

# Insuring the Lien of the Mezzanine Loan

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A Practice Note describing the options available to lenders seeking to insure the lien of a mezzanine loan. This Note discusses the perfection and priority of the lien of the mezzanine loan and highlights the steps lenders can take to maximize lien priority. This Practice Note also discusses the due diligence materials typically required by the UCC insurance policy issuer, the coverage available under the UCC insurance policy, including certain special factors to consider when a loan is intended for securitization in the secondary markets.

A mezzanine loan is a type of subordinate financing. As with all subordinate financing, mezzanine loans offer property owners the opportunity to increase available loan proceeds to acquire or refinance real property above the maximum loan amount available through a senior mortgage loan. For a general discussion of mezzanine loans, including their characteristics, notable advantages and disadvantages for each of the loan parties, and the documents customarily used to evidence and secure a mezzanine loan, see Practice Note, Mezzanine Loans in Commercial Real Estate Finance ([2-600-7787](#)).

A mezzanine loan can be obtained from the same financial institution providing mortgage financing or from a separate mezzanine lender. In commercial real estate transactions, mezzanine loans are typically closed contemporaneously with a senior mortgage loan, but may be closed later.

For a general overview of commercial mortgage loans, see Practice Notes, Commercial Real Estate Loans: Overview ([6-508-8754](#)) and Basics of Secured Commercial Real Estate Financing ([9-385-3780](#)).

## THE MEZZANINE LOAN AND ITS COLLATERAL

In contrast to subordinate or junior mortgage loans, mezzanine loans are not secured by real property but rather by a pledge of the equity ownership interests of the first mortgage borrowing entity. For a chart depicting the basic structure of a mezzanine loan, see Real Estate Mezzanine Lending Chart ([2-539-3505](#)).

While subordinate mortgage loans are subordinate by their express terms, in contrast, mezzanine loans are structurally subordinate to the senior loan because the mezzanine borrower:

- Is a distinct entity from the mortgage borrower.
- Does not directly own the property securing the senior mortgage loan.

To ensure the senior mortgage loan is unaffected by enforcement actions taken against the mezzanine borrower, the mezzanine lender requires the mezzanine borrower to be structured as a single purpose, bankruptcy remote entity (see Practice Note, Bankruptcy Remote Entities in Commercial Real Estate Transactions ([8-606-5185](#))).

## INSURANCE AVAILABLE TO THE MEZZANINE LENDER

Mortgage lenders have long required mortgage borrowers to purchase on their behalf a standard American Land Title Association (ALTA) mortgagee title insurance policy (or its equivalent in states where an ALTA policy is unavailable) in the amount of the mortgage loan. The borrower's delivery of an acceptable mortgagee title policy (or final pro-forma policy with an appropriate tri-party closing agreement among the lender, borrower and title company) is a condition to closing most senior mortgage loans (see Practice Note, Commercial Real Estate Loans: Closings: Lender's Title Insurance Policy and Survey ([6-513-3412](#))) and Standard Document, Escrow Closing Instruction Letter for a Commercial Mortgage Loan ([6-517-0923](#)).

A mortgage loan title policy insures that:

- The borrower has fee or leasehold title to specifically identified real property.
- No liens are superior to the lien of the senior mortgage except matters disclosed as exceptions to coverage under Schedule B of the policy.

For guidance reviewing title policies, see Practice Notes, Commercial Real Estate Loans: Due Diligence: What a Title Search Is ([8-513-3350](#)) and Understanding Title Insurance: Policy Coverage and Exceptions ([9-566-0227](#)).

Mortgagee title insurance is not directly available to a mezzanine lender because the mezzanine borrower does not have a direct insurable interest in the real property. Mezzanine lenders generally have two options available to them. They can obtain, where available:

- A title endorsement to the mortgage borrower's owner's policy which gives the mezzanine lender a right to any claim payable to the mortgage borrower under the owner's title policy up to the amount of the outstanding balance of the mezzanine loan before any payment is made to the borrower (see Mezzanine Financing Endorsement).
- A Uniform Commercial Code (UCC) insurance policy (see UCC Insurance Policy for Lenders).

The insurance coverage available under a UCC insurance policy depends on whether the pledged equity interest given to secure the mezzanine loan is classified as investment property or a general intangible under the UCC (see Lien Perfection and Priority).

