in recent years appear to have led lenders to fail to "price-to-risk," particularly

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the legal risks associated with equity and other personal-property collateral. However, in a complex and threatening environment, evidenced by the recent eruption of subprime-related credit-quality and liquidity issues, hazards to the bank's capital are substantially elevated. UCC insurance imposes a discipline and provides an insurance product that can significantly reduce these legal risks.

Considering the high level of both loan-origination and merger and acquisition activity in recent years, the opportunities for both human error and statistical risk modeling that is ineffective in abnormal economic circumstances pose significant undiagnosed danger to loan portfolios and the integrity of the documentation of their underlying collateral.

Risk managers are now able to shift commercial-loan risk associated with the broadening of the current consumer and residential-loan quality "meltdown" by utilizing a basic, traditional solution: "Time Tested Title Insurance: No Longer Just for Real Estate."

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Underwriting, Insuring and Protecting Lien Perfection and Clear Title

Many believe it is the secondary market, evidenced by the advent of Fannie Mae and Freddie Mac and their crucial roles in the American economy, that led to not only the importance of title insurance for residential (retail) transactions, but the investment community's need for enhanced, high-quality, real estate–related (wholesale) asset- backed securities.

This quality enhancement was provided by the nation's title industry and based on the industry's ability to deliver, insure and defend "clear title." Although UCC insurance is a relative newcomer to the financial markets, lenders and investors are poised to gain many of the same benefits currently and prominently enjoyed in the real estate markets.

Change, Uncertainty and Risk

Similar in many respects to traditional real estate title insurance, UCC insurance was developed specifically to insure the lender's security interest in non–real estate collateral, rather than the ownership or chain of title of real property. Significantly, the program was in development during a time of change and uncertainty for the commercial finance industry. Revisions to Article 9 of the Uniform Commercial Code were looming, scheduled to become effective in most states in July 2001. The substantial revisions represented uncertainty and risk to lenders and their outside counsel in the granting, perfecting and enforcing of their security interests.

There was also significant concern on the part of lenders and law firms with respect to compliance with the five-year transition rules of Revised Article 9. Non–real estate assets are defined by Article 9 of the Uniform Commercial Code and often referred to as "personal property" or "Article 9 collateral." Personal property includes inventory, furniture, fixtures, equipment, accounts receivable, deposit accounts, general intangibles, securities and pledges (often crucial to the mezzanine loan transaction). A general angst in the marketplace over the possible loss of priority in collateral virtually called out for a shift in risk — the core function of an insurance company and the basis for which UCC insurance protection would be positioned.

The Development of UCC Insurance

Being introduced by the title industry and served by a number of major, national underwriters providing insurance coverage to an industry requiring title insurance for essentially every real estate secured transaction, provided a unique opportunity to take advantage of existing sales, marketing and distribution channels. For the first time, the title industry would be able to insure "both sides" of a mixed-collateral transaction: those deals secured by both real property and personal property. Thus, a broadening of coverages was available to lenders already familiar with title insurance in transactions involving the financing of hotels, shopping centers, office buildings, manufacturing concerns, retail operations, power plants, casinos, hospitals and the like.

Now lenders could outsource UCC searches, document preparation and filing functions while wrapping the entire transaction in an insurance policy offered by Fortune 500 insurance companies, effectively shifting risk for the proper attachment, perfection and priority of their security interests in non–real estate collateral.

UCC Insurance Broadens Protection for Secured Lenders

UCC insurance would complement, if not replace, the costly, traditional, lender-required legal opinion crafted by borrowers' counsel with respect to perfection and priority and provide cost-of-defense in the event something went wrong. With regard to high-risk, low-billable documentation matters, outside counsel would be able to focus more appropriately on negotiating and drafting primary loan documents, letting the UCC insurers worry about UCC matters. The insurance coverage would also relieve liability to outside counsel in connection to priority and perfection issues.

There were those who believed that replacing the (multijurisdictional) opinion with actual (national) insurance coverage would serve to reduce risk to the law firms and, by extension, perhaps one day to reduce malpractice-coverage premiums.

Value of Shifting Risk

Like all insurance products, perhaps UCC insurance could be viewed as similar to the fire insurance we all purchase for our personal homes: you don't really need the fire insurance until the house catches on fire. In other words, there is unlikely to be a challenge to the lender's security interest, unless there is a default. However, unlike the fire at your home (that may not result in a total loss of contents), when a perfection or priority defect occurs, it is often catastrophic to the lender in that it consumes all collateral.

So, even loans known by the lender to be defective in documentation were not an issue until they were in (monetary) default. Naturally, by then, it is often too late — for our homes as well as the for the lender's collateral position. The $100 indemnity furnished by the bank's UCC search vendor, or the right to sue outside counsel, do not represent attractive alternatives to insured perfection and priority to the lender's risk-management team.

