

## **The Mezzanine Financing Endorsement**

By John C. Murray

© 2001. All rights reserved.

As a result of the increased securitization of real estate and the packaging of pools of loans for sale into the secondary market, mezzanine financing has become very popular in recent years. Mezzanine financing (or, perhaps more appropriately, mezzanine capital) fills the gap between the first mortgage financing, which usually has a loan-to-value ratio of forty to seventy-five percent, and the equity participation of the principals of the borrower, which is usually no more than ten percent of the cost of the project. Mezzanine financing commonly supplies financing of ten percent to fifty percent of the project's capital structure cost. This type of financing can take several forms. Most commonly, it involves extending credit to the partners or other equity holders of a borrower and taking a pledge of such parties' equity interests (including the right to distributions of income). Alternatively, the lender may take a preferred equity position, which is entitled to distributions of excess cash flow after debt service, ahead of the borrower's principals. A "combination" loan structure may also be used to combine a first mortgage loan with mezzanine financing at an aggregate loan-to-value ratio of ninety to ninety-five percent. This type of structure may contain a shared appreciation or contingent feature, an exit fee paid by the borrower, or sometimes, both.

The borrower in a mezzanine loan is often an LLC, and the equity participant in the borrowing entity is frequently itself an LLC. In those situations where the mezzanine lender is taking a pledge of some or all of the equity interests in one or more of these entities in connection with the mezzanine loan, the lender may look to the title insurer for special forms of title-insurance coverage. The lender may seek some form of non-imputation coverage, i.e., assurance that the title insurer will not deny coverage under the owner's policy based on matters known to the borrowing entity (or its members) being imputed to the lender. Copies of endorsements offering this type of coverage are attached hereto.

Title underwriters may require an affidavit and an indemnity agreement from the existing LLC members, and from the mezzanine lender when it exercises its foreclosure rights under the pledge and succeeds to an ownership interest in the mezzanine borrower. These affidavits and indemnity agreements will state that the respective parties have no knowledge of any fact that will affect the coverage under the policy, and will hold the title insurer harmless for losses resulting from its reliance on such affidavits and indemnities. The title insurer may also require, and review, financial statements from all relevant parties in order to achieve a comfort level for relying on the aforementioned indemnity.

The attached endorsements state that (as agreed to by the insured and its equity members) all payments for loss under the policy will go directly to the mezzanine lender,

---

and that there will be no denial of coverage as the result of the transfer of any of the LLC membership interests to the mezzanine lender. The endorsements further provide that the title insurer waives its right of subrogation and indemnity against any of the insured owner's equity owners until the mezzanine loan is paid in full. If a loss occurs under the policy, the amount paid by the title insurer is limited to the actual loss less a percentage thereof equal to the percentage of LLC membership interests not owned by the mezzanine lender at such time. If the loss occurs before the mezzanine lender's acquisition of the insured owner's membership interests, the mezzanine lender is not required first to pursue its remedies against other collateral. However, the title insurer's liability in any event is limited to the amount of the mezzanine loan, and the title insurer is entitled to credit for any amount paid out under a simultaneous loan policy. The title insurer is also entitled to reimbursement from payments received by the mezzanine lender from other security. The term "mezzanine lender" can be defined to include the owner of the mezzanine loan and each successor in interest in ownership of the mezzanine loan, and include any subsidiary or affiliate entity of the owner of the mezzanine loan. The availability and content of the attached endorsements will vary depending on factual and underwriting considerations, as well as statutory and regulatory restraints in certain states.

**MEZZANINE FINANCING ENDORSEMENT**

Attached to Policy No. \_\_\_\_\_

Issued by

FIRST AMERICAN TITLE INSURANCE COMPANY

1. \_\_\_\_\_ (“Mezzanine Lender”) is hereby added as a loss payee under this policy. The Company acknowledges that Mezzanine Lender has made a loan ( the “Mezzanine Loan”) to \_\_\_\_\_, a \_\_\_\_\_ real estate investment trust (the “Borrower”). The Borrower is the sole member of \_\_\_\_\_, LLC (“LLC 1”), a Delaware limited liability company that is the sole member of \_\_\_\_\_, LLC (“LLC 2”), a Delaware limited liability company that is the sole member of the Insured. To secure the Mezzanine Loan, the Borrower has granted to the mezzanine Lender a security interest in the Borrower’s membership interest in LLC 1 (the “Security Interest”). In the event of payment by the Company to the Insured for any loss insured against under the terms of the policy, all payments shall be made directly to the Mezzanine Lender. By its execution hereinbelow of this endorsement, the Insured, LLC 1, LLC 2 and Borrower (collectively, “Owners”) each approves of the terms and provisions of this paragraph pertaining to the naming of Mezzanine Lender as a loss payee.

