Mortgage Securities: New Type of Security Instruments

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Ukrainian securities laws have recently been amended to introduce new types of security instruments the "mortgage note" and "mortgage certificate". On 1 January 2004 the *Mortgage Act of Ukraine of 5 June 2003 No.898-IV* and the *Mortgage Lending, Operations with Consolidated Mortgage Debt and Mortgage Certificates Act of Ukraine of 19 June 2003 No.979-IV* (the *Mortgage Lending Act*) came into force. These legislative initiatives are often described as a revolution in mortgage and credit transactions. They are intended to provide better security to lenders and create a liquid market for secured debt obligations. Based on the new procedures described in the *Mortgage Act*, creditors should be able to foreclose on mortgaged property faster and more easily. This article presents an overview of the primary legal considerations affecting the implementation of these new types of securities.

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Mortgage note

Definition

The *Mortgage Act* defines a mortgage note as a debt instrument that certifies the unconditional right of its holder to claim certain funds from the debtor in performance of the principal (underlying) obligation, or to foreclose on the mortgaged property in the event that the debtor fails to satisfy its debt obligation. It is important to emphasise that a mortgage note can secure only a monetary obligation of the debtor. Such an obligation may arise under a loan agreement or some other contractual basis creating the monetary debt.

Issuance of a mortgage note

A mortgage note may be issued only if specifically provided for in the mortgage agreement. An appropriate provision of the mortgage agreement should describe the property to which the mortgage is applicable and the amount of the principal obligation secured by the mortgage note (or the specific criteria for determining such amount). If a mortgage note is issued, the payment obligation of the debtor under the mortgage agreement is replaced by a new monetary obligation under the mortgage note.

A mortgage note must be in writing, only in a single copy on a special, standard form approved by the State Commission on Securities and Stock Market as stipulated by a *Decision of the State Commission of 4 September 2003*. The blank form is a standard A4 sheet of paper and is secured by a holographic image to prevent fraudulent duplication. A mortgage note must be signed by the mortgagor (the owner of the mortgaged property) and the debtor if the debtor is different from the mortgagor. If either the debtor or mortgagor are legal entities, then the signature of the authorised person signing the note must also be certified by the seal of the legal entity.

When a mortgage note is issued, an appropriate mark confirming this should be made on each original copy of the mortgage agreement. A mortgage note must be registered together with the registration of the mortgage agreement. Currently, the register for this purpose is maintained by the Ministry of Justice of Ukrainian pursuant to the *Resolution of the Cabinet of Ministers On the Approval of the Temporary Procedure for the State Registration of Mortgages No.410 of 31 March 2004*. The registration itself is conducted by those notaries who have entered into an agreement with the state enterprise "Information Centre" of the Ukrainian Justice Ministry as administrator of the register.

Mandatory provisions of the mortgage note

A mortgage note must contain the following mandatory provisions in order to be valid:

(*1*) the words "Mortgage Note" in the title of the document and statement referencing the obligation of the debtor to perform the principal obligation in favour of the mortgagee during the term established by the mortgage agreement;

(*2*) the details of the parties — their names, addresses, USREOU, individual taxpayer's number for Ukrainian citizens, and country of registration for non resident legal entities;

(*3*) a reference to the mortgage agreement establishing the principal obligation;

(*4*) a description of the mortgaged property sufficient for its identification and/or its registration data;

(*5*) the description and the amount of the principal obligation, as well as the time and procedure for its fulfilment;

(*6*) the method of foreclosure on the mortgaged property, if it is stipulated in the mortgage agreement; and

(*7*) a note with the registration number, and the date and place of the registration of the mortgage agreement.

The *Mortgage Act* provides that a mortgage note may include other provisions, which reflect the content of the principal obligation and the mortgage, as negotiated by the parties. However, it should be emphasized that if the provisions of the mortgage note do not correspond to the provisions of the mortgage agreement or the agreement stipulating the principal obligation, then the provisions of the mortgage note shall prevail.

Transfer of the mortgage note

A mortgage note is a transferable document. The procedure for transferring the mortgage note is very similar to the procedure for transferring promissory notes. The mortgage note is transferred by an endorsement on the mortgage note by the holder (endorser) to a third party (endorsee), and the delivery of the original mortgage note to the third party endorsee. Such a transfer does not require the consent of the mortgagor or the debtor, if different from the mortgagor.

A transfer of the mortgage note through an endorsement vests the third party endorsee with all the rights of the mortgagee under the mortgage agreement and the principal obligation. Therefore, following issuance of a mortgage note, if it has been transferred to a third party (following the procedure described above), then the new holder of the mortgage note is subrogated to the rights of the original note holder and may demand the fulfilment of the principal obligation from the debtor, but has no recourse to the original mortgagee or other endorsers in the chain unless otherwise provided in the endorsement. If the debtor fails to fulfil the payment obligation, then the new owner can foreclose the mortgaged property. Although the prior mortgage note holder (endorser) is not liable to the new mortgage note holder (endorsee) for the performance of the primary obligation unless so provided in the endorsement, the prior mortgage note holder may be liable for the validity of the mortgage note and the accuracy of the information contained in it regarding the obligation and the existence of a valid mortgage agreement. This distinguishes a mortgage note from a promissory note under which a prior holder of a promissory note who endorsed it remains jointly and severally liable together with the issuer.

