

**UCC OPINIONS
IN REAL ESTATE FINANCINGS**

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ATTACHMENT A - Prepublication Exposure Draft of the UCC Report

UCC OPINIONS IN REAL ESTATE FINANCINGS

I. INTRODUCTION

A. Borrower Counsel Opinions

A real estate lender often requires an opinion of counsel for the borrower as a condition to the advance of a loan. There are many reports, white papers, and treatises addressing issues in drafting opinion letters in real estate finance matters that offer helpful insight into drafting legal opinions, including *Real Estate Opinion Letter Guidelines*, prepared by the Attorneys' Opinion Committee of the American College of Real Estate Lawyers and the Committee on Legal Opinions in Real Estate Transactions of the ABA Section of Real Property, Trust and Estate Law, 38 REAL PROP. PROB. & TR. J. 241 (2003), *The Real Estate Finance Opinion Report of 2012*, prepared by the Committee on Legal Opinions in Real Estate Transactions of the ABA Section of Real Property, Trust and Estate Law, the Attorneys' Opinion Committee of the American College of Real Estate Lawyers, and the Opinions Committee of the American College of Mortgage Attorneys, 47 REAL PROP. TR. & EST. L. J. 213 (2012) and THE ACREL PAPERS 121 (Spring 2013) (the "**2012 Report**"), and *Local Counsel Opinion Letters - A Supplement to the Real Estate Finance Opinion Report of 2012*, prepared by the Committee on Legal Opinions in Real Estate Transactions of the ABA Section of Real Property, Trust and Estate Law, the Attorneys' Opinion Committee of the American College of Real Estate Lawyers, and the Opinions Committee of the American College of Mortgage Attorneys, 51 REAL PROP. TR. & EST. L. J. 167 (2016) (the "**Local Counsel Supplement**"). Recently, the same groups that drafted the 2012 Report and the Local Counsel Supplement, together with the American College of Commercial Finance Lawyers, worked for several years on a report that will be released soon entitled *Uniform Commercial Code Opinions in Real Estate Finance Transaction Opinion Letters* (the "**UCC Report**"). The UCC Report addresses the types of UCC issues that will typically be addressed by real estate counsel as a part of their opinion practice. Attached to these materials as Attachment A is a draft of the current UCC Report (Prepublication Exposure Draft of May 15, 2018), which remains subject to review and revision. The final UCC Report will be published in Volume 53, Number 2 of the ABA Real Property, Trust and Estate Law Journal in late 2018.

The UCC Report does not purport to provide a complete review of all aspects of the UCC. It refers practitioners to more complete and extensive reports on pure UCC issues, such as the *Special Report of the*

TriBar Opinion Committee, U.C.C. Security Interest Opinions-Revised Article 9, 58 BUS. LAW. 1451 (2003) (the "**TriBar Report**"), Philip H. Ebling and Steven O. Weise, *What a Dirt Lawyer Needs to Know About New Article 9 of the U.C.C.*, 37 REAL PROP. PROB. & TR. J. 191 (2002), and *Initial Report of the Joint Task Force on Deposit Account Control Agreements*, 61 BUS. LAW. (2006) and the *Additional Report*, 64 BUS. LAW. 801 (2009) (collectively, the "**DACA Reports**"). The UCC Report instead provides guidance for real estate lawyers who are required to address UCC issues that typically arise in real estate financings. While fixtures may be the most common type of collateral that a real estate lawyer could expect to encounter in a real estate financing, it is not uncommon for real estate lawyers to be involved in financings including security interests in oil, gas, and other minerals, timber to be cut, farm products, equipment, and other goods, deposit accounts, and investment property. The UCC Report addresses each of these types of collateral and the specific rules and considerations applicable to each, while referring to the TriBar Report or other pure UCC authorities for more extensive treatment.

B. Who Can Benefit from the UCC Report

Although there are several opinion reports addressed primarily to UCC lawyers, "dirt" lawyers may seldom need the detail of such UCC reports as the TriBar Report or other pure UCC commentary. A dirt lawyer who is also expert in UCC matters will find the UCC Report a good review of UCC opinion matters. A dirt lawyer who only seldom addresses UCC opinion matters will find the UCC Report a streamlined version of issues applicable to the real estate practice. Firms with younger lawyers who may need to delve into UCC issues in real estate transactions will find the UCC Report a great teaching tool.

