purpose covenants, (iv) full recourse liability in the event of a bankruptcy filing on the part of the real estate owner and, if different, on the part of the mezz borrower, and (v) loan guaranties; and

The selection of techniques that are applied in the instance of any particular MREL to achieve said purposes requires an exercise of judgment by the MREL lender. The reasonableness of the techniques utilized in any particular MREL will be assessed in light of the credit characteristics of the MREL borrower, any guarantors and the underlying real estate at the time of origination. Utilizing this standard provides flexibility to the MREL lender and provides a basis for the regulator and auditor in analyzing the reasonableness of the judgment of the MREL lender; and

c. The real estate owner and, if different, the mezz borrower shall:

   i. Hold no assets other than, in the case of the real estate owner, the real property, and in the case of the mezz borrower (if different), the equity interest in the real estate owner;

   ii. Not engage in any business other than, in the case of the real estate owner, the ownership and operation of the real estate, and in the case of the mezz borrower (if different), holding an ownership interest in the real estate owner; and

   iii. Not incur additional debt, other than limited trade payables, a first mortgage loan (in the case of the real estate owner), and the MREL (in the case of the mezz borrower, if different).

d. At the time of the initial investment, the MREL lender shall corroborate that the sum of the first mortgage and the MREL does not exceed 100% of the value of the real estate as evidenced by a current appraisal. Acceptable appraisal methods are described in paragraph 11 of *SSAP No. 40—Real Estate Investments*.

e. The MREL lender shall report in Appendix A-001 to its annual statement the amount and percentages of its total admitted assets held in MREL and the largest three investments held in MREL except that such detail shall not be required for assets held in MREL totaling less than 2.5% of its total admitted assets.

Effective Date

6. Upon adoption of this issue paper, the NAIC will release a Statement of Statutory Accounting Principle (SSAP) for comment. The SSAP will contain the adopted Summary Conclusion of this issue paper. Users of the Accounting Practices and Procedures Manual should note that issue papers are not represented in the Statutory Hierarchy (see Section IV of the Preamble) and therefore the conclusions reached in this issue paper should not be applied until the corresponding SSAP has been adopted by the Plenary of the NAIC. It is expected that the SSAP will contain an effective date for years ending on or after December 31, 2001.

DISCUSSION

Definition of MREL

7. An MREL is a loan secured by a pledge of direct or indirect equity interests in an entity that owns real estate (the "real estate owner"). The real estate owner is typically the borrower under a mortgage loan secured by the same real estate. The MREL borrower ("mezz borrower") may be the real estate owner or one or more of the holder(s) of the direct or indirect equity interest(s) in the real estate owner. As used herein, "direct equity interests" means the then issued and outstanding shares or units of partnership, membership or other beneficial interests in the real estate owner, and "indirect equity

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interests" means the then issued and outstanding shares or units of partnership, membership or other beneficial interests in a member, partner, shareholder or other holder of direct equity interests in the real estate owner. The following illustrates one typical MREL structure:

Typical Sources and Market Characteristics of MRELs

8. Significant portions of large real estate loans are now originated with the intent of securitizing[1] the real estate mortgage loan. Mortgage loans targeted for securitization are typically subject to uniform underwriting and structuring requirements, including requirements that (a) the mortgage loan satisfy a loan to value ratio of 65% or less, (b) prohibit encumbrance of the real estate to secure additional debt, and (c) the borrower satisfy certain SPE (special purpose entity) requirements (as described below).

9. In many instances, the subject real estate project requires financing in excess of 65% of the value of the property. By utilizing a MREL, the real estate owner is able to obtain a low cost first mortgage loan and the mezz borrower is able to obtain additional project financing in the form of the MREL without jeopardizing the securitization of the first mortgage loan by subjecting the real estate to additional liens.

10. Like its securitized mortgage loan counterpart, MRELs typically have common underwriting and structuring characteristics. As noted above, MRELs are secured by a pledge of the mezz borrower's equity interest in the real estate owner. Similar to securitized loan requirements, the documents evidencing the MREL require that (a) the mezz borrower abstain from granting additional security interests in its equity interest in the real estate owner, and (b) both the real estate owner and the mezz borrower be a special purpose, bankruptcy remote corporation, limited liability company or limited partnership (a "SPE"). In the case of a limited partnership SPE, the general partner of such SPE must in turn be a SPE (and if the real estate owner is a limited partnership, the general partnership interest is also pledged to secure the MREL). The SPE requirements are intended to protect both the mortgage lender and the MREL lender from the risks associated with bankruptcy filings and consolidation of claims relating to affiliated entities.[2]

[1] A "securitized" real estate loan is a loan combined with other loans secured by real estate for sale in the secondary market, typically in the form of a commercial mortgaged backed security.
[2] In order to comply with typical SPE requirements, an entity

payment, and in a default scenario both ultimately result in the lender controlling real property with a first mortgage in place that requires current payments.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- *SSAP No. 4—Assets and Nonadmitted Assets*
- *SSAP No. 37—Mortgage Loans*

Generally Accepted Accounting Principles

- *FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises*
- *FASB Statement No. 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*

ISSUE PAPER 113 – EXHIBIT A

Uniform Commerical Code Questions and Answers

As further background on the treatment and structure of a mezzanine real estate loan, the following questions and answers are presented.

