UCC Plus
RISK MANAGEMENT
Fidelity National Financial Family of Companies

Theodore H. Sprink
Senior Vice President
National Marketing Director
Risk Management Program

Alamo Title
Chicago Title
Fidelity National Title
Security Union
Ticor Title

MEMORANDUM

***To:** Mezzanine Loan Market, Investors, Lenders and Counsel*
***From:** Ted Sprink, SVP, Fidelity National Financial, Inc*
***Date:** April 15, 2008 West Coast IMN Mezzanine Conference*
***Subject:** Moody's Approach to Rating Commercial Real Estate Mezzanine Loans*

Attached for your reference please find the report from Moody's Investor's Service entitled "U.S. CMBS and CRE CDO: Moody's Approach to Rating Commercial Real Estate Mezzanine Loans", dated March 29, 2007.

This report confirms that the mezzanine loan market indeed enjoys important stature in the secondary markets and that for capital market purposes, Moody's deems mezzanine debt as worthy of rating.

The report applauds the concept of "Opting- In" to Article 8 and anticipates that loans assets presented for rating have the benefit of UCC Insurance.

UCCPlus Mezzanine Insurance Policies, underwritten and produced by Chicago Title, Fidelity National Title and Ticor Title Insurance companies insure the lender's security interest for validity, enforceability, attachment, perfection and priority. Policies are low cost, include UCC search and filing functions, are life-of-loan, and provide for the cost-of-defense in the event of a challenge to the lender's security interest.

Such coverages provide a shifting of risk from the lender and outside counsel to one of the nation's leading Fortune 500 title insurance companies. Because we specialize in large, multi-site and complex transactions, UCCPlus underwriters are all experienced lawyers and senior paralegals.

One of the premises behind the Moody's report is that mezzanine loans that are insured tend to have greater value in the secondary market.

For information or to schedule a technical presentation for CLE credit, please contact Ted Sprink at telephone 619-744-4410, tsprink@fnf.com or www.uccplus.com.

701 B Street, Suite 1700 • San Diego, CA 92101 • Tel 619.744.4410 • Fax 619.544.6289 • Mobile 760.604.0277
email tsprink@fnf.com • www.uccplus.com

US CMBS and CRE CDO: Moody's Approach to Rating Commercial Real Estate Mezzanine Loans

AUTHOR:

Daniel B. Rubock
Senior Credit Officer
(212) 553-4683
dan.rubock@moodys.com

CONTACTS:

Jim Duca
Group Managing Director
(212) 553-1415
james.duca@moodys.com

Tad Philipp
Managing Director
(212) 553-1992
tad.philipp@moodys.com

Nicolas Levidy
Managing Director
(212) 553-4595
nick.levidy@moodys.com

Paolo Obias
Managing Director
(212) 553-1349
paolo.obias@moodys.com

WEBSITE:
www.moodys.com

CONTENTS:

- Summary
- The Rise of Mezzanine Loan Financing
- Mezzanine Loan Structures - Baseline Expectations
- Credit Considerations and Rating Methodology

SUMMARY

Just in the last two years, mezzanine loan issuance included in commercial real estate CDOs (CRE CDOs) has skyrocketed from a few score million dollars annually to over $3 billion per year. In a 2000 special report,[1] Moody's described the negative credit effect on senior mortgages of this then relatively arcane method of financing real estate: taking back security in the ownership interests of a real property owner, rather than taking a lien on the realty itself. The focus of the 2000 report was not on the mezzanine loan, but solely on how it and other subordinate debt affected senior mortgage financing. As the financing world changes, however, so must our focus change.

Mezzanine loans now have a natural capital markets outlet, and Moody's rates them in their own right, as standalone credits in the form of "rakes", and as part of CDOs. We no longer view them merely as an impediment to higher ratings on the senior secured debt. This report will outline Moody's view of a baseline, "credit neutral" mezzanine loan structure, and then will describe how we apply that view when we rate mezzanine loans.

THE RISE OF MEZZANINE LOAN FINANCING

Beginning in the early 1990's, when Moody's first began regularly rating commercial mortgage-backed securities, our primary focus, along with the rest of the real estate capital markets', was on the first lien *mortgage* position: the "M" in CMBS invariably meant "mortgage." With the sharp rise of CRE CDOs, the "M" now may frequently denote "*mezzanine-loan*" backed securities.