C. Outline of the UCC Report

The UCC Report consists of a discussion of UCC principles and issues in a commentary (the "**Commentary**") and an illustrative opinion form that reflects the matters discussed in the Commentary (the "**Illustrative Opinion**"). While the Illustrative Opinion does not purport to be mandatory, or even "best practice," it illustrates the concepts discussed in the Commentary in a concrete form that can be easily incorporated into financing opinions. The Illustrative Opinion is not just limited to UCC issues. Rather, the drafters of the UCC Report worked from the illustrative opinion form used in the 2012 Report and incorporated UCC opinions, assumptions, and issues into what was originally a pure real estate financing opinion. As a result, the Illustrative Opinion form offers a

comprehensive resource for the real estate opinion and for related UCC security interests.

While the UCC Report applies generally to all jurisdictions, these materials will assume that the opinion requested is from a Texas attorney who intends to opine solely on Texas law matters. The Texas attorney may be opining as lead (or only) counsel for the borrower or may be serving solely as local Texas counsel for a borrower who is represented by another firm acting as general or lead counsel or that may address laws of other jurisdictions. While the borrower's counsel may only address issues of Texas law, its opinion will carefully identify that limitation, as the Texas Business and Commerce Code (hereafter, the "*Texas UCC*") contains choice of law provisions in Chapter 9 that might require application of another law to the creation, attachment, or perfection of a security interest. Those matters will be discussed below.

II. GENERAL UCC PRINCIPLES

The Commentary begins with a discussion of the general rules of creation, attachment, and perfection of UCC security interests. These are the three steps necessary to create a security interest and to make it enforceable against third persons, including other secured parties, purchasers, and bankruptcy trustees. The initial sections of the UCC Report offer an outline of these steps generally applicable to all types of collateral and identify what an opinion giver must verify or assume as the basis of a borrower's counsel opinion. Later sections of the UCC Report then address instances in which the general rules have been modified to reflect different rules applicable to specific types of collateral.

A. Creation

The Commentary notes that the UCC does not actually define "creation" or specify what is required to create a security interest. UCC Report at 4. The concept actually appears in the definition of a security agreement as "an agreement which creates or provides for a security interest." Texas UCC §9.102(73). Creation (except in limited instances in which tangible personal property is physically delivered in pledge to a secured creditor, which is not typically involved in real estate financings) arises from the authentication of a security agreement that adequately describes the collateral to be subjected to the lien in favor of the secured party. Texas UCC §9.203. The question of the sufficiency of description of the collateral is important and will be discussed in more detail in the following sections.

Thus, the Commentary alerts the opinion giver that it must either determine or assume that the grant of a security interest was properly documented under UCC

and applicable non-UCC law, such as contract law and entity authorization law. UCC Report at 4 and 5. If the opinion giver is to opine on creation of a security interest, it must address the same issues that arise in any opinion on the creation of a lien, namely, verifying that all contractual and entity formation and authorization requirements have been complied with. Also, as noted below, it will have to consider the law governing those aspects of the contract or will have to assume their existence.

B. Attachment

A security interest attaches when the debtor obtains rights in the collateral and receives value for the grant of the security interest. Texas UCC §9.203. Attachment is based upon facts that are typically assumed by the borrower's counsel. Rights in the collateral is basically a title opinion, and it is not customary for borrower's counsel to provide such a title opinion. Value is defined in Texas UCC §1.204 to include, among other matters, a binding commitment to extend credit, the extension of immediately available credit, or any consideration sufficient to support a simple contract. On occasions, lender's counsel may argue that borrower's counsel should be able to opine that the borrower has received value, particularly in the case of the closing of a new loan. In most instances, however, borrower's counsel is able to push back against these requests. If counsel is serving as local Texas counsel in a multi-state transaction, for instance, it may not be reviewing or opining on the credit agreement or notes and would not be party to the flow of funds pursuant to the credit agreement.

C. Collateral Description

Critical to the creation and attachment of a security interest is the inclusion of a legally sufficient description of the collateral. This will be discussed in greater detail below in connection with discussions of the particular types of collateral that real estate counsel may cover in its opinions. Although descriptions can be very detailed, as often encountered in a deed of trust of improved property, it is possible to utilize the categories of UCC collateral, such as "fixtures," "equipment," "accounts," or "as-extracted collateral." However, a description of "all debtor's assets," which is adequate for a financing statement, is not adequate for purposes of the description in the security agreement.

Although the borrower's counsel is able to review the form of the description of the collateral, the Commentary reminds the opinion giver that "[l]egal sufficiency of the description does not mean that it is factually accurate." UCC Report at 6. Matters of completeness, adequacy, or accuracy of the description

are not typically within the knowledge of, or expected to be provided by due diligence of, the borrower's counsel, who would typically disclaim such matters in the opinion.

D. Perfection

A security interest is perfected and enforceable against third parties by one of the means recognized under the Texas UCC, including filing of a financing statement, filing of a mortgage as a fixture filing or filing of a security interest in as-extracted collateral, control of certain types of properties, such as deposit accounts or investment accounts, or possession of physical collateral. Texas UCC §9.203.

