
TITLE ISSUES

July 2007

VOLUME 19, NUMBER 1

UNDERSTANDING MEZZANINE FINANCING: BRIDGING THE FUNDING GAP

By Theodore H. Sprink, Senior Vice President and National Director of Sales & Marketing

UCC Insurance Division

Fidelity National Financial Family of Companies

A well-known and respected real estate development company is acquiring a leading competitor, which will firmly position the new entity as a market leader for its combined product line. Each company has operated for more than 15 years under its current ownership and management, each believes it has a solid balance sheet and both enjoy positive cash flows. There are savings that can be associated with eliminating certain expenses once the companies are combined; and it appears the purchase price is right.

To fund the acquisition and to provide working capital, a loan of \$75 million is required. Because the borrower does not believe it is a candidate to issue new stock through a private placement for the purpose of raising capital, a loan facility is needed. Notwithstanding adequate cash flow to service the proposed new debt, the bank is able to loan only \$60 million, referring to insufficient collateral as the basis for the \$15 million short-fall in required funding.

So, where does a qualified borrower with a proven track record, strong management, a solid business plan and healthy cash flow go during a time in which a "credit crunch" has become a factor?

BRIDGING THE FUNDING GAP

Mezzanine financing can provide additional capital to middle-market businesses in a manner gaining acceptance throughout the capital markets. It is a powerful resource for funding growth, oftentimes an important component of a larger financial structure, frequently involving expansion, leveraged buy-outs, and recapitalizations. Such funding opportunities generally represent a high yield loan facility for lenders and investors in so-called "mezzanine funds". Many such funds target transactions in the \$5 –100 million range.

DEFINING THE BRIDGE

Essentially, mezzanine funding provides subordinated debt financing with greater returns than traditional bank debt. The term "mezzanine" is related in the context of a capital structure to the phrase "in the middle". Sometimes referred to as "mezzanine capital", it is a form of junior debt that bridges the gap between private equity investment and the traditional bank loan. The



mezzanine debt is senior to the original equity but junior to the bank, hence, viewed to reside in the middle. Mezzanine financing is generally used to fill the gap between first mortgage financing and the equity participation of the principals of the borrowing entity. The mezzanine loan is often viewed as “interim” financing, and is sometimes referred to as a “bridge”.

The mezzanine component generally represents well below 50% of a “transaction’s” capital structure. With the Loan-To-Value (LTV) ratio of first mortgage financing commonly limited by loan agreement to 75% (which agreement frequently restricts further encumbrances in the form of second mortgages), the additional mezzanine component can contribute to an aggregate LTV of up to 95%. The 20% “differential” in this example, serves as the equity that can be used by the borrower *or its principals* to gain access to additional capital vis-à-vis the mezzanine loan facility.

The bridge then, is *new capital* available to finance acquisitions, growth, re-capitalizations and working capital needs in a manner that complements the underlying relationship with the senior lender.

Mezzanine financing is most often extended to the partners or equity holders of a borrowing entity, frequently a Limited Liability Company (LLC). The partners or equity holders are also commonly structured as LLC’s with the lender taking a pledge of the party’s equity interest as its security. The pledge of the equity interest in the LLC can be defined as either “investment property” or “general intangible” (personal property) pursuant to Revised Article 9 of the Uniform Commercial Code (UCC), 810 ILCS 5/9-101 et seq., and *can be insured for attachment, perfection and*

priority in a manner similar to traditional real estate title insurance for the real estate portion of the loan transaction.

WHY THE BRIDGE?

In the middle markets, there is a need for the funding of growth and expansion, there are many borrowers without sufficient traditional collateral to access necessary capital and there are many highly qualified investors attracted to filling the gap between debt and equity.

BUILDING THE BRIDGE

Targeted gross returns for lenders and investors are in the high teens to low twenties, and equity “kickers” or conversion rights are commonly factored into this expectation. Generally, mezzanine loans are interest-only at prime plus 2 - 4 points, often payable every six months with an average maturity of 5 - 7 years. The loan costs to the borrower, including legal and accounting fees may equal 5% of the loan amount, exclusive of any additional fees.

Unlike many banks seeking an early return of principal, mezzanine lenders generally focus on the relationship’s overall yield, hence an interest in future equity participation. Typically the exit strategy for the mezzanine lender is the borrower going public, an equity issuance, or the borrower being sold or otherwise re-financed. When one of these events takes place, the lender gets back principal, interest and any capital gains on the sale of the stock generated as the result of exercising conversion rights.

Because many senior lenders view mezzanine financing as having strengthened the balance sheet of the borrower by adding capital that is junior to their loan, an opportunity exists for the traditional lenders to benefit from the popularity of mezzanine financing, and the strength and impressive expertise of many of the major players underwriting and funding mezzanine loans.

STRENGTHENING THE BRIDGE

The Mezzanine market segment is commonly linked to the commercial real estate market, with a *pledged equity interest being closely tied to income producing real property*. The transaction is often a shopping center, hotel, office building, apartment complex or development project with similar characteristics. As a result, underlying concerns to mezzanine lenders include declining real estate values, aggressive low interest rate lending by traditional lenders, buyers who may have over-paid for a property and general economic factors. These fundamental market conditions contribute to impact property-rent growth and future revenue streams. Naturally, any new debt can represent potential strain on a property, and exposure to increased vacancies and declining rents. Highly leveraged assets may be difficult to re-finance or even to sell.

A major development providing additional protection to mezzanine lenders is the availability of “title insurance” covering the pledge of a membership interest in a partnership or LLC, which, as mentioned above, may be either investment property or a general intangible according to Revised Article 9 of the Uniform Commercial Code. *The mezzanine lender’s ability to enforce the validity and*

priority of its security interest can be both complex and challenging.