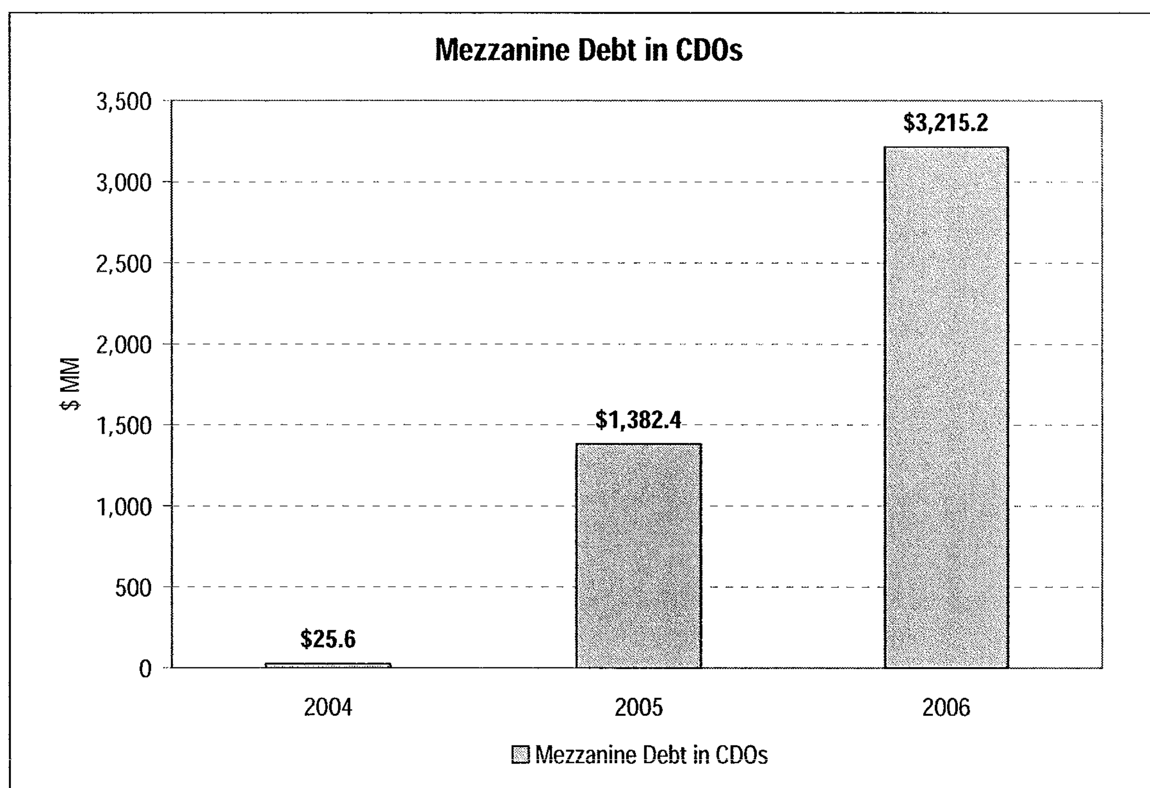
Subordinate financing for real estate has been around for as long as borrowers have desired increased leverage. Historically such financing was secured in the same way as senior financing: with a mortgage, just junior to the senior one. But the advent of structured finance and the experience of lenders during the savings and loan crunch of the late 80's and early 90's sensitized lenders - and rating

1 See, *CMBS: Moody's Approach to A-B Notes and Other Forms of Subordinate Debt*, Moody's Investors Service, *Special Report*, February 2000.

agencies - to the perils that second mortgages pose to the senior secured position.[2] Later, the "credit-spread" turmoil of 1998 encouraged issuers to limit large loans' senior debt in CMBS pools to investment-grade cutoffs, while still offering borrowers access to additional, subordinate debt. Bankers created several new arrangements, among them B-notes - first lien financing, yet subordinated via an intercreditor agreement to the securitized senior A-note. Mezzanine loans - that is, financing secured by pledges of *ownership interests* in the real property owning *entity* rather than by security in the real property itself - which always had been an alternative, but minor, financing route, increased as well.

A subordinate lender's exit strategy until recently was through portfolio investment or individual, note-by-note private placement to sophisticated investors; CRE sub-debt rarely if ever was rated or pooled. In 2000, Moody's published a special report entitled "*Moody's Approach to A-B Notes and Other Forms of Subordinate Debt*". In it, we described the effect that additional leverage in a variety of flavors would have *on the rating of the first mortgage or the A-note*: second mortgage, B-Note, mezzanine debt, and preferred equity, in that order of declining negative credit effect.

Normally, the increased leverage of a whole loan garners a certain "leverage penalty." The form of subordinate financing modulates that leverage penalty to varying degrees. B-notes (as they eventually devolved) now trigger the full leverage penalty, while mezzanine loans trigger about 1/3 of that penalty. This reduced penalty became for lenders one incentive to cast additional leverage as mezzanine debt rather than as a B-note, so as to minimize the negative credit impact on the rated senior loan.



CRE mezzanine debt placed into CRE CDOs increased from $25.6 million in 2004 to approximately $3.22 billion in 2006, and is on a dramatic upward swing. Because of the CRE CDO alternative, mezzanine loans now have a natural capital markets outlet, and Moody's rates them in their own right, not viewing them merely as an impediment to higher ratings on the senior secured debt (though they remain so, to a degree). This report will outline Moody's view of a baseline, "credit neutral" mezzanine loan structure, and how we apply that view in the ratings of mezzanine loans.

2 See, e.g., *Subordinate Mortgage Financing: The Perils of the Senior Lender*, Joshua Stein, Real Estate Review, Fall 1997, at page 3.

