



**REPORT ON LEGISLATION BY THE  
COMMERCIAL LAW AND UNIFORM STATE LAWS COMMITTEE<sup>1</sup>**

**A.3139  
S.3074**

**M. of A. Epstein  
Sen. Salazar**

AN ACT to amend the real property law and the uniform commercial code, in relation to requiring the recording of mezzanine debt and preferred equity investments; and to amend the tax law, in relation to including mezzanine debt in the mortgage recording tax

**A.3009-B (Budget Article VII) – Part VV**

AN ACT to amend the real property law and the uniform commercial code, in relation to requiring the recording of mezzanine debt and preferred equity investments; to amend the tax law, in relation to including mezzanine debt in the mortgage recording tax; and to repeal certain provisions of the tax law relating thereto (Part VV)

**S.2509-B (Budget Article VII) – Part SS**

AN ACT applying to a city having a population of one million or more to amend the real property law and the uniform commercial code, in relation to requiring the recording of mezzanine debt and preferred equity investments; and to amend the tax law, in relation to including mezzanine debt in the mortgage recording tax (Part SS)

**THESE BILLS ARE OPPOSED<sup>2</sup>**

The aforementioned proposed legislation and budget provisions (collectively the “Bill”) seek to amend New York real property law and the New York Uniform Commercial Code (the “NY UCC”) in an effort to collect a new mortgage recording tax in connection with certain financing transactions on which there is credit reliance by the lender on the value of New York real estate subject to a senior real estate mortgage. The financing transactions covered by the Bill do not themselves require the filing of a real estate mortgage and, therefore, no recording tax is

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<sup>1</sup> This report has been reviewed and is endorsed by the City Bar’s Real Property Law Committee (Dorothy Heyl, Chair).

<sup>2</sup> As stated in the text, this report takes no position on whether a mortgage recording tax should be imposed on mezzanine debt financing. That said, we oppose the Bill to the extent it would amend Article 9 of the NY UCC.

**About the Association**

*The mission of the New York City Bar Association, which was founded in 1870 and has 25,000 members, is to equip and mobilize a diverse legal profession to practice with excellence, promote reform of the law, and uphold the rule of law and access to justice in support of a fair society and the public interest in our community, our nation, and throughout the world.*

directly payable by the lender. These loans include mezzanine debt financings, i.e., where a loan is made to a person (the “Debtor”) who owns a controlling interest in the mortgagor entity, and the loan is secured by the Debtor’s equity interest (the “Pledged Interest”) in the entity that owns the real estate. The Bill seeks to collect a mortgage recording tax on the filing of a UCC Article 9 financing statement covering the Pledged Interest. It seeks to enforce payment of that new tax by providing that the security interest in the Pledged Interest is not enforceable against the Debtor and not perfected (i.e., not effective against the Debtor’s bankruptcy trustee and most third parties) unless a financing statement is filed against the Debtor covering the Pledged Interest and the tax is paid.

The Commercial Law and Uniform State Laws Committee (the “Committee”) of the New York City Bar Association takes no position on the wisdom of the New York legislature seeking to impose the mortgage recording tax on mezzanine debt financings.

However, the Committee opposes the Bill in so far as the Bill contains the non-uniform amendments to the New York UCC provided in the Bill. In short, the non-uniform amendments to the NY UCC will likely produce little additional revenue, will damage the Uniform Commercial Code, will reduce the availability or increase the cost of credit, and may prejudice settled transactions.

## **THE BILL WILL NOT FULFILL ITS PURPOSE**

First, the Bill will not, by amending the NY UCC, accomplish its intended purpose of requiring payment of the tax. The Bill, if enacted, would change the NY UCC only to the extent that the substantive law rules of the NY UCC would apply to the mezzanine debt financing in question. Sophisticated practitioners will easily be able to avoid this result by structuring the financing to involve legal entities organized in a state other than New York, to be governed by the UCC Article 9 of that other state and to provide for the exclusive jurisdiction and venue of the courts of that other state. Even if the security agreement might not be enforceable in New York, it would be enforceable in that other state, and, therefore, the parties would have no reason to pay the new tax.