Perfection of a security interest in the ownership of a partnership or LLC can be accomplished by 1) filing the appropriate UCC-1 Financing Statement in the appropriate jurisdiction, 2) by taking possession of the “collateral” if the interest is certificated or otherwise subject to a Control Agreement (such as a Deposit Account), or by 3) control if the security interest is deemed investment property. Control is generally considered the strongest method of perfecting the security interest in a pledge of a partnership or LLC membership interest.

In certain cases the mezzanine lender may improve its position by the manner in which it treats its security interest in the pledged collateral. At the request of the mezzanine lender, a partnership or LLC can “opt-in” to Article 8 of the Uniform Commercial Code, 810 ILCS 5/8-101 et seq., and elect to have its interest therein treated as *securities*.

Perfection would then be by three-way Control Agreement between the borrower, lender and the partnership or LLC. In addition to the use of a Control Agreement, the filing of a UCC1 Financing Statement is always recommended.

RISKS TO THE BRIDGE

Bank audits reveal that up to 40% of the loans reviewed may be subject to some type of documentation defect that could result in the lender’s security interest being set aside. These loans face the risk that a bankruptcy trustee could challenge the attachment, perfection

and priority of these security interests. Market research shows that, incredibly, most documentation defects are rather clerical in nature: incorrect name of borrower, wrong jurisdiction searched, wrong state of filing, the lack of filing the appropriate documents, an error in the collateral description and the like. The research indicates that it might be the lowest paid individual at either the bank or the law firm that was responsible for perhaps the greatest risk to the lender: the loss of reliance collateral.

Recent cases also illustrate a lender's exposure when relying on search vendors or outside counsel to assure proper attachment, perfection and priority of security interests in personal property. See *Lory v. Parsoff*, 745 N.Y.S.2d 218 (App. Div. 2002) (failure to file a UCC-1 Financing Statement by outside counsel led to a legal malpractice judgment); *Shelby County State Bank v. Van Diest Supply Co.*, 303 F.3d 832 (7th Cir 2002) (incorrect and ambiguous Financing Statement limited collateral subject to a bank's filing); *Puget Sound Fin., LLC v. Unisearch, Inc.* 146 Wn.2d 428 (2002). (UCC search vendor's liability for damages was limited to \$25 for the failure of the vendor's search to identify prior liens); and *In re: The IT Group, Inc. Co., et al, Fleet Nat'l Bank v. Whippany Venture I, LLC.*, 370 B.R. 762 (D. Del. 2004) (defective description in collateral and incorrect filing jurisdiction led to a lender failing to properly perfect its security interest). See also *First Nat'l Bank of Lacon v. Strong*, 278 Ill. App.3d 762 (1996).

PROTECTING THE BRIDGE

Attachment, perfection and priority of the mezzanine lender's security interest over other secured or intervening parties can be

insured by the use of UCC insurance, available from the nation's largest title insurance underwriters. This form of insurance has been widely embraced by leading mezzanine lenders primarily for the benefit of shifting the responsibility for the proper perfection of the lender's security interest in the collateral to a large insurance company for relatively modest costs, and for the value a "second set of eyes" such insurance underwriting represents.

UCC insurance is a lender title insurance product which insures the security interest in loans secured by non-real estate assets for validity, enforceability, attachment, perfection and priority. UCC insurance covers fraud and forgery, insures the gap and provides cost of defense coverage in the event of a challenge to the lender's security interest. Policies include UCC search and filing services, are life-of-loan and are frequently issued on a post-closing basis. Thus, lenders can outsource UCC search, document preparation and filing functions, while wrapping the entire transaction in an insurance policy, effectively shifting the risk of improper attachment, perfection and priority.

When combined with a traditional title insurance policy, UCC insurance enables the title industry to insure "both sides" of a mixed collateral transaction—those deals secured by both real property and personal property. Such transactions typically include sales and refinances of manufacturing concerns, retail operations, hotels, power plants, casinos, hospitals, and the like.

UCC insurance may replace the costly traditional legal opinion rendered by borrower's counsel as a lender requirement. In addition, with regard to high risk-low billable documentation matters, outside counsel may be able to more appropriately focus on negotiating and drafting primary loan documents. Thus, with UCC insurance, the parties to the transaction can let the UCC insurer worry about UCC matters and bear the cost of defense of these matters.

CONCLUSION

It is always recommended that lenders, investors and borrowers retain legal counsel experienced in such complex loan transactions. Major national law firms with a demonstrated expertise in the mezzanine markets and capable of negotiating fair and

equitable loan facilities will serve to reduce costs associated with loan origination in the long run.

UCCPlus Insurance Protection was introduced as a valuable component of mezzanine financing by Fidelity National Title, Chicago Title and Ticor Title insurance companies in late 2001. ***UCCPlus*** insures mezzanine and asset based loans secured by non-real estate assets for attachment, perfection and priority. Coverage extends to validity, enforceability, fraud and forgery, and provides for the costs of defense in the event of a claim. Additional details about coverage and exclusions from coverage can be found at www.uccplus.com or by contacting the author at telephone number 619-744-4410 or tsprink@fnf.com.

We welcome your topic suggestions for future Title Issues. If you are interested in submitting your ideas, please e-mail us at: Patrick.quist@ctt.com or complete this form and mail to:



Chicago Title Insurance Company

505 E. North Ave. Suite 300 Carol Stream, IL 60188

Patrick Quist, Vice President, Attorney Agency Sales, SW/Metro

TOPIC: _____

Submitted By: _____

Company/Firm Name: _____

Address: _____

City, State, Zip Code: _____

Telephone Number: _____

Date: _____

For additional Title Issues, please log on to the CTIC Metro Website:

www.cmetro.ctic.com or visit The National Information Website at: <http://www.ntiweb.com>