MEZZANINE LOAN STRUCTURES - BASELINE EXPECTATIONS

Defining Mezzanine Loans

Mezzanine lending, for this report, means lending to a borrowing entity or group of entities that directly or indirectly owns a real property-owning entity, which debt is secured by a perfected first security interest in the mezzanine borrower's pledged ownership interests in the property owner. Enforcement of the lender's remedies is not through mortgage foreclosure (as no real property lien is granted to the mezzanine lender), but through a "UCC"[3] foreclosure of the lender's interest in either the mezzanine borrower's ownership interests in the property owner (a "general intangible"), or, if the mezzanine collateral was "certificated", the "securities" the mezzanine lender controls or physically holds.[4]

Mezzanine loans may be short term or long term, amortizing or interest only, floating or fixed rate, though the current market sees most mezzanine loans as relatively short-term, interest-only, floating rate transactions.[5] In contrast to some preferred equity deals that have debt characteristics, few if any mezzanine loans destined for the capital markets have cumulative returns or equity "kickers": they are straight debt notes, for the most part, albeit at higher spreads to reflect the risk of being in the transition zone between debt and equity.

Most mezzanine loans are targeted to be at the bottom of the debt stack and are expected to receive below-investment-grade shadow ratings. Isolated mezzanine transactions, however, may reach low-to-mid investment grade levels, often when the real estate is located in jurisdictions with hefty mortgage recording taxes.[6]

Baseline Expectations

Mezzanine Loan Agreement

Moody's expects that the overall substance of a mezzanine loan agreement will be comparable to that of a CRE mortgage loan agreement. It will have most of the same terms, conditions precedent, affirmative and negative covenants, events of default and representations and warranties - altered, of course, to reflect the nature of collateral - to those obtained by mortgage lenders.

Merely as examples, these provisions range from representations on zoning and environmental compliance, to covenants on leasing, operating and capital budgets, and alterations, to insurance requirements and use of insurance proceeds, to restrictions on transfers, additional indebtedness and encumbrances, to requirements for qualified property managers. When mortgage and mezzanine loans are originated simultaneously, the mortgage loan agreement often serves as a template for the mezzanine loan agreement. The takeaway here is that the same careful attention to structure and legal issues - and the establishment of equivalent borrower obligations - are expected for mezzanine loans as for senior mortgage lending, notwithstanding that mezzanine lending may be backed by a "weaker" form of security, because underlying all, the source of the value is the same: real estate.

Underwriting, Due Diligence and Third Party Deliverables

Moody's analyzes credit data in a similar manner to mortgage loans to arrive at sustainable cash flow, Moody's property value and Moody's LTV, which drive the shadow rating of the mezzanine loan. Therefore, Moody's expects to receive for its review the same quality and quantity of underwriting information, due diligence materials and third party deliverables (such as appraisals, financial statements, asset summary reports, environmental and engineering reports, underlying title policies, insurance policies, legal opinions and certificates) as we receive when reviewing mortgage loans.

Special Purpose, Bankruptcy-Remote Entities

The mezzanine borrowing entity or entities should abide by the same structured finance theory and practice as do mortgage loan borrowers. That means the borrowing entities generally should be special purpose, bankruptcy remote entities. Two independent directors and nonconsolidation opinions should be obtained when

3 Uniform Commercial Code.

4 The term "mezzanine financing" is at times applied more loosely to other forms of subordinate debt, such as B-notes and debt-like preferred equity. This report focuses on the most typical form of non-mortgage financing, meaning loans secured by the pledge of ownership interests in a real-property-owning entity.

5 A small but rapidly growing portion of the mezzanine loan market, however, is fixed-rate debt that matches the term of the senior mortgage debt.

6 These investment-grade mezzanine loans are subject to tranching penalties and rating caps, as more fully described below.

total loan proceeds of both mortgage and mezzanine loans exceed the same thresholds that apply to REMIC debt. Nonconsolidation opinion "pairings" should follow senior lending theory and practice: the mezzanine borrowers (and general partners or managing members, as applicable) should be paired with the ultimate upper-tier sponsors and with the property owner and related property managers, and mezzanine borrowers should be paired with each other, if there are multiple levels of mezzanine debt.

Pledge of 100% of the Ownership Interests

Moody's expects that 100% of the beneficial ownership interests in the property-owning entity will be pledged as collateral, so that any foreclosure of the mezzanine loan will produce a transfer of all the equity interests in the property owner, leaving behind no minority interests. Complete control of the property owner is crucial to Moody's assumptions, as a pledge of split or partial ownership interests opens the door to many imponderable legal, structural and credit risks and claims.

Recourse Carveout Guarantees

Recourse carveout guarantees are a vital part of proper mezzanine lending, just as they are in mortgage financing. Because the mezzanine lender does not have a lien on the physical real estate, in many ways mezzanine lending is more akin to senior *unsecured* financing than to mortgage financing.[7] That makes recourse-carveout guarantees even more compelling in the mezzanine world. Any mezzanine lender relies heavily on its trust in, and the proper behavior of, the mezzanine borrower. For this reason, though it is not currently the market standard, recourse carveout guarantees in mezzanine loans perhaps should be a bit broader than in mortgage financing, and could - as a credit positive - include (in addition to the customary litany in mortgage financing) contingencies such as third party contract disputes, certain judgments against the property owner, breach of ground lease obligations, impermissible changes to organizational or senior loan documents, unapproved transfers such as deeds in lieu of foreclosure, and non-permitted financings or incurrence of unsecured debt. Provision of full debt recourse (not just "damages liability") for filing of voluntary bankruptcy petitions, or soliciting, causing or cooperating with the filing of an involuntary petition by the mezzanine borrower, the property borrower or any affiliated entity in the ownership chain, is particularly helpful.[8]

Cash Management

Ideally, the mezzanine loan should provide for an adequate cash management system[9], such as a hard lockbox[10] and a separate cash management account for the mezzanine lender, into which all property-related cash flow is deposited after payments required by the mortgage loan's waterfall, to pay mezzanine debt service and other mezzanine loan-level waterfall amounts. The cash management account should be coordinated with that of the mortgage lender's - often in the same bank - for ease of administration. Underlining the need for a cash management arrangement is the fact that mezzanine lenders, unlike mortgage lenders, generally do not have the right to demand the appointment of a receiver of rents upon a loan default.