## MEZZANINE FINANCING ENDORSEMENT

In 2003, ALTA adopted an endorsement designed for mezzanine lenders referred to as the Form 16 (mezzanine financing) endorsement. This title endorsement is not available in every state and the price of the endorsement varies. For a list of available title endorsements in a particular jurisdiction or to compare availability across multiple jurisdictions see Real Estate Finance State Q&A Tool: Question 12.

If a mezzanine financing endorsement is available, mezzanine borrowers should expect the mezzanine lender to require the related mortgage borrower to purchase this endorsement in transactions where all or a portion of the equity interests in the borrowing entity are pledged as security for the mezzanine loan.

## MEZZANINE AND MORTGAGE LENDER'S INTEREST IN THE MORTGAGE BORROWER'S OWNER'S POLICY

Although the mezzanine lender has no security interest in the real property owned by the mortgage borrower, it still has an interest in evaluating the collateral given to secure the mortgage loan. This is because the value of the pledged interests securing the mezzanine loan depends on the value of the mortgage borrower which, in turn, is determined by the value of the assets the mortgage borrower owns.

### Mortgage Lender's Interest

The mortgage lender has an insurable interest in the property because the property is directly mortgaged to the lender as collateral for the mortgage loan. To reduce the income drain on the mortgaged property and isolate the mortgage borrower from the risk of bankruptcy, mortgage lenders routinely require their mortgage borrowers to be formed as a SPE. An SPE is:

- Formed exclusively for the purpose of owning and operating the mortgaged property.
- Restricted from incurring other debt and obligations.
- Limited in the activities in which it may engage.

A nonrecourse mortgage lender is particularly concerned about the value of the property and isolating the mortgage borrower from the risks of bankruptcy because enforcement of a nonrecourse loan is limited (except in specific circumstances) to:

- The mortgaged property.
- Any income derived from the mortgaged property, including the proceeds of any property and title insurance policy.

### Mezzanine Lender's Interest

Although the mezzanine lender does not have an insurable interest in the property directly, it has an insurable interest in any residual value in the property owned by the mortgage borrower, including rights to any proceeds paid under the owner's title insurance policy. Therefore, mezzanine lenders must verify in due diligence that:

- The mortgage borrower holds legal title to the real property collateral securing the senior mortgage loan.
- Title to the mortgaged property is free and clear of liens and defects except those expressly disclosed in the owner's title policy.

The benefits of obtaining a mezzanine financing endorsement include:

- The right of the mezzanine lender to receive title insurance proceeds otherwise payable to the mortgage borrower under the owner's title insurance policy (up to the amount of the outstanding balance of the mezzanine loan).
- Assurance that the owner's title policy cannot be amended without the express written consent of the mezzanine lender.
- A standstill agreement with the title insurer regarding any right of subrogation the title insurer may have against the mortgage borrower, the mezzanine borrower, or any guarantors of the mezzanine loan.

The mezzanine financing endorsement is one of a few endorsements that require the signature of the mortgage borrower in addition to the signature of the title company. The mortgage borrower's signature gives the insurer authority to pay claims under the policy to the mezzanine lender (up to the outstanding balance of the mezzanine loan) before it pays the mortgage borrower any amounts under the policy.

## COVERAGE AFFORDED UNDER THE MEZZANINE FINANCING ENDORSEMENT

A mezzanine financing endorsement provides three types of title insurance coverage not normally available under an owner's title policy. These coverages are:

- **Additional insured.** This coverage makes the mezzanine lender an insured party under the mortgage borrower's fee title policy.
- **Fairway endorsement.** This coverage protects against a lapse in coverage that might otherwise result because of a change of membership or dissolution of the insured (the limited liability company mortgage borrower).
- **Non-imputation.** This coverage modifies the standard exclusion in the owner's title policy jacket which would otherwise except coverage for:
  - matters created, suffered, assumed, or agreed to by the insured mortgage borrower;

- matters known to the insured mortgage borrower but not found on the public record or disclosed under the title policy; and
- losses suffered resulting from the mortgage borrower's failure to pay value for the interests insured under the owner's policy.