In addition to understanding the requirements of these steps, counsel must be aware of the potential governing law issues that determine which state's laws govern the steps necessary for perfection of the security interest. These issues are discussed in further detail below. *See*, Stephen C. Tarry, *Traps for the Unwary in Perfecting UCC Security Interests*, *Essentials of Business Law: Protecting Your Business* (State Bar of Texas, 2018).

A particular issue that arises in connection with perfection is properly identifying the name of the debtor in the financing statement. In the case of a corporation, limited liability company, or other entity that would constitute a "registered organization" under Texas UCC §9.102(71), the financing statement must use "the name that is stated to be the registered organization's name on the public organic record most recently filed with or issued or enacted by the registered organization's jurisdiction of organization that purports to state, amend, or restate the registered organization's name." Texas UCC §9.503(a)(1). The "public organic record" under Texas UCC §9.102(68-a) is not the information reported on the applicable Secretary of State's website (which could contain an error in transcription from the certificate of formation of the applicable entity). In order to verify that the correct name has been listed it would be necessary to obtain copies of the actual filings themselves from the Secretary of State. Unless borrower's counsel has access to that information it would typically assume that the name of the debtor has been correctly listed in the financing statement.

The determination of the name of an individual as a debtor has raised many questions in all states. An individual may have one name on a birth certificate, may use a nickname or initials rather than a full name in business transactions, and may have one driver's license from Texas with one name and a previous driver's license from another state with a slightly different name. These variations cause problems for the careful lender

that is trying to search UCC records for prior filings and also the careful lender that is trying to use the correct name to be perfected against subsequent third parties. Texas UCC §§9.503 (a)(4) and (5) and (g) address these concerns. If the debtor has a Texas driver's license (or personal identification card in lieu of a driver's license) that is not expired, the name on the license or card must be used. If the individual has more than one such license or card, the most recently issued one must be used. If the individual does not have a Texas driver's license or identification card, the financing statement must provide "the individual name of the debtor or the surname and the first personal name of the debtor" although there is no indication as to how the searching or filing lender can determine this.

Each of these steps is required by the lender, but they may not be matters that borrower's counsel should be required to address in its opinion. Many of these steps are typically assumed in the borrower's counsel financing opinion, as discussed below.

E. Priority

The Texas UCC contains specific and detailed rules for determining the priority of a security interest as against other creditors, purchasers, lienors, licensees, and other persons. Texas UCC §§9.317-343. However, the Commentary notes that it is typical for a UCC opinion in a real estate financing to exclude any opinion as to priority and to provide an express exclusion of any matters regarding priority. As a result, the UCC Report does not dive into these detailed and somewhat complex rules governing priority of security interests and instances in which a perfected security interest will be subject to rights of other parties.

III. OPERATIVE LAW

If borrower's counsel intends to address only Texas law in its opinion, it must consider the various instances in which the laws of a state other than Texas may govern the creation, attachment, or perfection of a security interest.

A. Creation

Creation of a security interest is essentially a matter of contract between the grantor and the secured party. Their contract can generally select the laws of whatever jurisdiction they wish that bears a reasonable relationship to the transaction under Texas UCC §1.301(a). That section excludes the rules governing perfection, the effect of perfection or nonperfection, and priority (discussed below) from the ability of parties to make such choices. Texas UCC §1.301(b). Texas UCC §1.301(c) further provides that if a transaction is a

“qualified transaction” under Section 271.001 of the Texas Business and Commerce Code that section will determine the effect of the parties’ choice of law. If borrower’s counsel intends to address solely Texas law but the security agreement contains a choice of another state’s laws to govern the agreement, the borrower’s counsel opinion would typically assume that a security interest has been created under the laws of the governing jurisdiction.

B. Attachment

Attachment is creation of security interest, typically by authentication of a security agreement, together with the grantor’s acquiring rights in the collateral subject to the security agreement. This also is subject to the laws of the jurisdiction selected by the parties.

C. Perfection

Unlike creation and attachment, the state whose laws govern perfection is not subject to the determination of the parties. Rather, it is strictly governed by the provisions of the Texas UCC, and the borrower’s counsel opinion would typically either assume or satisfy itself that Texas is the proper state to govern the perfection of the security interest. The state governing perfection in the case of fixtures and other specific collateral is discussed below. In most other cases the laws of the jurisdiction of the “location” of the debtor will govern perfection, the effect of perfection or non-perfection, and priority of a security interest. Texas UCC §9.301(1). An individual is located at the individual’s principal residence. Borrower’s counsel may not have the necessary information to opine on that issue and would likely assume that as a part of an opinion. A registered organization, such as a corporation or limited liability company, is located in the state in which it has been organized, which is a fairly easy test to confirm. However, organizations that are not “registered organizations” are located at its place of business (if there is only one) or at its chief executive office (if there is more than one). Texas UCC §9.307. If the opinion involves such an opinion it would typically assume the facts necessary to determine its location.