2. In the event of loss or damage from a matter insured against under this policy, the Company shall not deny liability to the Insured on the ground that any or all of the membership interests in the Insured have been transferred to or acquired by Mezzanine Lender directly or indirectly, after the Date of Policy pursuant to the Security Interest.

3. Notwithstanding Section 3(b) of the Exclusions from Coverage of this policy, the Company assures Mezzanine Lender that, unless and until Mezzanine Lender shall have been paid in full, in the event of loss or damage insured against under the terms of the policy, the Company will not deny its liability thereunder on the ground that the defect, lien, encumbrance or other matter creating or causing the loss was known to the Insured if such defect, lien, encumbrance or other matter was not known to the Company, was not shown in the public records and was not actually known (as opposed to known by imputation by operation of law) to Mezzanine Lender, but which matter was known to any one or more of the Owners or to any owners of interests in Borrower (“Principals”) (whether actually known or known by imputation) at the Date of Policy shown on Schedule A.

All rights of subrogation and indemnity that the Company may have against any Owners shall not be asserted in respect of matters for which Mezzanine Lender is afforded coverage pursuant to the provisions of this paragraph 3, unless and until the

Mezzanine Loan shall have been paid in full; the Company's subrogation rights against the Principals shall not be affected hereby. In the event of loss under this endorsement following acquisition by Mezzanine Lender of some or all of the interests in the Insured, the amount of such loss paid by the Company under this endorsement shall be equal to the actual loss (as determined under the Conditions and Stipulations of the policy) less a percentage of such loss equal to the percentage of membership interests not owned, directly or indirectly, by Mezzanine Lender at the time such loss is paid. In the event of loss under this endorsement prior to the acquisition by Mezzanine Lender of any direct or indirect interest in the Insured, the amount which the Company shall be liable to pay shall be determined without requiring Mezzanine Lender to pursue its remedies against any collateral which secured the Mezzanine Loan. The liability of the Company under this endorsement shall in no case exceed the diminution in the value of the land caused by the defect, lien, encumbrance or other matter less the liability of the Company under any loan policy of title insurance insuring any deed of trust or mortgage shown in Schedule B of this policy. In no event shall the loss paid to Mezzanine Lender pursuant to the provisions of this paragraph 3 exceed the amount of the Mezzanine Loan.

Subrogation rights of the Company shall include entitlement to reimbursement for all amounts paid under this endorsement should the Mezzanine Loan be repaid or recovered through other security, such possible repayment or recovery being intended to render loss described herein as contingent. Company agrees that it will not exercise its subrogation rights set forth in this paragraph until the Mezzanine Loan shall have been paid in full.

As used in this endorsement Mezzanine Lender means the Mezzanine Lender named hereinabove, and includes the owner of the Mezzanine Loan and each successor in ownership of the Mezzanine Loan (reserving, however, all rights and defenses as to any successor that the Company would have had against Mezzanine Lender and any successor thereto who is a predecessor in interest to the then owner of the Mezzanine Loan, unless the successor making the claim hereunder acquired the Mezzanine Loan as a purchaser for value without knowledge of the asserted defect, lien, encumbrance, adverse claim or other matter insured against by this policy affecting title to the estate or interest in the land). Without limiting the generality of the foregoing, the rights of the Mezzanine Lender under this endorsement shall inure to the benefit of any entity that is owned or controlled by \_\_\_\_\_, to whom a transfer is made by Mezzanine Lender of the Mezzanine Loan or any interests therein.

The liability of the Company under this policy shall in no case exceed the least of:

(i) the amount of insurance stated in Schedule A, or, if applicable, the amount of insurance as defined in paragraph 2(c) of the conditions and stipulations; or

(ii) the amount of the indebtedness secured by the Mezzanine Loan as determined under paragraph 9 of the conditions and stipulations, at the time the loss or damage insured against hereunder occurs, together with interest thereon;

or

(iii)the difference between the value of the insured estate or interest as insured and the value of the insured estate or interest subject to the defect, lien, encumbrance or other mater insured against by this policy.

This endorsement is made part of the policy and is subject to all of the terms and provisions thereof and of any prior endorsements thereto. Except to the extent expressly stated, it neither modifies any of the terms and provisions of the policy and any prior endorsements, nor does it extend the effective date of the policy and any prior endorsements, nor does it increase the face amount thereof.

**Dated:** **FIRST AMERICAN**  
**TITLE INSURANCE COMPANY**

By: \_\_\_\_\_  
Authorized Signatory

The undersigned join in the execution of this endorsement to evidence their consent to the Mezzanine Lender being named as a loss payee under the policy pursuant to the provisions of paragraph 1 hereof.