All three types of title insurance coverage benefit only the mezzanine lender. The mezzanine financing endorsement can be issued both before and after the senior mortgage loan closes, but if purchased after closing, would not cover matters arising in the gap period (the time period after the effective date of loan policy being endorsed and before the mezzanine financing endorsement is effective). The mezzanine endorsement does not insure the attachment, perfection, or priority of the lien of the mezzanine debt. For that protection, mezzanine lenders must look to the UCC insurance policy.

### UCC INSURANCE POLICY FOR LENDERS

UCC insurance policies are widely used in lending transactions, particularly in transactions involving mezzanine loans or loans secured by personal property rather than real property collateral (see Practice Note, Closing Corporate Transactions Involving Real Estate ([7-562-1345](#))).

A lender's UCC insurance policy insures the attachment, perfection, and priority of the secured party's lien on specifically identified personal property collateral. Title and lien priority to personal property is not insurable under an ALTA loan policy. In the case of a mezzanine loan, the personal property collateral consists of the mezzanine borrower's ownership interests in the mortgage borrower.

A UCC insurance policy issued in connection with a mezzanine loan can cover risks such as:

- Claims by other lien creditors.
- Claims by state and federal taxing authorities.
- Losses, including the loss of priority, due to errors in the filing and indexing of UCC-1 financing statements and any required UCC-3 continuation statements.
- The inadequacy of the security interests created under the security agreement between the mezzanine borrower and the mezzanine lender.
- Losses due to any inconsistency between the collateral description in the security agreement and the collateral's description in the financing statements placed in the public record.
- Losses due to any inconsistency between the precise legal name of the debtor and the debtor's name as it appears in any UCC filing securing the mezzanine loan.
- Security interests that prime the mezzanine loan due to filings made in the gap period between the date of the UCC search performed at loan closing and the date filing perfects the mezzanine loan.

The scope of coverage under a particular policy depends on the insurance and endorsements available in the jurisdiction, which may be regulated by statute. The unique facts of each loan transaction are evaluated during policy underwriting and also affect available coverage (see Underwriting and Due Diligence).

### UCC CONSIDERATIONS

The priority given to a perfected security interest under the UCC is affected by the classification assigned to the personal property collateral. Article 9 of the UCC allows the membership interests of a limited liability company to be classified as either investment property or general intangibles. Mezzanine borrowers can expect the insurer and its lenders to closely review the organizational documents of the mortgage borrower to ensure the lien created under the mezzanine loan achieves the greatest level of priority available under the UCC.

#### Lien Perfection and Priority

Pledged membership interests can be designated as investment property (which includes certificated and uncertificated securities) or as a general intangible, which is a catch-all category for personal property not otherwise defined under Article 9 of the UCC. While general intangibles can be perfected only by filing, investment property can be perfected by:

- Filing a UCC-1 financing statement in the appropriate jurisdiction.
- Possession, if the investment property is a certificated security.
- Control.

If the pledged interests are designated as a security, the mezzanine lender obtains control of the security if:

- In the case of a certificated security, it is delivered to the mezzanine lender. Delivery of a certificated security is achieved if the certificate is:
  - issued in bearer form;
  - issued in the name of the mezzanine borrower with an indorsement by the mezzanine borrower in blank (see Standard Document, Certificate of LLC Interests (Mezzanine Loan) ([w-007-5236](#))); or
  - assigned to the mezzanine lender under a separate agreement delivered with a certificate indorsed by the mezzanine borrower in blank.
- In the case of an uncertificated security, the mortgage borrower agrees in writing to follow the written instructions of the mezzanine lender party without further consent of the mezzanine borrower as the registered owner of the security (see Standard Document, Control Agreement (Mezzanine Loan) ([w-006-9041](#))).

Generally, the first party who perfects its lien by filing has priority. However, in the case of a security, perfection by control will prime a security interest perfected by any other method, even if control occurs after the date a competing lien is perfected by filing. Article 9 also defers to Article 8 if the investment property is transferred to a party who is protected under Article 8 of the UCC (see Opting Into Article 8).

Mezzanine lenders typically require the mortgage borrower's organizational documents to contain provisions allowing the mezzanine lender to achieve the highest lien priority available under the UCC, including:

- Designating the limited liability interests as securities (as that term is defined under Article 8 of the UCC).
- Opting into Article 8 of the UCC.

Designating the interests as securities allows the pledged interests to be treated as investment property under Article 9 enabling the mezzanine lender to:

- Perfect its security interest by control.
- Vote the interests pledged.
- Attain perfected purchaser status.