IV. FIXTURES

A. Creation and Attachment

Fixtures constitute the type of collateral most often included in a real estate financing and most often required to be addressed by borrower’s counsel in a real estate financing opinion. Fixtures are defined in Texas

UCC §9.102(41) as “goods that have become so related to particular real property that an interest in them arises under the real property law of the state in which the real property is situated.” The Texas UCC does not attempt to provide a special definition for UCC purposes but refers back to real property law for guidance. The Texas Supreme Court outlined the steps for the determination of a “fixture” in *Logan v. Mullis*, 686 S.W.2d 605 (Tex. 1985) as involving a review of the mode and sufficiency of annexation (either real or constructive), the adaptation of the article to the use or purpose of the realty, and the intention of the party who annexed the article to the realty. *Id.* at 607. These are obviously questions of fact that may be determined only at the time of litigation. Goods that would not meet the test of fixtures under Texas law would likely be classified as “equipment” which is defined as “goods other than inventory, farm products, or consumer goods” in Texas UCC §9.102(33).

The identification of what does or does not constitute a fixture has importance in the determination of the type of financing statement to be used, namely, a fixture filing rather than a standard financing statement covering equipment; the state whose laws will determine the perfection or non-perfection of the security interest, namely the state in which the fixtures are located rather than the location of the debtor; and the relative priority, in certain instances, of the holder of a fixture filing against an encumbrancer of the real property. Lenders typically perfect against such goods both as fixtures and as ordinary goods, such as equipment, without engaging in a detailed analysis of the proper classification. However, a lender financing only fixtures, such as an HVAC system or industrial component, that is not taking a mortgage on the underlying real property would be concerned about the priority of its lien against a lender providing general financing for the debtor and taking a mortgage on the real property. In the limited circumstances reflected in Texas UCC §9.334, the fixture filer can have priority over an encumbrancer or owner of the real property.

As noted in the Commentary, a fixture, by definition, is property in which a lien may arise under the real property law of the state, and is therefore subject to the lien of the mortgage itself. However, as a matter of customary practice, lenders typically will file both a deed of trust and a fixture filing as well as a financing statement covering “goods” or “equipment” (along with other items of collateral).

While the lender will attempt to perfect in goods regardless of whether they constitute fixtures or ordinary goods, borrower’s counsel should not be expected to opine on the character of the property. As noted from the *Logan* case, the determination is a factual

matter and borrower's counsel, at least in a real estate financing matter, should not be expected to assure the lender as to the proper characterization of the property. The Commentary suggests that borrower's counsel merely address the creation of a security interest in goods that are or are to become fixtures under Texas law, without identifying which, if any, property might be a fixture.

B. Perfection

A security interest in fixtures is perfected by a fixture filing. A fixture filing is defined in Texas UCC §9.102(40) as "the filing of a financing statement covering goods that are or are to become fixtures and satisfying Sections 9.502(a) and (b). The term includes the filing of a financing statement covering goods of a transmitting utility that are or are to become fixtures." The requirements of Texas UCC §9.502(a) are applicable to every financing statement and require the name of the debtor, the name of the secured party, and a description of the collateral. Texas UCC §9.502(b) provides the additional requirements applicable to a fixture filing, including an indication that fixtures are claimed, indicate that it is to be filed for record in the real property records, provide a description of the real property sufficient to give constructive notice of a mortgage under Texas law and, if the debtor does not have an interest of record in the real property, the name of a record owner. The fixture filing must be made in the jurisdiction in which the fixtures are located under Texas UCC §9.301(3).

Under Texas UCC §9.502(c) the record of a mortgage can serve as a fixture filing, and is commonly utilized in Texas. While it would also be possible to create a separate fixture filing (in the form of a UCC financing statement) this may create an issue for a lender that utilizes both a deed of trust and a separate financing statement. That is because the separate financing statement will lapse unless it is continued every five years under Texas UCC §9.515(a) (with certain exceptions) while a record of a mortgage filed as a fixture filing remains effective without the need for continuation, until the mortgage is released or satisfied of record or its effectiveness is otherwise terminated as to the real property under Texas UCC §9.515(g).