The Case for UCC Insurance

Because most banks have grown through mergers and acquisitions, there is little consistency in commercial-loan underwriting standards. Market research in the early days of the development of the concept of UCC insurance found that up to 40% of loans reviewed were subject to some type of documentation defect that could result in the lender's security interest being set aside.

But, all so frequently in recent years, the loans were either not in default (yet) or were in some manner adjusted to reflect a satisfactory internal rating, notwithstanding the potential for the borrower to head toward insolvency. It is in an insolvency proceeding that often results in a challenge to the lender's security interest, either by the Bankruptcy Trustee, the Creditor's Committee or even the borrower.

Recent cases recognized by the title industry as publicly adjudicated illustrate lenders' exposure from relying on search vendors and/or outside counsel to ensure proper attachment, perfection and priority of security interests in personal property. For example, the failure to file a UCC-1 Financing statement by outside counsel led to a legal malpractice judgment against a law firm in an action brought by the client, in *Kory vs. Parsoff*, 745 NY S. 2d 218 (2002). An incorrect/ambiguous financing statement limited the collateral subject to a bank's filing in *Shelby County State Bank vs. Van Diest Supply* 303 F. 3d 7th Cir (2002). In another example, a UCC search vendor's liability for damages was limited to $25 for the failure/inaccuracy of the vendor's search in identifying

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prior liens in *Puget Sound Financial, LLC vs. Unisearch, Inc.* 146 Wn. 2d 428 (2002). Further, a defective description in collateral and incorrect filing jurisdiction led to a lender failing to properly perfect its security interest in *Fleet National Bank vs. Whippany Venture* I 370 B.R. 762 (d. Del 2004).

The exposure for lenders and outside counsel often takes form in the categories mentioned, with litigation and loss of collateral supporting the case for UCC insurance. Other cases generally fitting into these categories include:

In re Knudson, 929 F.2d 1280 (8th circuit 1991), *District of Columbia vs. Thomas Funding*, 15 UCC Rep Serv 2d 242 (D.C.), *First National Bank of Lacon vs. Strong* (663 N.E. 2d 432 Ill. App 3d 1996), *ITT Commercial Finance Corp vs. Bank of the West* (166 F.3d 195 5th Cir 1999), *LaSelle's Bicycle World* (120 B.R. 579 Bankr. N.D. Okla 1990), *In re Matter of Ellingson Motors* (139 B.R. 919 Bankr D. Neb 1991), *Franklin National Bank vs. Boser* (972 S.W. 2d 98 Tex App. 1998), *Avalon Software, Inc.* (209 B.R. 517 D. Ariz. 1997); *In re: Isringhausen* (20 UCC Rep Serv. 2d 366 Bankr S.D. Ill. 1993), *Banque Worms vs. Davis construction Co, Inc.* 831 S.W. 2d 921 (Ky. Ct. App 1992), *In re Nenko, Inc.* 209 B.R. 588 (Bankr E.D. NY 1997), *Schaheen vs. Allstate Financial Corp.*, 17 UCC Rep. Serv. 2d 1309 (4th Cir. 1992), and *Mellon Bank, N.A. vs. Metro Communications, Inc.* 945 F.2d 635 (3rd Cir 1991).

UCC INSURANCE HAS, IN MANY TRANSACTIONS, REDUCED LOAN-ORIGINATION COSTS, INCREASED LENDER AND INVESTOR-TRANSACTION PROTECTION (AS WELL AS TRANSPARENCY), ELIMINATED UCC-RELATED DOCUMENTATION DEFECTS AND FILING ERRORS, AND SHIFTED RISK FROM OUTSIDE COUNSEL WITH REGARD TO THE LEGAL OPINION.

UCC Insurance Today for Credit Quality and Liquidity

UCC insurance has, in many transactions, reduced loan-origination costs, increased lender and investor-transaction protection (as well as transparency), eliminated UCC-related documentation defects and filing errors, and shifted risk from outside counsel with regard to the legal opinion. UCC insurance has further served to enhance the strength and value of loans and loan portfolios securitized or otherwise sold into the secondary market.

Perhaps most crucial in today's unstable economic environment is that lenders can now improve internal credit quality utilizing UCC insurance, which is positioned to provide for reduced loan loss reserves and, in turn, lead to lower regulatory capital requirements. This provides for increased liquidity and bank operating margins. **TSL**

Ted Sprink is senior vice president and national marketing director for the UCC Risk Management Program of the Fidelity National Financial Family of Companies. UCCPlus insurance policies are centrally underwritten and produced by Chicago Title, Fidelity National Title and Ticor Title insurance companies, collectively a leading Fortune 500 provider of loan-origination and closing services. Fidelity National Financial purchased in December 2008 the Lawyers Title and Commonwealth Title insurance brands from LandAmerica Financial Group.

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