

Project Level Co-Investment Programs

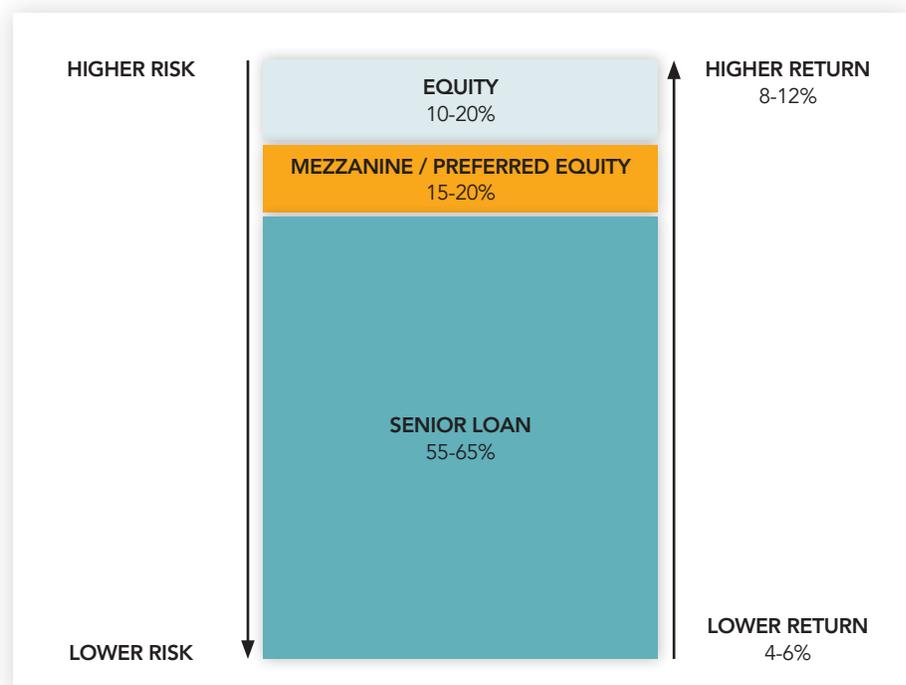
Preferred Equity and Mezzanine Debt

Over the past few years, the current real estate cycle in the United States has matured enough that real estate investors are, once again, considering mezzanine debt and preferred equity investments. We, as lawyers, witnessed similar interest in the previous cycle, but investing in the middle of the capital stack went out of favor with the arrival of the credit crisis. This article (1) compares mezzanine debt and preferred equity investments and (2) describes how to understand, identify and mitigate risk in investing behind a mortgage lender, while also not taking the “first dollar” of losses that a common equity investor would. Leverage can enhance returns to equity. Sponsors will seek mezzanine debt and preferred equity to decrease the amount of common equity in a particular asset-level capital stack. Most mortgage lenders will not loan more than 55-65 percent loan to

value. Some real estate investors want to further enhance returns to equity more than traditional mortgage leverage will permit. This middle spot in the capital stack fills the 15-20 percent “tranche” between the 55-65 percent¹ loan to value that a mortgage lender may provide up to 70-85 percent loan to value, above which the common equity lies in the capital stack.

What is mezzanine debt?

Mezzanine debt looks, feels and functions like a loan, but is subordinate to the collateral of the senior mortgage lender. The hallmarks of a loan are present: a loan agreement and/or promissory note containing a maturity date and interest rate; a security agreement with respect to a



¹ Our prototypical capital stack is in a hypothetical generic real estate investment transaction and each actual investment will differ from product type to product type and based on the nature of transaction, i.e. core, core-plus, value-add or construction/development.

collateral package, i.e. ownership interests and other personal property; an environmental indemnity and perhaps guaranties, recourse carve-out or otherwise. A mezzanine lender's collateral is the ownership and control of the mortgage borrower by way of a pledge and security agreement given by the owner of the mortgage borrower, i.e. a holding company, that is, itself a bankruptcy-remote, special purpose entity. This collateral is both separate and apart from the mortgage lender's collateral and also structurally subordinate. Mezzanine loan documents may look like the mortgage lender's loan documents, but many mezzanine lenders use their own forms of loan documents. The relationship between mortgage lender and mezzanine lender is governed by an intercreditor agreement, which sets out the notice and cure rights afforded to each lender, among other obligations and prohibitions.

What is preferred equity?

Preferred equity functions as something more akin to a joint venture investment among two or more equity owners. The distinguishing characteristics of preferred

equity from common equity are a lower rate of return, perhaps an 8-12 percent return instead of a 10-20 percent return. Preferred equity is different from mezzanine debt in that a preferred equity holder usually does not have collateral in the borrowing/lending sense, but rather a set of contractual control rights. Those rights likely will include the right of the preferred equity holder to "remove" the common equity and then to assume control of the asset or project by way of the entity. A preferred equity investment can be documented as simply as a few paragraphs in the limited liability company agreement or limited partnership agreement serving as the governing document for the applicable entity or, rather, may be more detailed, with long governing and control provisions that detail the contractual relationships among various equity owners. Repayment of preferred equity is usually not guaranteed, but most preferred equity will have a mandatory redemption connected to a date certain and, perhaps, other events described in the governing document. Preferred equity is contractually subordinate to a mortgage lender, usually by way of a subordination

agreement between the preferred equity holder and the mortgage lender. Most subordination agreement forms are extremely mortgage lender favorable and most preferred equity holders are “deeply subordinated.”