Balloon Maturity

Moody's prefers that the maturity of the mezzanine loan be coterminous with maturity date of the senior loan, when rating mezzanine loans.[11] While the conventional thinking is that senior loan term default risk is reduced when the sponsor need not forage for mezzanine financing during the term, Moody's believes that this convention actually benefits the mezzanine lender as well. The balloon date of the senior loan is a natural "break point"

7 Indeed, in bankruptcy, the claims of the equity owners (which the mezzanine lender would be after a successful UCC foreclosure) come *behind* those of unsecured creditors.

8 In past years, it was not uncommon for mezzanine loans not bound for capital markets execution to benefit from an unfettered full-recourse credit guaranty from a moneyed sponsor. This approach - which has value - is inconsistent with structured finance practice that dictates analysis of credit risk strictly on the merits of a particular asset's cash flow. Full recourse credit guarantees (as distinguished from "bad-boy" recourse carveout guarantees) increase the risk of consolidation of the borrowing entity with its sponsor in bankruptcy. However, given the right circumstances (for instance, a full recourse credit guaranty by an investment-grade rated entity on a below-investment-grade rated mezzanine loan), the penalty that would be applied for the added substantive consolidation risks could be substantially outweighed by the benefit supplied by the guaranty.

9 Moody's will look for cash management especially when the senior loan already has such a system established.

10 Where the mezzanine loan is backed by a strong property and strong borrower, lockboxes that are "in-place," but spring into effect upon a low debt service coverage trigger, are a common alternative.

11 There is a view that balloon risk on the senior loan is reduced when mezzanine debt matures *after* senior loan maturity. Some question that assumption, believing that a takeout senior lender may prefer to have a cleaner capital financing slate, thereby making the later maturity date of the mezzanine loan theoretical only. In any event, what may be good for the mortgage goose may not always be good for the mezzanine gander.

when sponsors will be embarking on an all out effort to restack the debt of its asset The major financing shops now are "one-stop-shopping", and the convenience of refreshing all buckets at once becomes a credit positive. The vital intercreditor agreement negotiations will also probably produce a more favorable result for the mezzanine lender when both replacement loans are originated simultaneously. Even if the mortgage lender and mezzanine lender are not the same, the takeout mezzanine lender would be comforted to know that there is a simultaneous, identifiable exit strategy for the existing senior debt.

Certificated Entities under the UCC

Limited liability company, limited partnership and general partnership interests usually are deemed "general intangibles" under the UCC. Security interests in general intangibles are perfected under Article 9 of the UCC by filing UCC-1 forms in appropriate government filing offices. However, there are great benefits to the secured lender if a mortgage borrower must "opt-in" to Article 8 of the UCC, and must "certificate" its ownership interests as "securities" under Article 8. 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. The benefits to the mezzanine lender of certificating mortgage borrower interests far outweigh the minor disadvantages, if any, in Moody's view. 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.[12] UCC-1 financing statements should additionally be filed, as "fail-safe" protection.

Title Insurance

Mortgage lenders invariably obtain lender's title insurance in the United States, and few borrowers purchase real estate without the benefit of an owner's title policy. Mezzanine lenders' title policies differ from mortgage lender's title coverage, because they are derivative of the property owner's coverage; in essence, they are meant merely to "cut-through" to the owner's existing coverage. In years past, there was robust debate about whether mezzanine insurance title coverage was worth the cost: is the incremental benefit worth the premium? Recently, however, the mezzanine lending community has coalesced about a package of coverage that mezzanine borrowers have accepted as appropriate. Moody's acknowledges the intelligence of independently-arrived-at market standards, and agrees with the market that mezzanine title policies add value; we embrace them as a baseline for mezzanine lending. Therefore, Moody's generally expects that mezzanine loans presented for rating will have the benefit of an ALTA 16 "mezzanine financing endorsement"[13] - or its equivalent - where available and reasonably priced[14] representing access to an owners's policy in an amount at least equal to the combined value of the senior and mezzanine loans,[15] as well as in all cases the benefit of a "UCC insurance policy" where available.