If the lender insists on filing both a deed of trust as a fixture filing and a separate fixture filing, the borrower's counsel should not be asked to opine on whether particular items of property constitute fixtures. Assuming that the security agreement or deed of trust was governed by Texas law, it could simply adopt a formulation, such as the one suggested in the UCC Report (modified for a Texas transaction) that "the Deed of Trust is in form sufficient to create a security interest

in that portion of the [Collateral] that is fixtures or goods that are to become fixtures under [the Texas UCC]." UCC Report at 10. Assuming that the real property (and any fixtures) are located in Texas, perfection could be addressed with a formulation (modified for a Texas transaction) such as "the Deed of Trust to be filed as a fixture filing is in form sufficient for filing in [the office of the applicable clerk of court] and when recorded will be sufficient to perfect the security interest of the ... Secured Party in the interest of the ... Debtor in that portion of the [Collateral] consisting of goods that are or that became fixtures under the real property law of the [State of Texas]." UCC Report at 11.

While the office designated for the filing of a record of the mortgage on the related real estate is generally the proper office for filing a fixture filing (whether the deed of trust or a separate fixture filing) an exception is made in the case of a transmitting utility. All financing statements with respect to transmitting utilities, including fixture filings, are filed with the Secretary of State. Texas UCC §9.102(81) defines transmitting utilities as persons primarily engaged in the business of operating railroads and similar utilities, transmitting communications, transmitting goods by pipeline or sewer, or transmitting or producing and transmitting electricity, steam, gas, or water. For that reason, the Illustrative Opinion suggests an assumption that the debtor is not a transmitting utility if the opinion addresses the proper filing office for a fixture filing. UCC Report at 40.

V. AS-EXTRACTED COLLATERAL AND TIMBER TO BE CUT

As-extracted collateral is oil, gas, or other minerals that are subject to a security interest created by a debtor who had an interest in the minerals before extraction (such as a deed of trust affecting the minerals) and that attached to the minerals as extracted. In addition, the term refers to accounts arising out of the sale at the wellhead or minehead of oil, gas, or other minerals in which the debtor had an interest before extraction. Texas UCC §9.102(a)(6). While opinions on as-extracted collateral are most likely to be requested in connection with financings of oil and gas properties, rather than "dirt," the rules for creation, attachment, and perfection are the same as for fixtures. Under Texas UCC §9.301(4) the local law of the jurisdiction in which the wellhead or minehead is located governs perfection, the effect of perfection or non-perfection, and the priority of a security interest in as-extracted collateral. The limitations, assumptions, and exclusions that would be proper for an opinion including fixtures would also be appropriate in an opinion addressing as-extracted collateral. Texas UCC §9.501(a)(1)(A) stipulates that

the financing statement is filed in the office designated for filing a deed of trust on the related property.

A security interest in timber to be cut is also subject to the same rules as fixtures. The local law of the jurisdiction in which the goods are located govern perfection under Texas UCC §9.301(3). Texas UCC §9.501(a)(1)(A) stipulates that the financing statement is filed in the office designated for filing a deed of trust on the related property. However, as noted in Official Comment 3 to that section, once the timber is cut, it becomes ordinary goods and the location of the debtor, rather than the location of the timber, governs perfection. Assuming the debtor is also located in Texas (such as a Texas corporation or limited liability company) the proper filing office for filing a financing statement in the cut timber is the office of the Secretary of State.

VI. DEPOSIT ACCOUNTS

Deposit accounts may be present in various types of real estate financings. For instance, a lender may require the creation of a deposit account for receipt of rents and other proceeds from the property or require the establishment of reserve accounts to fund taxes or insurance or maintenance expenses. While the rules for creation and attachment of a security interest in a deposit account follow the general rules applicable to UCC security interests, the choice of law rules for perfection and the means of perfection of the security interest are very different.

A. Choice of Law

The normal rule for the choice of law to govern perfection and the effects of perfection or non-perfection of a security interest is the jurisdiction of the location of the debtor. In the case of a registered organization, such as a corporation or limited liability company, the debtor is located in the state in which it was created. In the case of a deposit account, however, the choice of law is the local law of the depository bank's jurisdiction. Texas UCC §.304(a). To determine the depository bank's jurisdiction, the lender works through a range of possibilities in Texas UCC §9.304(b), including the account agreement between the bank and its customer, an agreement between the bank and its customer specifically selecting the laws of a particular jurisdiction, and including other less definite possibilities, including the state in which the office identified in an account statement is located or the chief executive office of the bank. As a practical matter, it is common for a secured party to require a specific choice of law in a deposit account control agreement, commonly referred to as a DACA, which is discussed below as a method of perfection. Thus, even in the case

of a borrower that is a Texas registered organization, perfection may be governed by the laws of another jurisdiction that Texas borrower's counsel may not be able to address.