See [Opting Into Article 8](#). For a broader discussion about the creation, perfection, and priority of security interests created under Article 9 of the UCC, see [Practice Note: UCC Creation, Perfection, and Priority of Security Interests \(6-381-0551\)](#).

The loan parties should be aware that the insurance provider bases policy coverage on its underwriting and due diligence, including:

- The designation the mortgage borrower assigns to the collateral.
- The steps taken by the parties to optimize lien priority.

See [Underwriting and Due Diligence](#).

### Opting Into Article 8

Mezzanine lenders can strengthen the lien of their security interest by requiring the mortgage borrower to opt into Article 8 of the UCC under the terms of the entity's governing documents. The benefits to the mezzanine lender include:

- The right to vote (in place of the mezzanine borrower) with regard to any action that attempts to change the designation of the pledged interests as a security under Article 8 (see [Standard Document, Irrevocable Proxy Agreement \(Mezzanine Loan\) \(w-006-9089\)](#)).
- Protected purchaser status, if the mezzanine lender:
  - enters into the mezzanine loan without notice of any adverse claim; and
  - takes control of the security (see [Lien Perfection and Priority](#)).

Protected purchaser status gives the mezzanine lender the power to defeat competing claims of third parties to the extent the pledged interests under those competing claims are treated as general intangibles or perfected by filing alone.

If opting into Article 8, closing counsel must ensure that the issuer follows the specific requirements or formalities imposed under Article 8 that apply to the facts of the transaction.

One notable disadvantage of opting into Article 8 and designating the pledged interests as securities is that the provisions of the UCC that may otherwise override anti-assignment provisions under the formation documents of the issuer do not apply. To ensure that the mezzanine lender obtains a perfected, enforceable security interest in the pledged collateral, the mezzanine lender and insurer must address any anti-assignment language under the mortgage borrower's organizational documents that:

- Prohibits or restricts any member or partner from transferring or pledging its interests in the entity, including restrictions on governing rights, economic rights, or both.
- Requires the prior consent of the issuer or any other party to a pledge or transfer of the interests.
- Gives another party a right of first offer or right of first refusal, drag-along rights, tag-along rights or any other buy-sell agreement with respect to the interests.

- Creates a default under the issuer's formation documents if any member or partner pledges or transfers its interests.

To address any anti-assignment language in the mortgage borrower's organizational documents, a mezzanine lender will typically require:

- All necessary amendments or consents from the mortgage borrower and other third parties consenting to the pledge of the membership interests.
- An express authorization from the mortgage borrower allowing the mezzanine lender to exercise its economic and non-economic rights in the pledged collateral.

For an in-depth discussion of overriding anti-assignment provisions, see [Practice Note, Security Interests: LLC and LP Interests: Overriding Anti-Assignment Provisions \(6-520-9317\)](#).

If the mezzanine lender is not requiring the mortgage borrower to opt into Article 8, the mezzanine lender will usually require an agreement with the mortgage borrower prohibiting it from later opting in and designating the interests as a security. This attempts to prevent a later pledge to another creditor who could achieve protected purchaser status if it perfects its security interest on certificated or uncertificated securities by control. The competing lien of a protected purchaser would have lien priority over a mezzanine loan secured by a general intangible or perfected by filing alone, even if the competing lien is later in time.

### UNDERWRITING AND DUE DILIGENCE

The UCC policy insurer performs specific due diligence to underwrite the policy. Generally, the policy provider reviews:

- The proposed mezzanine loan documents.
- The organizational documents of the mezzanine borrower and mortgage borrower.
- Copies of all certificates representing the mezzanine collateral.

Counsel should provide early drafts of all relevant documents to the insurer so it can flag any impediment to coverage that is disclosed during due diligence and underwriting. Failure to provide the necessary due diligence early in the transaction can lead to delays and costly amendments to closing documents.

### MEZZANINE LOAN DOCUMENTS

The insurer also reviews all proposed mezzanine loan documents to establish, among other things, that the security interest in the pledged collateral has been properly created. The insurer asks to review all mezzanine loan documents including:

- The mezzanine loan agreement.
- The mezzanine pledge and security agreement.
- A control agreement, if the pledged interests are uncertificated securities.