Intercreditor Agreements

The relationship of the mezzanine lender to the mortgage lender and the rights the mezzanine lender can extract through the intercreditor agreement are keystones to the potential success or failure of a mezzanine loan. Mezzanine loan collateral is fragile; all that the mezzanine lender ultimately has is the right to step into the

12 The pledge agreement additionally should include an irrevocable proxy for purposes of UCC Article 8.

13 At least one commentator has noted that the ALTA 16 endorsement's attempt to have the *property owner* assign its rights to proceeds under its owner's title policy to the *mezzanine lender* (and some lenders who take such an assignment of proceeds in complete lieu of the ALTA 16) could cause the property owner to run afoul of special purpose, bankruptcy remoteness principles, by essentially incurring "suretyship" debt to the mezzanine lender. See, *Enforcing Security Interests in Membership Interests and Partnership Interests*, Dennis B. Arnold, Commercial Real Estate Finance 2007, Practicing Law Institute, at p.717. Though the series of unfortunate events necessary to trigger this contingency is not very likely to occur, and will probably have minimal impact on the balancing tests that nonconsolidation opinions apply, this issue should be disclosed and addressed in the nonconsolidation opinion of the *property owner*.

14 New York State has particularly high-priced mezzanine loan endorsements.

15 In some situations, typically in non-acquisition financings, the property owner is reluctant to purchase an increased amount of (or a new) owner's title insurance to which the mezzanine loan endorsement would "cut-through." In acquisition financing, this reluctance is rarely encountered. The provenance of the loan - and the reason for absence or presence of title insurance - should make no difference for rating purposes. A loan that has full title protection simply is a bit better than one that doesn't have this protection. However, the effect of an absence of such coverage will be greater at the investment-grade tranches of the mezzanine loan, and will significantly diminish deeper into the capital stack, as the marginal risk of not having such coverage becomes overwhelmed by the plain-vanilla real estate risks being rated at below-investment grade levels. Nevertheless, in the absence of such coverage, the non-recourse carveout guarantee should include recourse for the risks that ALTA 16 addresses, and an assignment of title insurance proceeds of the existing owner's policy will help to mitigate the negative effects of not having a full array of title insurance protection.

shoes of its borrower, *as the mortgage borrower.* The greater the array of rights that are granted by the senior lender that pad and polish those shoes, the greater the value of the mezzanine loan, and, marginally, the higher the loan's shadow rating will be. An intercreditor agreement usually is not a win-win arrangement, but is something that memorializes the zero-sum accommodations lenders forge with each other. If some senior lenders had their choice, no intercreditor agreement would be granted. The fact that there *is* mezzanine debt and the fact that there *is* an intercreditor agreement, however, are baked into the leverage penalty that Moody's applies to senior loans that have additional mezzanine debt. The question then becomes, what is a "credit-neutral" intercreditor agreement and its terms?

In 2002, *CMBS World* published a "suggested standard form" of senior loan-mezzanine loan intercreditor agreement that was drafted after a diverse group of senior lenders and junior lenders met. It is posted to the Commercial Mortgage Securities Association (CMSA) website[16] and has been come to be known as the "CMSA form" of intercreditor agreement. Though never "approved" by Moody's, over the last five years, it indeed has become - with its strengths and weaknesses - the "standard" - or at least the "blacklining" base - for almost all capital markets mezzanine loan intercreditor agreements. The CMSA form is now the "credit neutral" platform against which Moody's weighs whether modifications to this form are credit positive or credit negative to either the senior mortgage loan or the mezzanine loan. Material changes to this form may have positive or negative effects on the shadow rating of the related mezzanine loan and on the senior loan.[17]

Interest Rate Caps

Because the majority of mezzanine loans are floating rate, an interest rate cap agreement mitigates the volatility of debt service stress. The cap agreement should be pledged to the mezzanine lender.

Miscellaneous Provisions

- The property management agreement should be terminable upon default under the mezzanine loan, subject to senior lender consent. This is particularly important if an affiliate of the borrower is the property manager. The manager should execute an assignment and subordination agreement benefiting the mezzanine lender.
- Ideally, the mezzanine lender should be an "additional insured" on the property owner's property and casualty insurance policies and ACORD certificates.
- The mortgage borrower's organizational documents should have provisions prohibiting both the issuance of additional interests and opting-out of UCC Article 8 without the lender's written consent. The pledge agreement should also include an acknowledgement of the limited guild of "qualified transferee" bidders at a UCC foreclosure sale.
- A certified organizational/structural chart should be supplied, ideally as an exhibit to the loan agreement.

CREDIT CONSIDERATIONS AND RATING METHODOLOGY

Conservation of Expected Loss

When rating the capital stack of CRE debt, Moody's starts with the axiom that the total "expected loss" (EL) of a loan structure with a variety of components of a given total leverage should *roughly* equal the EL of a whole loan of similar total leverage. The complexity of a loan structure adds a bit of rating "friction" to the total EL, but, more or less, the EL of an 85% whole loan should roughly equal the EL of a 67% A-note + 18% B-note which should roughly equal the EL of a 67% senior mortgage + 18% mezzanine loan. The weaker the subordinate leverage component, the greater the proceeds available at the higher investment grade levels (i.e., the lesser the leverage penalty to the senior debt or A-note); the stronger the subordinate component, the lesser the pro-