B. Perfection

Unlike most other types of collateral, a security interest in a deposit account cannot be perfected by filing a financing statement. Rather, the security interest is perfected only by "control." Control is defined in Texas UCC §9.104(a) and can be satisfied in one of three ways. First, if the secured party is also the bank in which the account is maintained, the secured party will have control of the account and will be perfected. As a result, in many financings the secured party will require the deposit account to be maintained with it, rather than with another institution. However, if the deposit account is not maintained with the secured party, the debtor, the secured party, and the depository bank would execute a DACA in which the depository bank agrees that it will comply with a direction of the secured party as to disposition of the funds in the account without further consent by the debtor. Such a DACA will also typically stipulate the operative "jurisdiction of the bank" for purposes of the choice of law applicable to perfection, as noted in Section VI.A above. Finally, but less typical, is for the secured party itself to be the customer of the depository bank.

A secured party has control even if the debtor can access the funds in the deposit account prior to contrary instructions from the secured party. Texas UCC §9.104(b). The Commentary cautions that a DACA that contains a right of contractual interpleader for the bank may not be adequate to grant control of the account to the secured party, as the bank would retain the contractual right to disregard the instructions of the secured party. However, a statutory right of interpleader should not destroy the control of the secured party. UCC Report at 21.

C. Specific Opinion Issues

The Commentary outlines specific elements of the creation and perfection of a security interest that should be addressed by assumptions (or by determination after appropriate due diligence). First, it must be determined that the entity holding the deposit account is, in fact, a bank. Texas UCC §9.102(29) defines a deposit account as "a demand, time, savings, passbook, or similar account maintained with a bank. The term includes a nonnegotiable certificate of deposit. The term does not include investment property or accounts evidenced by an instrument." Texas UCC §9.102(8) defines a bank as "an organization that is engaged in the business of banking. The term includes savings banks, savings and

loan associations, credit unions, and trust companies.” Borrower’s counsel should not be expected to investigate the nature of the entity with whom the account is established and should be allowed to assume that fact. A second assumption that the opinion should include is that the account is in fact a deposit account and is not an investment account. It is entirely possible that what the parties believe will be a deposit account will, initially or over time, turn out to be an investment account, if the depository bank and the customer decide to invest proceeds in investment securities. In that case, it is still possible to perfect a security interest in an investment account, but that would involve analysis under Chapter 8 and Chapter 9 of the Texas UCC as discussed in Section VII.

VII. INVESTMENT PROPERTY

In certain types of financings such as mezzanine financings the lender will take a security interest in the entity owning the real property (rather than the real property itself) and that security interest, rather than a mortgage lien, will be the primary collateral for the loan. For instance, a limited liability company may own real property that it will mortgage to a first lien lender, but to obtain additional funding it may obtain a mezzanine loan secured by a security interest granted by the limited liability company members in the LLC owning the real property. This type of financing involves a number of issues, including the need for inter-creditor agreements between the real estate lender and the mezzanine lender, and those issues are beyond the scope of these materials. *See*, Cary Barton, *Documentation for Mezzanine Loans, Including Inter-Creditor Agreements*, 39th Annual Advanced Real Estate Law Course (State Bar of Texas, 2017) and Jonathan Thalheimer, *Mezzanine Loans*, 27th Annual Advanced Real Estate Law Course (State Bar of Texas, 2005). However, the method by which the mezzanine lender can obtain a perfected security interest in the LLC membership interests is covered by the UCC Report. The UCC Report also addresses creation and perfection of security interests in securities accounts and securities entitlements in those accounts.

A. What is (or is not) Investment Property

The definition of investment property in Texas UCC §9.102(a)(49) includes a security, whether certificated or uncertificated, security entitlement, and a securities account. Those terms are defined in Chapter 8 of the Texas UCC. As a result, borrower’s counsel who is asked to opine on the creation and perfection of a security interest in the equity interests of an entity will have to consult both Chapter 8 and 9 when addressing this opinion and when determining whether a particular entity interest constitutes investment property (and thus subject to perfection of a security interest as investment

property). A “security” under Texas UCC §8.102(a)(15) must, among other tests, either be (i) of a type dealt in or traded on securities exchanges or securities markets or (ii) be a medium for investment and by its terms expressly provide that it is a security governed by Chapter 8. As a result, a share in a corporation would be a security under the test in (i) and the terms of Texas UCC §8.103(a). However, a limited liability company membership interest or a partnership interest would not be a security unless the entity and its members have taken an additional step of “opting in” under the test in (ii) and Texas UCC §8.103(c). In the absence of that second step, a limited liability company interest or a partnership interest will be a general intangible rather than investment property.