1. How is a security interest of this type characterized under the UCC?

   Either investment property, general intangible or instrument
   Security interest in shares of a corporation should be investment property. See § 9-102(a)(49); § 8-102(a)(15); § 8-103(a)
   Partnership or limited liability company- generally a general intangible. See § 9-102(a)(42)
   If such interests represented in writing could be classified as "instruments". See § 9-102(47).
   Possibility of misclassification of an interest in a closely held corporation as an instrument. See In re U.S. Physicians, Inc., 236 B.R. 593 (Bankr. E.D. Penn. 1999)
   Require borrowers to opt into Article 8. See § 8-102(a)(15)(iii)(b) investment property.

2. How does the insurer perfect its security interest?

   A security interest in investment property is perfected by either obtaining "control", See § 9-314, or filing a financing statement. See § 9-312(a).
   An interest that is perfected by control has priority over one perfected by filing. See § 9-328.
   A secured party has control of investment property when the secured party may transfer that property without further consent from the owner. See § 8-106.
   If the collateral is a certificated security in bearer form control is achieved by possession. See § 8-106(a).
   If the collateral is a certificated security in registered form control is achieved when the secured party takes possession of the certificate and the certificate is endorsed to the party or is registered in the party's name upon issue or transfer. See § 8-106(b). Certificated securities are accompanied by executed stock powers.
   If the collateral is an uncertificated security control is achieved by "delivery" of the security, which can be achieved by the secured party becoming the registered owner, or the issuer providing that it will comply with instructions of the secured party without further action from the registered owner. See § 8-106(c). A pledge or security interest in uncertificated securities is typically acknowledged by the issuer delivering an "Initial Transaction Statement". See § 8-408.
   An interest in a general intangible is perfected by filing a financing statement. See § 9-310.
   An interest in an instrument may be perfected by filing a financial statement, See § 9-312(a), or by possession. See § 9-313.
   Security interest extends to all proceeds generated by the pledged securities. See § 9-306(1).
   Typically, regardless of the nature of the securities pledged, the secured party will file UCC financing statements as a precautionary measure.

3. What steps does the insurer take to realize on the collateral?

   Once the borrower is in default, the secured party may possess the collateral either through

4. Does the answer differ under the old UCC and the amended UCC, due to take effect in 2001?

> The most significant change relevant to these transactions is that a security interest in an instrument may now be perfected by filing; where the prior Article 9 allowed perfection of an instrument only by possession. See § 9-312(a).
> Where a subsequent purchaser is unaware of the secured party's interest, the interest may be extinguished upon purchase. See § 9-330(d). This risk is minimized by the secured party obtaining an Initial Transaction Statement confirming registration of the pledge of uncertificated securities and by the secured party taking possession of certificated securities together with executed stock powers.
> The filing of a financing statement does not constitute notice. See § 9-331.

5. Could a fraudulent borrower further encumber the real estate and thus defeat the insurer's interest in the real estate?

Yes, but some factors that mitigate the risk:

> Typically, a mezzanine loan will have a hard lockbox. Since no cash will flow to a subsequent encumbering lender, most mortgagees would be dissuaded from loaning funds with the security of a second mortgage.

It is common to obtain for the benefit of the Mezzanine Lender as well as the First Mortgagee an environmental indemnification. The value of this will depend upon the creditworthiness of the indemnifying party.

The SPE covenants will limit the activities the entity may engage in which if honored would limit the obligations that a mezzanine lender would assume. Violation of the SPE covenants would trigger personal recourse liability in those situations when the SPE covenants are carve-outs to the non-recourse provisions.

The lender protections against environmental liabilities in a first mortgage situation may be overrated since to sell the property with significant environmental problems is likely to result in significant loss. Most often the lender assesses the environmental liability and may elect to take title and cure the problem before selling. The mezzanine lender may similarly elect to take title and cure the problem if that makes economic sense.

The mezzanine lender assumes ownership of stock/membership interest/partnership interests in a SPE that holds title to potentially contaminated real estate. By avoiding any action that would cause a court "to pierce the corporate veil" (a difficult standard for a plaintiff to overcome) the mezzanine lender's sole exposure it its investment in the SPE. The Lender can be further insulated by transferring ownership of the real estate SPE to an SPE created by the mezzanine lender.

7. Are there similar types of structural risks introduced by this structure that should be part of the criteria for determining whether mortgage loan treatment is appropriate?

You have identified the three major risks:

Certainty of ability to foreclose

Possibility that junior mortgages or liens could encumber the property with no ability to foreclose out the mortgages or liens

Liability for entity level obligations

There are some distinct advantages:

A mezzanine lender can gain control over the property in say 30 days as compared to years in judicial foreclosure states.

The lockbox structure, atypical in a classic second mortgage, prevents the borrower from milking the property and diverting cash.

The SPE structure, atypical with second mortgages prior to the advent of securitized transactions, limits the activities of the borrower to the single mortgaged property making it less likely that other activities or properties adversely affect the mortgaged property.

The Intercreditor Agreement with the First Mortgagee is likely to be more advantageous than any agreement reached by a second mortgagee. Cure rights can frequently be obtained.

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