16 http://www.cmbs.org/standards/Intercreditor_Agreement.pdf

17 One increasingly common change to the CMSA form is to the definition of "Qualified Transferee" (QT). It essentially provides that a qualified transferee is *any* CDO that has at least one class of investment grade certificates. Of course, CDO issuances almost invariably have at least some *Aaa*, let alone one investment grade class. Under this definition, then, any CDO can become the owner of any size mezzanine loan on any property. This can have negative credit rating effects on the shadow rating of the *senior loan*, especially where material consideration was given to the identity of the original property-level borrower. Moody's believes this definition should be pared back in most cases (especially for large loans), to provide that the CDO be managed by an entity that is otherwise a Qualified Transferee (or if not, is subject to rating agency review), and that all loans and REO be serviced by servicers approved by Moody's for CMBS deals. Additionally, marquee properties or particularly large loans may need to have the "Eligibility Requirements" of the QT definition - which are typically $250 million in net worth and $600 million in assets - increase to greater amounts to reflect the needed deeper pockets and deeper real estate expertise of the mezzanine lender or CDO manager, to match the challenges of the asset.

ceeds available at the top and therefore the greater the leverage penalty, and the greater the proceeds for the subordinate debt. The concept is akin to a "law of conservation of expected loss": to the extent the expected loss is reduced or increased in one layer of the capital stack, it must be reflected in a greater or lesser expected loss in the remaining layers.

Because a mezzanine loan is a "weaker" form of security to its holder than its alternatives (second mortgage, B-notes), we view it as having a lesser negative effect on the senior debt, and therefore logically it must bear a greater portion of the expected losses when the total loan leverage defaults. The following section will detail how Moody's measures the effect of the intrinsic structures of mezzanine loans on their ratings.

Why Mezzanine Loans Usually Provide a Weaker Form of Collateral

The gold-standard of real estate security is the mortgage, a form of lien that has been polished to a high sheen over centuries of tortuous common law and statutory developments. Though over-reaching lenders caused courts of equity to scale back many of its harsh, literally medieval provisions, mortgages remain powerful, lender-friendly instruments. A first mortgage lien takes priority over almost every imaginable contingency that may arise after its perfection. It supersedes any sale or transfer of title by the borrower; it supersedes judgment creditors' liens, second mortgages, most non-property tax liens, most mechanics' liens, and any other instruments recorded against the realty after the mortgage. When the time comes to foreclose the borrower's "equity of redemption," the winning bidder at the foreclosure sale (many times the lender) gets from the sheriff's or trustee's deed the state of title *of the realty itself* precisely as it existed on the date mortgage was recorded.

In contrast, a mezzanine loan's lien does not touch the real estate or, vis-à-vis the realty, "relate back" to the date of the loan. Instead, it simply gives the lender the right to step into the mezzanine borrower's currently existing, potentially well-worn shoes, as those shoes exist on the date of the mezzanine loan foreclosure. The mezzanine lender's position after foreclosure is thus subject to whatever a borrower in its wisdom or foolishness - or disregard of promises to the mezzanine lender - may have done to the real estate asset. Subordinate debt, contract claims of service providers, claims of tenants, judgment creditors, mechanics' liens, federal and state tax liens, all will trump the interests of the mezzanine lender. The borrower could even sell the underlying real asset from under the mezzanine lender and misapply the proceeds, or less reprehensibly, give a deed-in-lieu of foreclosure to the senior lender. The mezzanine borrower can also make changes to organizational documents, or disputes between partners or members can have fallout effects on the equity interests a mezzanine lender may inherit. In bankruptcy, claims of plain-vanilla unsecured creditors rank higher than the claims of the equity (i.e., the mezzanine lender after UCC foreclosure).[18]

The process of realization on the mezzanine lender's collateral itself currently is *terra incognita*. One argument frequently proffered in support of mezzanine loans is that a UCC foreclosure is much swifter than a mortgage foreclosure (especially judicial foreclosures required in many states that don't use the deed-of-trust format), and so the mezzanine lender theoretically can swoop in faster to protect its interest than would a B-note holder, who is subject, among other things, to "servicing standard" limitations, the shifting of control rights by appraisal reduction, and standstill covenants in the intercreditor agreement. But this is largely untested theory, with few well-litigated mezzanine loan default empirical data points.[19] B-note holders over the last five years have been beneficiaries of an increasing array of consultation and control rights, which additionally erode the lack-of-control argument against B-notes. There also are open legal issues of what standards of "commercial reasonableness" would be required to effect a bullet-proof sale of mezzanine collateral, and how courts may view baked-in transfer restrictions common in capital markets deals.[20]

18 Mitigation of many of these risks can be found in the expanded "warm-body" recourse guarantees discussed above. But these guarantees do not eliminate these hazards.

19 One academic writer has even gone so far as to urge courts to adopt the real estate mortgage concept of "equity of redemption" (which would throw a mortgage-like monkey wrench into the works) to the foreclosure of mezzanine loans, arguing that in modern times, mezzanine loans are effectively becoming a common surrogate of mortgage financing, and borrowers should therefore receive similar sympathy and protection from courts of equity. See, *Once a Mortgage, Always a Mortgage - The Use (and Misuse) of Mezzanine Loans and Preferred Equity Investments*, Andrew Berman, Stanford Journal of Law, Business & Finance, Autumn 2005.

20 One nettlesome issue is whether an important limitation on the transferees of ownership interests (the "Qualified Transferee" of capital markets intercreditor agreements) could prove troublesome to the UCC requirement that a sale, where the winning bidder is likely to be the lender, must be "public". What does "public" mean? It is likely, but not by all means certain, that a court would recognize the natural audience for mezzanine foreclosures to be the sophisticated parties that "qualified transferees" usually are defined to be.