Certainly a lender could take a security interest in a limited liability or partnership interest as a general intangible, but lenders may require the borrower and the entity to opt in to Chapter 8 and to provide for issuance of certificated securities to represent the equity interests. The reason for this is that a lender who can perfect a security interest in a security by control (discussed below) has priority over another secured party that has perfected only by possession or by filing a security interest. Texas UCC §9.328.

Securities entitlements are the interest of the debtor in a financial asset that has been credited to an account. If a debtor establishes an account to receive rentals or reserves, but then invests the money in the account in securities or similar property, it is likely dealing with a securities account rather than a deposit account. Texas UCC §8.501.

B. Perfection

A security interest in investment property can be perfected by filing a financing statement, by control, or, in the case of certificated securities, by possession of the certificate. Filing is not the preferred method because a secured creditor who has perfected its interest by control has priority over a secured party who has perfected by filing. Texas UCC §9.106 directs the creditor to Texas UCC §8.106 for the method of obtaining control of a certificated or uncertificated security or a security entitlement. Under Texas UCC §8.106(a) and (b) control of a certificated security arises from delivery and any necessary indorsement (if in registered form). Under Texas UCC §8.106(c) control of an uncertificated security requires either becoming the registered owner of the security under Texas UCC §8.301(b) or by obtaining the agreement of the issuer that it will comply with instructions from the secured party without further consent from the registered owner. Under Texas UCC §8.106(d) control of securities entitlement arises from becoming the entitlement owner or obtaining the

agreement of the securities intermediary to comply with instructions from the secured party without further consent from the registered owner. An issuer or securities intermediary is not required to enter into such an agreement with a secured party under Texas UCC §8.106(g), even if directed by the owner or entitlement holder.

C. Governing Law

The Commentary identifies an important consideration in the determination of whether Texas is the jurisdiction that will govern perfection of the security interest in investment property. The general rule, as noted in Section III.C, defaults to the location of the debtor. If the lender's security interest is perfected by filing a financing statement, that rule still applies.

If the security interest is perfected by possession or control of a certificated security, the law of the jurisdiction where the certificated security is located governs perfection. Texas UCC §9.305(a)(1). The Commentary suggests that an opinion addressing perfection of a certificated security would assume not only that the security is a certificated security but would also assume the location at which the secured party obtains possession. UCC Report at 24.

If the security is an uncertificated security the law of the issuer's jurisdiction governs perfection by control. Texas UCC §9.305(a)(2). The issuer's jurisdiction is generally the jurisdiction of formation under Texas UCC §8.110(d).

If the security is a securities entitlement the law of the securities intermediary's jurisdiction governs perfection by control. Texas UCC §9.305(a)(3). The securities intermediary's jurisdiction is generally determined by the applicable contracts between the intermediary and its customer with default rules as set forth in Texas UCC §8.110(e). As in the case of a DACA, discussed at Section VI.A, it is typical to provide a specific choice of law in the securities account control agreement so that it is not necessary to work through the myriad of possible jurisdictions under Chapter 8.

VIII. SPECIFIC OPINION CLAUSES.

As in the case of the borrower's counsel opinion regarding the effectiveness of a deed of trust as creating a mortgage lien and assignment of leases and rents, the opinion will carefully identify the documents examined for the opinion and incorporate assumptions, exceptions, and limitations that address the particular issues involved in covering personal property or fixtures

in the opinion. The Commentary notes the tendency in real estate financings to include a "laundry list" of exceptions or limitations, but it takes the position that many of these matters are not actually required to be stated in the opinion. It reflects comments from the Tribar Report that many assumptions and exceptions "could be understood, as a matter of customary practice, to apply to an opinion concerning a security interest whether or not stated in the opinion letter." UCC Report at 28. It also notes that many assumptions and exceptions that might be helpful in a pure UCC opinion (not as a part of a real estate transaction) would arguably not be needed in an opinion limited to collateral, such as fixtures, involved in a real estate financing. However, many counsel are not comfortable with relying upon "customary practice" to identify all assumptions and exceptions and wish to provide for many of these explicitly in the opinion. The Illustrative Opinion provides limited examples of specific language for opinion givers to use to address such issues.

A. Documents Examined

Depending upon the nature of the collateral and the means of perfection of the security interest, the Illustrative Opinion identifies the instruments that would be needed for the UCC opinion. These could include a security agreement, the deed of trust granting a lien on fixtures and serving as a fixture filing, a DACA, certificate of pledged collateral, the control agreement from the issuer of an uncertificated security, the financing statement, and UCC fixture filing. Although an opinion may assume the correctness of the debtor's name and the jurisdiction of its formation, if a registered entity, often the borrower's counsel will also review the certificate of formation to verify that information. UCC Report at 31-32 and 34.

