LOST CERTIFICATED INTEREST IN A REAL ESTATE MEZZANINE TRANSACTION

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There is an ever increasing problem as mezzanine financing transactions from 2006 and 2007 are being reworked and the certificates representing the pledged equities cannot be found.

A "mezzanine transaction" traditionally involves the pledging of the equity that owns the real estate. The additional financing increases the financial stack which when added to the mortgage financing can bring the total to 80% or more of the transaction.

In 2007, when Moody's published its Approach to Rating Commercial Real Estate Mezzanine Loans it made the recommendation that mortgage borrower must "opt-in" to Article 8 of the UCC, and must "certificate" its ownership interests as "securities" under Article 8.

The rationale was explained as follows: The mezzanine lender then can obtain priority and perfection of its security interest merely by taking control or physical delivery of the LLC or partnership certificates, and can take advantage of so-called "protected purchaser" status. Therefore, Moody's expects that mortgage loan borrowers will irrevocably "opt-in" to Article 8 of the UCC and will certificate the partnership or LLC membership interests that will be pledged to the mezzanine lender.

In 2006 and 2007 when mezzanine financing was at its height, over 90% of the transactions included "opting-in" to Article 8 of the UCC and having the pledged equity certificated. Those certificates were taken at closing by lender's representative perfecting the lien. Possession provided the control requirement of the statute.

The certificates were endorsed in blank and were to be held by the lender throughout the life of the loan. The certificates were and are negotiable security instruments.

As these loans have matured, been assigned and sold and in some cases defaulted, the equities represented by those certificates need to be located and passed to any new secured party. Unfortunately, new lenders and their insurance companies are finding more and more situations where the certificates cannot be located. As they are negotiable, it creates a potential liability should those certificates be obtained by a third party without knowing that they had been lost or even stolen. (The views in this article are solely those of the author.)

The UCC, under Article 8, specifically addresses what needs to be done in this situation by the original secured party in order to protect any new secured party that will accept a replacement certificate.

Section 8-405, entitled Replacement of Lost, Destroyed or Wrongfully Taken Security Certificate sets forth the requirements:

(a) If an owner of a certificated security, whether in registered or bearer form, claims that the certificate has been lost, destroyed, or wrongfully taken, the issuer shall issue a new certificate if the owner:

> **(1) so requests before the issuer has notice that the certificate has been acquired by a protected purchaser;**
> **(2) files with the issuer a sufficient indemnity bond; and**
> **(3) satisfies other reasonable requirements imposed by the issuer.**

To overcome the potential liability of a lost or stolen certificate surfacing after a new loan is in place using that equity as collateral, expensive options are available to the original lender/secured party. It can obtain a bond in the amount of the original loan. This is a very expensive product which any lender would be reluctant to pursue. It normally requires a cost of upwards of 10% of the amount in question. So on a $100 million dollar loan, $10 million would be required to obtain the bond.

The alternative is to offer an indemnity should the original certificate surface. Any new lender or any insurance company issuing a UCC policy insuring the transaction would require financial information from the proposed indemnitor to determine if it has sufficient financial assets should a claim arise. Considering the size of most of these mezzanine deals, considerable assets would be needed to meet this requirement.

What we have seen is that the certificates are rarely if ever lost. They are usually misplaced. They are taken at the real estate closing and with the other closing documents placed in a box and stored. The real estate closer may not realize the negotiable status of the document. We have seen situations where extensive searches have turned up certificates on the date of closing avoiding the pricey requirements dictated by the code.

It is essential that those handling the closing of mezzanine financing transactions be aware of the negotiable status of the certificates and maintain them carefully so that they are readily available in the future. If they are only stuffed away in a file without documentation to indicate their location, these lost certificates that were to provide comfort in the form of valuable collateral at the time of the original closing will be transposed into exceptionally costly mistakes when they can't be located at a later date.

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