Remedial action: What does enforcement look like?; What do I actually have at the end of the enforcement path?

It is important to understand the “exit” from a mezzanine or preferred equity position because it will assist in evaluating how to structure the investment and properly request credit support or the other material business terms of the investment. A mezzanine lender’s collateral is personal property, as opposed to real property for a mortgage lender, and the Uniform Commercial Code (“UCC”) governs creation, attachment and remedies with respect to security interests in personal property, specifically, Article 9, Secured Transactions. The UCC foreclosure process for security interests in personal property is governed by statute from state to state. There are three ways to sell collateral: (i) public

sale, (ii) private sale or (iii) accepting the collateral as partial or full satisfaction of the debt. A secured lender selecting either of the first two options determines who should conduct the sale, how it should be advertised, etc. Rarely will a secured party conduct the sale on its own, and if it does, such a decision should be commercially reasonable. The norm is to employ a professional such as an auctioneer. The sale process is the means to take ownership and control of a mezzanine loan where the borrower has breached and defaulted.

UCC Article 9 imposes the standard of commercial reasonableness on “every aspect” of the sale “including the method, manner, time, place, and other terms.” Even though the foreclosing lender is not required to procure the absolute best price for the collateral, taking steps to maximize recovery will help to ensure that the sale is commercially reasonable and will mitigate the risk of other potential setbacks. Upon the completion of an Article 9 sale, the buyer takes whatever rights the debtor had in the collateral, and the foreclosing party’s security interest is discharged as well as any subordinate security interests and, generally, any subordinate liens. Security interests senior to the foreclosing party’s interest remain.

Proceeds of the sale are first applied to expenses in connection with the sale, then to satisfy the outstanding debt owed to the foreclosing lender and, finally, to satisfy any debts secured by security interests junior to the foreclosing lender’s security interest. Any surplus must be remitted to the debtor, in this case the owners in the holding company acting as mezzanine borrower.

An investor or issuer of mezzanine debt should consider, as an initial investment matter, successor liability. Upon foreclosure, the mezzanine lender takes ownership of the assets of its borrower, but also its liabilities, including all contracts and all torts. This can be a concern, especially if the foreclosing lender purchases the collateral for itself and expects to continue with the business, because it is unlikely that a foreclosing mezzanine lender will be able to fully rely on its borrower to disclose all liabilities in this situation.

In addition to public or private sales, a mezzanine lender may accept the collateral in full or partial satisfaction of the debt. The UCC provides that the secured party may accept collateral in (x) full satisfaction of the obligations if the debtor does not object within 20 days of a proposal made, after default, by the secured party or (y) partial



satisfaction of the secured obligation, if the debtor consents after default.

All of the above is, of course, subject to the intercreditor agreement that has been negotiated with the mortgage lender. The intercreditor agreement sets forth, from a mezzanine lender's perspective, the following: (1) when and how the mezzanine lender may realize upon its pledged equity collateral; (2) notice and cure rights afforded to the mezzanine lender with the mortgage borrower is in breach of the mortgage loan; (3) acquisition by the mezzanine lender of the mortgage loan as a cure; (4) consent rights as to certain material modifications of the mortgage loan documents; and (5) how the mezzanine lender may (or may not) finance its position.

By way of contrast, preferred equity holders do not need to undertake a foreclosure process, but, rather, take the remedial path set out in the negotiated entity governing document. Even with a well-drafted and negotiated, investor-favorable set of terms, the recovery path for a preferred equity holder is probably slower and less clear than a UCC foreclosure. Typically, the remedial path for a holder is to issue a notice of "removal" or to

declare a "control event," provide whatever cure right has been negotiated and, thereafter, assume management of the mortgage borrower. All remedies are likely contained within a few pages of provisions within the governing document.

There is no intercreditor agreement between a preferred equity holder and a mortgage lender. Many mortgage lenders do not regard a preferred equity holder as having any "special" rights or remedies. Rather, mortgage lenders mandate that preferred equity holders "stand still" until and unless the preferred equity holder has finished its control take-over process and satisfied mortgage lender's other requirements, which are likely to include substituting or adding a guarantor under the mortgage loan.