B. Assumptions

Representative assumptions for UCC opinions identified in the Illustrative Opinion (modified for a Texas transaction) could include:

- (i) that the description of the collateral is accurate and reasonably identifies the collateral;
- (ii) that value has been given for the grant of the security interest;
- (iii) that the debtor has rights in the collateral;
- (iv) that the financing statement or fixture filing correctly identifies the name of the debtor;
- (v) that the debtor is not a transmitting utility;
- (vi) that the location of the wellhead or minehead or location of standing timber (for an opinion on as-extracted collateral or timber to be cut) is in Texas;
- (vii) that the jurisdiction of formation of the debtor is Texas;

(viii) that an account described in the DACA is a “deposit account,” that the bank described in the DACA is a “bank” in each case as defined in the Texas UCC, and that the bank’s jurisdiction is and will remain Texas;

(ix) that any pledged equity interests are certificated securities (if applicable), have been duly issued, have been endorsed or registered to the secured party, and will be delivered to and will be maintained by the secured party in Texas; and

(x) that any pledged equity interests are uncertificated securities (if applicable) and have been assigned to and registered in the name of the secured party (if control is achieved by registration).

UCC Report at 35-42.

Although the Illustrative Opinion does not contain a specific assumption in cases in which creation and attachment of a security interest might be governed by the laws of a jurisdiction other than Texas, while Texas law might govern solely the perfection of the security interest, the Commentary does address that possibility. It suggests that a perfection opinion in such a case would limit its scope to collateral “of the type in which a security interest can be perfected under [Chapter 9 of the Texas UCC] and which may be perfected through the filing of a financing statement under [Chapter 9 of the Texas UCC] to the extent a security interest in the Collateral has attached.” UCC Report at 16-18.

C. Formulation of Opinion Clauses

The Illustrative Opinion provides specific language that opinion givers may utilize in crafting the operative clauses of the opinion at pages 42-50 of the UCC Report. While too lengthy to repeat in these materials, they offer formulations for addressing creation, attachment, and perfection of security interests by filing or by other means discussed in the Commentary, form of the deed of trust or financing statement for recording in the proper recording office, and perfection of security interest in fixtures, deposit accounts, and investment property. The Illustrative Opinion reflects the point made in the Commentary that counsel should not be expected to identify whether any items of collateral constitute fixtures. Its suggested language is limited to the opinion that the filing of the fixture filing “will be sufficient to perfect the security interest of the ...Secured Party in the interest of the...Debtor in that portion of the Collateral consisting of goods that are or that become fixtures under the real property law of the State [of Texas] [to the extent a security interest in the fixtures has attached.]” UCC Report at 48.

D. Exclusions or Limitations

For counsel who include a “laundry list” of exclusions or limitations that apply post-closing, such as

need to continue a financing statement, rights of other parties, such as purchasers, to take free of the security interest, effect of a change of the debtor’s name, and other post-closing events, the Illustrative Opinion offers limited examples of clauses that could be used. The Commentary advises that since a perfection opinion “speaks as of the date of the opinion letter and does not implicitly opine that, once perfected, a U.C.C. personal property security interest will continue to be perfected regardless of the possible effect of subsequent events occurring or not occurring after the date of the opinion letter,” customary practice makes such clauses unnecessary. UCC Report at 8; TriBar Report at 1484. However, it also notes that many practitioners do include such limitations, although the “risk of [that approach] is that the qualifications expressed will not be sufficiently comprehensive, thereby implying that other post-perfection events are not relevant.” UCC Report at 8. Although the Commentary does not recommend the laundry list approach, the Illustrative Opinion offers the following single clause for the opinion giver who is not comfortable without some post-perfection exclusion: “we offer no opinion as to the continued perfection of the security interest. Without implying any limitation on the foregoing...we point out that the continued perfection of any security interest in any U.C.C. Collateral (i) may be affected by the removal of such U.C.C. Collateral to another jurisdiction or upon the change of the name or the state of organization of any debtor, or (ii) that is perfected by the filing of a financing statement, may be affected by the failure to file a timely continuation statement.” UCC Report at 52-53.

IX. CONCLUSION

The UCC Report provides helpful resources for attorneys engaged to deliver real estate financing opinions in transactions including UCC collateral. The Commentary covers essential UCC topics and can serve as a teaching tool and a refresher. Attorneys can utilize the report in negotiations with lenders requiring opinions on matters that borrower’s counsel does not believe are appropriate. While the UCC Report does not purport to mandate a form of opinion, it offers concrete language that is helpful in drafting opinions.

ATTACHMENT A

**PrePublication Exposure Draft of
Uniform Commercial Code
Opinions in Real Estate Finance Transaction Opinion Letters**

[Intentionally Omitted]