The insurer also requires:

- Evidence of an irrevocable proxy from the mortgage borrower giving the mezzanine lender the power to vote the interests of the mezzanine borrower regarding matters relating to Article 8 (to the

extent the mezzanine lender requires the mortgage borrower to opt into Article 8 of the UCC).

- UCC-1 financing statements.

### ORGANIZATIONAL DOCUMENTS OF THE LOAN PARTIES

Because a UCC policy insures the lien creation, perfection, and priority of the mezzanine loan, the insurer needs to review the governing documents of the mortgage borrower and borrower parties to establish, among other things, that:

- The mezzanine borrower has lien free title to the pledged collateral.
- The loan transaction is properly authorized by the loan parties.
- The documents optimize the mezzanine lender's ability to attain and preserve lien priority.

The loan parties should expect the insurer to require copies of the organizational documents of the mortgage borrower and the mezzanine borrower including the following:

- An organizational chart.
- Copies of the filed articles of formation and all amendments.
- Signed copies of the operative governing document (by-laws, operating agreements, or partnership agreements) and all amendments.
- Evidence of good standing in each entity's state of formation.
- Appropriate consents and resolutions authorizing the loan transaction generally and the pledge of ownership interests specifically.
- Any contribution or assignment agreements.

### CERTIFICATED SECURITIES REPRESENTING THE PLEDGED COLLATERAL

The insurer needs to review copies of the certificated securities and all indorsements to the certificates to confirm they contain all appropriate information, legends, and signatures. The pledged ownership interests must be traced back to the date the mortgage borrower was formed. If applicable, the mortgage borrower is expected to submit copies of any prior certificates representing the pledged collateral, including certificates marked "cancelled," replacement certificates, and duplicate originals.

Before closing, the mezzanine lender must also provide evidence and confirmation that it is in possession of the pledged certificated securities and control has been established in accordance with the UCC. The mezzanine lender must be extremely careful to properly safeguard the original certificates. A standard lender's UCC insurance policy does not insure (absent a special endorsement) against lost, stolen, or destroyed certificates (see Standard Document, Certificate of LLC Interests (Mezzanine Loan): Box: Don't Lose Those Certificates ([w-007-5236](#))).

### SPECIAL CONSIDERATIONS RELATING TO LOAN SECURITIZATION

Loan counsel should consider the requirements and expectations of the credit rating agencies if the loans are expected to be presented for rating in connection with securitization in the secondary markets (see generally, Practice Notes, Commercial Mortgage-Backed

Securities (CMBS) Financing: Overview ([9-583-9145](#))) and Credit Ratings and Credit Rating Agencies ([7-382-1002](#)).

Failure to satisfy rating criteria can affect the rating assigned to the securities issued in connection with securitization of a loan. Rating agencies generally expect that:

- The pledged interests under a mezzanine loan will represent 100% of the ownership interests in the mortgage borrower leaving no unsecured minority interests.
- The mezzanine lender will obtain, where available:
  - a mezzanine financing endorsement (or its equivalent) in an amount at least equal to the combined value of the senior and mezzanine loans; and
  - a UCC insurance policy.
- The senior mortgage lender and mezzanine lender will enter into an intercreditor agreement (see Practice Note, Intercreditor Agreements Between Senior Mortgage Lenders and Mezzanine Lenders ([w-001-6308](#))).
- The mortgage borrower will opt into Article 8 of the UCC allowing the mezzanine borrower to achieve protected purchaser status.
- The pledged interests will be represented by certificated securities.
- The security interest will be perfected by both:
  - filing; and
  - control.

For large loans, in which the mortgage borrower delivers a nonconsolidation opinion, the rating agencies may require the opinion giver to address the fact that the rights assigned to the mezzanine lender under the owner's policy by way of the mezzanine financing endorsement (see Mezzanine Financing Endorsement) is a technical violation of the bankruptcy-remote requirements which prohibits the mortgage borrower from guarantying or providing surety for any other loan.

The right granted under the mezzanine endorsement has become a permissible exception to the bankruptcy-remote requirements imposed on mortgage borrowers. However, the rating agencies may still require the opinion giver to examine the assignment in a reasoned opinion.

For a general overview of opinions given in real estate transactions, see Practice Note, Legal Opinions: Commercial Real Estate Finance ([3-590-8127](#)).

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