Under the choice-of-law rules contained in the NY UCC and in the Uniform Commercial Code of each other state of the United States or other Uniform Commercial Code jurisdiction (New York and each other Uniform Commercial Code jurisdiction being herein referred to as a “UCC Jurisdiction”), the NY UCC would generally not apply to enforcement of the security interest in the Pledged Interest if the security agreement provided that the security interest was governed by the law of another UCC Jurisdiction and the other UCC Jurisdiction bears a reasonable relation to the transaction.<sup>3</sup> Moreover, under the choice-of-law rules contained in the NY UCC and in the Uniform Commercial Code of each other UCC Jurisdiction, the NY UCC would generally not apply to the perfection of the security interest if the Debtor were “located” in another UCC Jurisdiction.<sup>4</sup> Under these choice-of-law rules, the Debtor would be “located” in another UCC

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<sup>3</sup> UCC § 1-301(a). The citations to the Uniform Commercial Code in this paper are to the Official Text of the Uniform Commercial Code promulgated by the American Law Institute and the Uniform Law Commission. The NY UCC contains the same sections as the sections cited.

<sup>4</sup> UCC § 9-301.

Jurisdiction if the Debtor is (a) an individual who principally resides in another UCC Jurisdiction, (b) a corporation, limited liability company, limited partnership, statutory trust, or in some cases business trust organized under the laws of another UCC Jurisdiction, (c) a general partnership whose chief executive office is located in another UCC Jurisdiction, or (d) a common law trust whose trustee is located in another UCC Jurisdiction under the foregoing rules.<sup>5</sup>

Given these choice-of-law rules, many mezzanine debt financings will not be captured by the Bill, either because the security agreement is governed by the law of another UCC Jurisdiction or because the Debtor is “located” in another UCC Jurisdiction. In many of the transactions to which these provisions would apply, the Debtor would be an organization formed under the laws of another UCC Jurisdiction (generally, Delaware).

Moreover, even if the security agreement would otherwise be governed by New York law or the Debtor would otherwise be located in New York, transacting parties could still avoid payment of the tax. They could change the governing law to that of another UCC Jurisdiction for existing transactions or provide for a governing law of another UCC Jurisdiction for future transactions, in each case if the UCC Jurisdiction bears a reasonable relation to the transaction. The Debtor could also change the Debtor’s location for existing transactions to another UCC Jurisdiction or establish a location in another UCC Jurisdiction for future transactions. For example, an individual who would otherwise principally reside in New York could contribute the Pledged Interest to a single member limited liability company organized under the law of Delaware, and the limited liability company, then viewed as “located” in Delaware, could grant the security interest in the Pledged Interest. Delaware law would then govern the perfection of the security interest by the filing of a financing statement, not New York law.

Since the transactions that the Bill seeks to capture are overwhelmingly drafted and negotiated by knowledgeable and experienced practitioners, the parties are likely to be aware of the change in the law proposed by the Bill and of their opportunity to draft around the Bill’s scope. As a result, the Committee believes that parties who are well advised will be able to easily structure their transactions to avoid payment of the tax.

Even if the Bill were amended to change the NY UCC choice-of-law rules, a change which the Committee would strongly oppose, and one that would have damaging unintended consequences for transactions not intended to be affected by the Bill, the change would not be effective in any dispute over enforcement or perfection of the security interest in the Pledged Interest that occurs in a forum in another UCC Jurisdiction. In fact, the parties could agree to an exclusive forum in another UCC Jurisdiction or to a non-exclusive forum other than New York.

## **THE BILL WILL HAVE A DELETERIOUS EFFECT ON THE NY UCC AND FINANCINGS PERFECTED BY CONTROL**

Second, even if the substantive law rules of the NY UCC did apply after giving effect to the choice-of-law rules, the Bill will damage the NY UCC in a way that will make financing in reliance on the Pledged Interest less available or more expensive. Here is why.

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<sup>5</sup> See UCC § 9-307 and related definitions in UCC § 9-102(b).