Typical legal issues and negotiations

As a lender to a holding company, whose subsidiary is, itself, a borrower, a mezzanine lender is aligned with the borrower group in negotiating with a senior lender. In other words, the looser the mortgage loan documents, the better for

the mezzanine lender. A mezzanine lender, on the other hand, will be negotiating for itself when entering into an intercreditor agreement. In this regard, the mezzanine lender's borrower will be paying for three sets of lawyers: the mortgage lender's counsel, the mezzanine lender's counsel and its own. So, there are incentives working in favor of quick resolution to the intercreditor agreement. Fine enough if the mortgage lender is willing to "go by" the prototypical CMSA/CMBS template or something similar, but many mortgage lenders are not willing or have their own variants to the CMSA/CMBS prototype. And many refuse to use a mezzanine lender's stock Intercreditor agreement. Under these circumstances, a mezzanine lender's counsel will be fighting on a mortgage lender's terms.

An important consideration for a mezzanine lender is whether to request a guaranty from its borrower's sponsors. Generally, a non-recourse carveout guaranty is recommended, but some mezzanine lenders will choose to forgo because either the mortgage lender will not permit guaranties from the same parties obligated to mortgage lender or the mortgage lender will require a subordination of mezzanine

lenders' rights with respect to such guaranties if the same guarantors are used for both of the mortgage loan and mezzanine loan. Consider alternate guarantors or alternate assets from such guarantors and requiring a guaranty anyway. A non-recourse carveout guaranty will provide a mezzanine lender with a "deep pocket" if the equity collateral is not sufficient to fully repay the principal and interest plus costs and fees related to the mezzanine loan. Additionally, this type of guaranty will further dissuade the sponsor group from filing for bankruptcy protection.

It is often the topic during a mezzanine loan term sheet stage whether a mezzanine lender will participate in the "ups" of a deal and receive an "equity kicker." In other words, will the mezzanine lender participate in the equity, based upon the success of the underlying real estate investment? While there are financial incentives to do so, such an equity participation feature does have the effect of blurring the line between debt and equity, which can lead to a re-characterization and, thusly, frustrating the mezzanine lender's original investment intent and/or creating "knock-on" legal issues for the mezzanine lender's internal investment goals, prohibitions and approvals.

One additional consideration before turning back to preferred equity is the topic of due diligence and title or entity insurance coverage. Most title insurance companies have divisions that are in the business of issuing an insurance product with respect to a mezzanine lender's security interest in its collateral. The insurer will review the borrower's entity documents, and the mezzanine lender's loan documents and will issue a policy insuring the mezzanine lender if the mezzanine lender fails to have a valid first-priority security interest in the borrower. Additionally, a mezzanine lender should request that the title insurer itself issue a mezzanine loan endorsement to the mortgage borrower's (owner's) policy of title insurance. These two insurance products are a nominal cost and should be considered as a best practice.

Similar to a mezzanine lender and its alignment with its borrower as against a mortgage lender, a preferred equity investor will be aligned with its common equity partner in battling a mortgage lender, but even more immediately because preferred equity is *part of* the mortgage borrower. The mortgage lender, however, is much less sympathetic to preferred equity investor's pleas for any cure rights. It is unlikely that a preferred equity holder will be granted cure



rights like a mezzanine lender. A preferred equity holder will be required to “stand still” until such time as it provides additional credit support to the mortgage lender and has taken over control of the mortgage borrower. Until that time, all other preferred equity remedies are locked out.

Another distinguishing feature of preferred equity investor from a mezzanine lender is that the law does not regard a lender, acting as a lender, as having a fiduciary duty to its borrower. The same is not true of a preferred equity investor, or any equity investor, for that matter. Preferred equity providers should take care to have their counterparties waive whatever fiduciary duty may be implied by choosing Delaware law² for their governing documents. Otherwise, counterparties may have claims for breach of fiduciary duties, complicating or, worse, thwarting preferred equity investor remedial exercise.

Notably, it is market practice for a preferred equity provider to receive some credit support from a counterparty parent for deficiencies under the governing document. Usually, this means some form of joinder or guaranty for

indemnification obligations under entity governing document and other obligations, like completion of a project, recourse events or other fundamental duties of the common equity in operating or managing a project.

Finally, in the list of key considerations for investors is the topic of tax considerations. Investors that are sensitive to complying with the REIT rules generally can invest either by way of preferred equity or mezzanine debt, but tax counsel should be involved to ensure that, on the one hand, ownership of mezzanine debt will not run afoul of the requirement for investments to be made in “real estate assets,” and, on the other hand, a preferred equity investment is being made with an operating partner possessing basic knowledge of the REIT rules and who agrees to follow the REIT investor’s direction on REIT matters in a manner intended to prevent “bad” REIT income.

² See, e.g., 6 Del. C § 18-101 et seq.

Conclusion

Preferred equity investors and mezzanine lenders enjoy enhanced returns but with additional risk compared to mortgage lending. Investing in the middle tier of the capital stack comes with a greater risk of actual enforcement, which, itself, can become a long, winding road without a proper understanding of the enforcement path and considering whether the provider/lender can quickly find a third-party receiver or has the in-house capability, financial and manpower, to actually take over development, operation and management from the sponsor. If not, the practical bar to enforcement can become a more daunting challenge than legal enforcement.

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