Finally, mezzanine lenders only very infrequently benefit from agreements with third parties, such as ground lessors (who grant well-defined "ground lease financeability" rights and give ground lease estoppel certificates to mortgage lenders), major tenants (who usually are signatories to SNDAs[21] and give tenant estoppel certificates), major building contractors, or reciprocal easement agreement counterparties, among others.

Mezzanine lending may, in some limited cases, enjoy certain benefits over a B-note. In states where long, drawn out mortgage foreclosures often prevail, versus states that have swift, no-nonsense realization processes, mezzanine lending could have a slight advantage over B-notes, because of the (theoretical) swiftness of wresting control of the asset from the borrower. Mezzanine lenders with particularly deep pockets and sophisticated real estate experience can infuse needed capital and intelligence into a property and property owner upon a UCC foreclosure more easily than can B-note holders.[22] Moody's will examine each mezzanine loan on a case-by-case basis to determine if "extenuating circumstances" exist that could lessen somewhat the adjustments to rating mezzanine debt that are described below.

Approach to Rating Mezzanine Loans

Moody's begins by evaluating the underlying real estate asset's credit risk. That credit risk is a function of (a) the default probability of the entire capital structure and of the mezzanine loan individually, (b) the severity of loss assuming default of the mezzanine loan and/or of the senior loan, and (c) where in the capital stack the mezzanine loan resides and how "thick" the mezzanine loan is in comparison to all outstanding realty-related debt. Moody's establishes the "bottom dollar" default risk, and severity of loss for the mezzanine piece. These numbers become input for further pool-wide analysis. But the key driver of ratings for mezzanine loans is the *bottom-dollar default risk.*

We calculate bottom-dollar default risk by applying our large-loan rating approach. Moody's performs its usual CMBS analysis of submitted data relating to the real estate asset and debt encumbering both the asset and its owning entities. The Moody's LTV of the *entire* capital structure is then used in arriving at the bottom dollar default risk.

For instance, if a commercial property has a Moody's value of $100 million, and is encumbered with a $67 million A-note, a $10 million B-note, and an $8 million mezzanine loan, the all-in debt figure is $85 million, and the all-in Moody's LTV will then be 85%. An 85% Moody's LTV whole loan may have a bottom dollar default risk or shadow rating of, perhaps, *B2.*

But this will not be the bottom dollar default rating *of the mezzanine loan,* because we must first make a variety of adjustments, which we now describe.

Adjustments and Caps to Mezzanine Debt Ratings

General Adjustments:

- Moody's first determines whether the mezzanine loan meets the "credit neutral" expectations outlined in the first section of this report. To the extent that these baseline expectations are exceeded or are missed, appropriately sized adjustments are made.
- As in the rating of senior debt, the presence or absence of assorted features will inure to the benefit or detriment of a mezzanine loan's rating. For instance: the term of the loan (the shorter, the more positive); the asset class (industrial, positive; nursing home, less positive); fixed vs. floating rate; and Red-Yellow-Green® score, will all affect the loan's rating.[23]

Adjustments Relating to Probability of Default:

- Moody's then generally notches down the tranched rating of a mezzanine loan *two rating notches* from target LTV levels, beginning at the *Aa* level, tapering gradually to a *one-notch adjustment* at the *Baa3* level and below. The adjustment remains at one notch for *Ba* and *B* tranches, and finally diminishes to *no notches* at the *Caa* level. This scaled adjustment reflects the diminishing relative negative effect that the structural infir-

21 Subordination, Non-disturbance and Attornment Agreements.
22 This factor may apply more strongly to portfolio holders of mezzanine loans, that may have quick and easy access to repositioning funds.
23 Increasingly, we see the A-note in CMBS REMIC transactions, and the mezzanine note in CRE CDO deals. Most times, both forms of debt are playing a zero-sum-game: what is good for one is usually bad for the other (excepting, of course, high quality real estate underlying both). Our approach to rating each portion is that of a referee: we will look at the credit effect of structures from both sides.

mities of mezzanine lending have at tranches with greater inherent risk potential. But because we believe that exogenous risk factors can *slightly* increase the overall default probability of mezzanine loans, and that there will almost always be increased loss severity because of the very nature of mezzanine collateral, we keep the adjustment at one notch through *Ba* and *B* levels.

Adjustments Relating to Severity of Loss:

- The "thickness" of the mezzanine loan and its rated tranches and its placement in the capital stack will dictate the severity of loss percentages that Moody's applies, assuming default. This concept is similar to the "leverage of loss" approach Moody's uses in other contexts. Losses given default are subject to an "overhead" effect: that is, once a loan defaults, legal, servicing and other costs invariably accrue to a minimum "floor" amount. If the rated tranche - or even the entire mezzanine loan - is too thin, these floor amounts will eat up a very large part, or even the entire amount, of the tranche or loan. Because mezzanine loans typically are at the bottom of the capital stack, these losses strike these portions of the debt first, and hardest. In addition, losses due to market value volatility of the underlying asset naturally will hit the bottom portions of the capital stack first and hardest.