Because the Bill requires perfection of the security interest in the Pledged Interest solely by the filing of a financing statement, the Bill will eliminate a uniform method, in effect in UCC Jurisdictions throughout the United States, for a security interest in the Pledged Interest to be perfected by possession or control (not by filing a financing statement) and to obtain priority over a competing security interest perfected by a financing statement. Consider a Pledged Interest consisting of shares in a corporation or an interest in a partnership or limited liability company which has elected for the Pledged Interest to be a “security” under the Uniform Commercial Code.<sup>6</sup> A security interest in the Pledged Interest may be perfected by the method of “control.”<sup>7</sup> Under that method, the Pledged Interest could be evidenced by a certificate endorsed and delivered by the Debtor to the lender, the Pledged Interest could be registered in the lender’s name rather than in the name of the Debtor, or in some cases the mortgagor could agree to follow instructions from the lender as to the Pledged Interest without further consent of the Debtor.<sup>8</sup>

Currently, if control is achieved by the lender in any of these ways, not only is the lender’s security interest in the Pledged Interest perfected without the filing of a financing statement but also the security interest is senior to a security interest in the Pledged Interest perfected by the filing of a financing statement. This is the case even if the competing security interest in the Pledged Interest was perfected by the filing of the financing statement before the lender obtained “control” of the Pledged Interest.<sup>9</sup>

This non-temporal priority for a security interest in a Pledged Interest perfected by “control” was intentional to facilitate financings based on Pledged Interests as reliance collateral. A lender which was relying on the general assets of the Debtor as collateral knows to take the steps to perfect its security interest in the Pledged Interest by “control” if the lender is relying on the Pledged Interest as collateral rather than other general assets of the Debtor.

If the Bill eliminates “control” as a method of perfection, then the lender, to be assured of the first priority of its security interest in a Pledged Interest, would need to conduct a Uniform Commercial Code search against the Debtor. If the search discloses a financing statement filed against the Debtor and covering the Pledged Interest, whether specifically, as “investment property” as defined in the NY UCC, or as “all assets” or “all personal property,” the lender will need to obtain a release or subordination of the security interest from the competing secured party in order for the lender to be assured that its security interest in the Pledged Interest would be senior to that of the competing secured party. If the lender perfected its security interest by the filing of a financing statement without obtaining the release or subordination, the lender’s security interest would be junior to that of the competing secured party.<sup>10</sup>

Accordingly, if the Bill were enacted, in assessing the cost of the financing, the lender would need to take into account not only the burden of arranging for the Uniform Commercial Code search to be conducted against the Debtor but also the time and expense of negotiating the

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<sup>6</sup> See UCC § 8-103.

<sup>7</sup> UCC § 9-314(a).

<sup>8</sup> UCC §§ 8-106 and 9-106.

<sup>9</sup> UCC §§ 9-328.

<sup>10</sup> UCC §§ 9-322(a)(1).

release or subordination from the competing secured party. And, if the competing secured party declined to provide the release or subordination, it is likely that the lender would not provide the financing at all without additional credit enhancements from the Debtor, which many debtors may be unable to provide.<sup>11</sup>

Third, if the Bill would render existing financings perfected by control to be unenforceable and unperfected, without fair and gradual transition provisions, the Bill would upset settled expectations of numerous transacting parties. Millions of dollars of financing transactions have been completed in reliance upon “control” as method for a lender to perfect a security interest in a Pledged Interest and for the security interest to have first priority. A lender who had relied upon perfection by “control” might not have filed a financing statement covering the Pledged Interest and, in any event, might not have obtained a release or subordination from a competing secured party whose security interest was perfected by the earlier filing of a financing statement. If the Bill were enacted and even if the lender, who has not previously done so, then immediately filed a financing statement against the Debtor and covering the Pledged Interest, the perfection and priority of the security interest would be in doubt. Such a retroactive destruction of a validly perfected security interest would be both questionable and unfair.

## **CONCLUSION**

For all these reasons, it would be misguided to attempt to collect a real estate mortgage tax by imposing the tax on the filing of a New York financing statement with respect to debt secured by personal property, and then mandating that financing statements be filed when they are not otherwise required because they are not governed by the New York UCC or, if so governed, can be perfected by control of the property without the need for filing. Parties will structure to avoid New York law and New York courts and will cease to use entities organized under New York law. The costs of such financings will be increased. All of these impacts will only have the effect of eroding New York’s commercial pre-eminence, while doing little to create tax revenue because of the ease of avoidance.

Commercial Law and Uniform State Laws Committee  
Alan Kolod, Chair  
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<sup>11</sup> Although the Committee’s objections to the Bill are not based on effects of the COVID-19 pandemic, the Committee does note that the effect of the Bill for parties not able to draft around the scope of the Bill would be to (a) diminish the provision of credit to commercial real estate at precisely the time when many property owners, as the result of the pandemic, may be seeking *more* financing, and (b) delay the restoration of commercial real estate value - a significant part of New York’s tax base - to its pre-pandemic level.