Re-financing using mortgage notes

One of the principal advantages of mortgage notes is the ability it gives to mortgagors or mortgage note holders to raise additional funds. The *Mortgage Act* provides for the following refinancing methods:

• alienation (sale) of the mortgage note by endorsement with the reimbursement to the endorser of the value of the mortgage note in an amount determined by the parties;

• a sale of the mortgage note with a re-purchase commitment (a repo transaction);

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• a pledge of the mortgage note by the mortgagor or its holder in order to secure performance of their liabilities to other creditors; and

• issuance of mortgage securities — mortgage bonds and mortgage certificates.

Mortgage certificate

Definition and legal nature of mortgage certificates

The *Mortgage Lending Act* defines a mortgage certificate as a special type of security secured with the mortgage assets or mortgages. The *Mortgage Lending Act* established two types of mortgage certificates: (*i*) fixed-income certificates, and (*ii*) participation certificates.

Mortgage certificates share certain common features with bonds and investment certificates of investment funds. They allow for their holder to either receive interest and the value of the mortgage note (similar to bonds) or in some instances, to have a right for a share of the payment from the mortgaged assets securing the mortgage note (similar to investment certificates). However, the *Mortgage Lending Act* has established a great number of features significantly differentiating mortgage certificates from other types of securities, as well as distinguishing fixed-income certificates from participation certificates.

Procedure for issuance of mortgage certificates

According to the *Mortgage Lending Act*, only a financial institution can act as an issuer of mortgage certificates. Before the issuer can start the procedure of issuance of certificates it must comply with *inter alia* the following legislative requirements: (*1*) an appropriate executive body of the issuer must enact a formal decision on issuance of the certificates; (*2*) to receive the permission for issuance of the certificates from the State Commission on Regulation of the Financial Services Markets; (*3*) to register the issuance of the certificates with the State Commission on Securities and Stock Market; (*4*) to form or acquire mortgage assets; (*5*) to appoint a financial institution to act as trustee; and (*6*) to appoint a bank as a mortgage administrator.

In order for an issuer of the certificates to form mortgage assets that will further secure the certificates, the issuer must combine all mortgage obligations evidenced by mortgage agreements into one consolidated mortgage debt. Simultaneously, all mortgages under such mortgage agreements must be combined into one mortgage pool.

Mortgage certificates can circulate freely. An initial public offering (IPO) of the certificates may be made either by the issuer or by securities traders contracted by the issuer. The *Mortgage Lending Act* has established that contracts in respect of the certificates do not require certification by a notary. The National Depositary System services the free circulation and depository for mortgage certificates.

The certificates may be issued in one of the following forms:

• registered documentary certificates;

• registered non-documentary certificates;

• bearer documentary certificates.

The form of the certificates is established in the decision to issue the certificates. Certificates of the same issue are required to be issued in the same form.

Article 14 of the *Mortgage Lending Act* establishes a number of mandatory requirements for the mortgage certificates regarding the nominal value, circulation period and details of the certificates. These requirements apply to fixed income certificates as well as participation certificates. However, there are also a number of features distinguishing one type of mortgage certificates from another. Some of these features are discussed below.

Fixed-income certificates

Fixed-income certificates are certificates secured by the mortgage assets and provide their holders with the following rights: (*a*) to receive the nominal value within the time period established by the terms of their issuance; (*b*) to receive interest on certificates on the terms provided by the information on certificates issuance; and (*c*) in the event of the issuer of the certificates failing to honour its commitments, to obtain satisfaction of their claims out of the value of the mortgage assets securing the certificates' prior to other of the issuer's creditors.

Mortgage assets are collateral for the performance of the obligations arising out of fixed-income certificates. If a debtor of the principal obligation under the mortgage agreement fails to fulfil its obligation, the mortgage manager shall take measures aimed at the forced collection of payments and foreclose the mortgage object. The mortgage manager shall transfer the proceeds from the sale of the real estate to the payment administrator.

Participation certificates

The peculiar feature of participation certificates, as compared to fixed-income certificates, is that all participation certificates are registered securities and, therefore, may not be issued in the form of bearer certificates. Furthermore, participation certificates are secured by mortgages and grant the holder the right to receive its share in the payments of the mortgage assets according to the agreement on purchase of the participation certificates.

The holder of a mortgage certificate assumes the risk that the mortgagors will fulfil their principal obligation before the end of the established time period. In the event that an issuer of participation certificates fails to perform its obligation, the holder of such participation certificates has the right to satisfy its claims from the value of the mortgaged assets held in the trust estate by the trustee.

Conclusion

The appearance of mortgage notes and mortgage certificates is likely to have a substantial impact on the securities market and to make secured lending more attractive to banks and other creditors. Nevertheless, because of the gaps and inconsistencies in Ukrainian real estate laws, one should not underestimate the importance of comprehensive due diligence for any real estate transactions that involve secured lending. ■