\_\_\_\_\_, LLC.  
a Delaware limited liability company

By: \_\_\_\_\_  
Its: \_\_\_\_\_  
Name: \_\_\_\_\_

LLC 1, LLC.  
a Delaware limited liability company

By: \_\_\_\_\_  
Its: \_\_\_\_\_  
Name: \_\_\_\_\_

LLC 2, LLC.  
a Delaware limited liability company

By: \_\_\_\_\_  
Its: \_\_\_\_\_  
Name: \_\_\_\_\_

## MEZZANINE FINANCING ENDORSEMENT

Attached to Policy No.

Issued by

\_\_\_\_\_ TITLE INSURANCE COMPANY

1. \_\_\_\_\_, a \_\_\_\_\_, as lender and the other lenders, from time to time ("**Mezzanine Lender**"), is hereby added as a loss payee under this policy. The Company acknowledges that Mezzanine Lender has made a loan to \_\_\_\_\_ (the "**Borrower**" or the "**Insured**") and has been granted a security interest in the Borrower's [**membership/partnership**] interest in the Insured as collateral for such loan (the "Security Interest"). In the event of payment by the Company to the Insured for any loss insured against under the terms of the policy all payments shall be made to the Mezzanine Lender.

2. Notwithstanding anything to the contrary contained in this policy, in the event of loss or damage from a matter insured against by this policy, the Company shall not deny liability to the Insured on the ground that any or all of the [**membership/partnership**] interests in the Insured have been transferred to or acquired by Mezzanine Lender after the Date of Policy pursuant to the terms of that certain Security Interest.

3. Notwithstanding the Exclusions from Coverage of this policy, the Company assures Mezzanine Lender that in the event of loss or damage insured against under the terms of the policy, the Company will not deny its liability thereunder on the ground that the defect, lien, encumbrance or other matter creating or causing the loss was known to the Insured if such defect, lien, encumbrance or other matter was not known to the Company, not shown in the public records and was not actually known (as opposed to known by imputation by operation of law), to Mezzanine Lender, but which matter was known to any one or more of the other [**members/partners**] of the Insured itself (whether actually known or known by imputation) at the original date of policy shown on Schedule A.

Provided, however, that the Company shall have no liability under this paragraph 3 of this endorsement to any [**member/partner**] of the Insured other than Mezzanine Lender and all rights of subrogation and indemnity that the Company may have against any such other [**member/partner**] of the Insured shall not be affected hereby. In the event of loss under this endorsement following acquisition by Mezzanine Lender of some or all of the interests in the Insured, the amount of such loss paid by the Company under this endorsement shall be equal to the actual loss (as determined under the Conditions and Stipulations of the policy) less a percentage of such loss equal to the percentage of [**membership/partnership**] interests owned by any [**member/partner**] other than Mezzanine Lender at the time such loss is paid. In the event of loss under this endorsement prior to the acquisition by Mezzanine Lender of any interests in the insured,

the amount which the Company shall be liable to pay shall be determined without requiring Mezzanine Lender to pursue its remedies against any of its collateral which secures the indebtedness. The liability of the Company under this endorsement shall in no case exceed the diminution in the value of the property caused by the defect, lien, encumbrance or other matter less the liability of the Company under any loan policy of title insurance insuring any deed of trust or mortgage shown in Schedule B of the policy. In no event shall the loss paid to Mezzanine Lender pursuant to the provisions of this paragraph 3 exceed the amount of indebtedness for which the **[membership/partnership]** interest in the Insured are or were collateral. Provided, however, that nothing in this endorsement shall affect or impair the Company's rights of subrogation with respect to the insured land.

Subrogation rights of the Company shall include entitlement to reimbursement for all amounts paid under this endorsement should the indebtedness secured by the **[membership/partnership]** interests in the Insured be repaid or recovered through other securities, such possible repayment or recovery being intended to render loss described herein as contingent. Company agrees that it will not exercise its subrogation rights set forth in this paragraph until the Mezzanine Lender's indebtedness is paid in full.

As used in this endorsement Mezzanine Lender means the Mezzanine Lender named hereinabove, and includes the owner of the indebtedness secured by the **[membership/partnership]** interests in the Insured, and each successor in ownership of the indebtedness (reserving, however, all rights and defenses as to any successor that the Company would have had against Mezzanine Lender and any successor making the claim hereunder acquired the indebtedness as a purchaser for value without knowledge of the asserted defect, lien, encumbrance, adverse claim or other matter insured against by this policy affecting title to the estate or interest in the land.

This endorsement is made part of the policy and is subject to all of the terms and provisions thereof and of any prior endorsement thereto. Except to the extent expressly stated, it neither modifies any of the terms and provisions of the policy and any prior endorsements, nor does it extend the effective date of the policy and any prior endorsements, nor does it increase the face amount thereof.

[Remainder of page intentionally left blank.]

Dated: \_\_\_\_\_, 2000

COMPANY

\_\_\_\_\_ TITLE INSURANCE

By:

\_\_\_\_\_

Authorized Signatory