Adjustments to Highly-Rated Mezzanine Loans:

- Moody's *caps* the tranching of mezzanine loan ratings at the *Aa* level. For the reasons described above, we believe that risks inherent in the mezzanine loan structure are incompatible with a *Aaa* level rating.
- Tranched ratings of mezzanine debt at the *A* and *Aa* level depend upon a number of variables, including the absolute size of the mezzanine loan and its relative percentage of the overall capital structure, the size of the equity buffer in the asset, and coverage of the underlying realty by adequate amounts of liability insurance. Weakness in these areas may materially diminish the amount, or even eliminate, proceeds at these rating levels. These buffers protect against the risk that tort and contractual liability and other judgments not covered by insurance might eat into the equity collateral of the mezzanine lender.

The Benefits of Pooling

As in conduit and large loan pools, the benefits of pooling a diverse collection of mezzanine loans can be powerful. Many of the infirmities of individual mezzanine loans begin to dissolve into actuarial-like probabilities that can be estimated and accounted for in tranching a CRE CDO into high investment grade territory. From the assorted collection of below investment grade mezzanine debt credits, *Aaa*-rated tranches may emerge.

The shadow rating of one mezzanine loan by its nature must address the inherent volatility of risk relating to one asset and *one* ownership structure. For instance, for reasons discussed above, we do not feel comfortable tranching an individual mezzanine loan to the *Aaa* level. Once a diverse collection of mezzanine loans is assembled, however, it becomes highly unlikely that all loans will suffer the indignity that thwarts the possibility of Aaa proceeds.

The caps and adjustments that are applied by Moody's to an individual loan therefore begin to diminish - but not totally disappear - as mezzanine loans are pooled into diverse, increasingly uncorrelated collections.

Doc ID# SF95585

© Copyright 2007, Moody's Investors Service, Inc. and/or its licensors and affiliates including Moody's Assurance Company, Inc. (together, "**MOODY'S**"). All rights reserved. **ALL INFORMATION CONTAINED HEREIN IS PROTECTED BY COPYRIGHT LAW AND NONE OF SUCH INFORMATION MAY BE COPIED OR OTHERWISE REPRODUCED, REPACKAGED, FURTHER TRANSMITTED, TRANSFERRED, DISSEMINATED, REDISTRIBUTED OR RESOLD, OR STORED FOR SUBSEQUENT USE FOR ANY SUCH PURPOSE, IN WHOLE OR IN PART, IN ANY FORM OR MANNER OR BY ANY MEANS WHATSOEVER, BY ANY PERSON WITHOUT MOODY'S PRIOR WRITTEN CONSENT.** All information contained herein is obtained by **MOODY'S** from sources believed by it to be accurate and reliable. Because of the possibility of human or mechanical error as well as other factors, however, such information is provided "as is" without warranty of any kind and **MOODY'S**, in particular, makes no representation or warranty, express or implied, as to the accuracy, timeliness, completeness, merchantability or fitness for any particular purpose of any such information. Under no circumstances shall **MOODY'S** have any liability to any person or entity for (a) any loss or damage in whole or in part caused by, resulting from, or relating to, any error (negligent or otherwise) or other circumstance or contingency within or outside the control of **MOODY'S** or any of its directors, officers, employees or agents in connection with the procurement, collection, compilation, analysis, interpretation, communication, publication or delivery of any such information, or (b) any direct, indirect, special, consequential, compensatory or incidental damages whatsoever (including without limitation, lost profits), even if **MOODY'S** is advised in advance of the possibility of such damages, resulting from the use of or inability to use, any such information. The credit ratings and financial reporting analysis observations, if any, constituting part of the information contained herein are, and must be construed solely as, statements of opinion and not statements of fact or recommendations to purchase, sell or hold any securities. **NO WARRANTY, EXPRESS OR IMPLIED, AS TO THE ACCURACY, TIMELINESS, COMPLETENESS, MERCHANTABILITY OR FITNESS FOR ANY PARTICULAR PURPOSE OF ANY SUCH RATING OR OTHER OPINION OR INFORMATION IS GIVEN OR MADE BY MOODY'S IN ANY FORM OR MANNER WHATSOEVER.** Each rating or other opinion must be weighed solely as one factor in any investment decision made by or on behalf of any user of the information contained herein, and each such user must accordingly make its own study and evaluation of each security and of each issuer and guarantor of, and each provider of credit support for, each security that it may consider purchasing, holding or selling.

MOODY'S hereby discloses that most issuers of debt securities (including corporate and municipal bonds, debentures, notes and commercial paper) and preferred stock rated by **MOODY'S** have, prior to assignment of any rating, agreed to pay to **MOODY'S** for appraisal and rating services rendered by it fees ranging from $1,500 to approximately $2,400,000. Moody's Corporation (MCO) and its wholly-owned credit rating agency subsidiary, Moody's Investors Service (MIS), also maintain policies and procedures to address the independence of MIS's ratings and rating processes. Information regarding certain affiliations that may exist between directors of MCO and rated entities, and between entities who hold ratings from MIS and have also publicly reported to the SEC an ownership interest in MCO of more than 5%, is posted annually on Moody's website at www.moodys.com under the heading "Shareholder Relations — Corporate Governance — Director and Shareholder Affiliation Policy."