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Preferred Equity and Mezzanine Loans as Subordinate Financing Tools

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Probably from the time the modern mortgage was created some 500 years ago, real estate owners and developers have looked to increase their leverage and finance their projects with capital that is junior to the mortgage debt but senior to the owner/developer equity. Notwithstanding the post-2008 retrenchment, the past few decades in particular have witnessed a boom in the creation of structures for this junior capital, ranging from second mortgages (pure debt) to joint ventures (pure equity). This article examines two of the most common subordinate financing structures—mezzanine loans and preferred equity—and considers whether the real estate market's general preference for "mezzanine debt" as opposed to preferred equity is warranted, or at least should be reconsidered.

Structure of Investments

Mezzanine loans and preferred equity are similar in certain fundamental respects. In each case, the owner or developer seeks capital from a third party, who is willing to provide such capital in exchange for a return commensurate with the increased risk profile of capital that is junior to the mortgage debt. In each case, the mezzanine lender or preferred equity investor (each, a 'capital provider') funds capital to a direct or indirect owner of the property (the 'financing vehicle').[1] The capital provider is willing to be in a (structurally) subordinate position to a senior mortgage lender provided that it is granted an interest in the financing vehicle (rather than the property itself).

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However, whereas a mezzanine lender's interest is a security interest—typically, 100 percent of the equity interests in the financing vehicle is pledged to the mezzanine lender—a preferred equity holder owns its own equity interest in the financing vehicle. As discussed in more detail below, this means that a mezzanine lender can exercise remedies by consummating a UCC foreclosure, while a preferred equity holder has only those specific and tailored rights and remedies included in the operating agreement of the financing vehicle.

Any contemplated junior capital investment can be structured as either preferred equity or a mezzanine loan. However, in general, investments intended to have a simple structure with current payments of interest and a fixed maturity date (with or without extension options) are usually structured as mezzanine loans, while investments with more complicated features, such as a cash distribution "waterfall" that allows the owner/developer to receive some cash flow distributions while the junior capital is still outstanding, or the capital provider sharing in the "upside" on top of its promised return, lend themselves more readily to a preferred equity structure.

> While preferred equity holders may structure their investment and remedies with greater flexibility, mezzanine lenders may have greater certainty in the exercise of their remedies and hold a more liquid investment.

Priority

Both mezzanine lenders and preferred equity contributors are structurally senior to the common equity of the financing vehicle (subject, in the case of preferred equity, to any specific exceptions agreed to by the preferred equity holder and specified in the operating agreement), and structurally subordinate to mortgage lenders, any other liens and encumbrances on the property (e.g., mechanics' liens and real estate taxes), and other unsecured liabilities of the property owner. A mezzanine loan, as a secured obligation of the mezzanine borrower, may have priority over unsecured creditors of the financing vehicle, while a preferred equity interest would be structurally subordinate to the creditors of the financing vehicle. However, the financing vehicle is usually structured as a single purpose entity and is not typically an operating entity, so liabilities of the financing vehicle are more of a theoretical concern than a practical concern. Consequently, the issue of priority does not materially favor either mezzanine debt or preferred equity.[2]

Remedies

A security interest in mezzanine loan collateral (the pledged equity interests) is created and perfected under Article 9 of the Uniform Commercial Code (UCC). Although not automatic, and replete with pitfalls if various technical requirements are not observed, the personalty foreclosure process under the UCC is a well-established and largely formulaic process which has been successfully completed many times during the recent downturn, and which in any event is much faster than foreclosure of real property. While the UCC requires a commercially reasonable sale process that will involve a marketing process similar to any auction sale of the property, mezzanine lenders can typically consummate a UCC foreclosure in 60 days or less.

Preferred equity investments are not secured in the strict sense, and foreclosure is not an available remedy. Rather, the preferred equity holder can exercise whatever contractual rights and remedies provided in the operating agreement or other applicable organizational documents of the financing vehicle. For example, the preferred equity holder can have the right to take over management and/or force a sale of the property (or in a more extreme case, redeem all of the common equity for a nominal sum and become the sole owner of the financing vehicle), if the preferred equity interest has not been redeemed in full (i.e., return of all capital and preferred return) by a certain date or if certain other material covenants are breached. All of these preferred equity remedies should be enforceable, and the resulting ability to have automatic, self-exercising remedies is a potential advantage of the preferred equity structure.

In reality, however, enforcing preferred equity remedies can be complicated and uncertain, and far from automatic. If there is a dispute whether a preferred equity holder's remedies have been triggered, there is typically no recourse until and apart from litigation or arbitration, which can result in a delay in enforcement and would permit the common equity holder to assert additional defenses and counterclaims based on partnership law and fiduciary principles.

Thus, despite the potential for greater rights and more immediate results, many providers of junior capital have opted for a mezzanine loan structure because of the perceived track record and certainty of the UCC foreclosure process. The point is well-taken; however, savvy preferred equity investors have bridged this gap to obtain flexibility on remedies, without materially sacrificing certainty, by demanding a "bad boy" guaranty pursuant to which a common equity principal has recourse liability for any spurious challenge to the exercise of the capital provider's remedies—a standard protection required by mezzanine lenders.

Tax Treatment

The tax treatment of a mezzanine loan is relatively straightforward from both the owner/developer's and capital provider's perspectives (i.e. interest is deductible for the owner/developer and the capital provider would recognize ordinary income). The tax treatment of preferred equity investments is far more complicated and fact-dependent. For state law purposes, the capital provider is a member or partner of the financing vehicle and is entitled to distributions in accordance with the operating agreement and the provisions of applicable law. The tax efficiency of the preferred equity structure will depend in large part on the tax attributes of the owner/developer and the capital provider, and whether the investment is characterized appropriately as debt or equity for tax purposes—particularly if the preferred equity is structured to be substantively similar to debt (for example, elimination of common equity if the preferred equity is not fully redeemed by a date certain), in which event the parties may create a risk of recharacterization of preferred equity as debt (both for bankruptcy and for tax purposes).

Bankruptcy Risk

Although bankruptcy risks are always taken into account in structuring financing vehicles, the prevalence of SPE borrower structures in mortgage and mezzanine financings has significantly mitigated the impact of bankruptcy on real estate investments. In a bankruptcy of the property-owning entity (the most likely bankruptcy scenario, assuming the absence of operating liabilities at the financing vehicle level), neither the preferred equity holder nor the mezzanine lender would be a creditor (secured or unsecured) of the debtor, so neither method of subordinate financing poses added risk or provides any relative benefit.

Moreover, neither type of capital provider would likely be prevented from exercising its remedies against the financing vehicle by the automatic stay in a bankruptcy of the property-owning entity.

In the unlikely event of a bankruptcy of the financing vehicle, a mezzanine lender would be a secured creditor, while a bankruptcy court could characterize (or equitably recharacterize) a preferred equity holder investing at the same level as a creditor or simply as a priority equity member, depending on the court's interpretation of both the preferred equity contribution and the financing structure as a whole. While standing as a creditor (particularly a secured creditor) would offer some benefits vis-à-vis any unsecured creditors of the financing vehicle, the practical reality is that there are unlikely to be any significant third-party creditors, which limits the value of creditor status.

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In a bankruptcy of the financing vehicle, a preferred equity holder would not likely be subject to the automatic stay, and could likely exercise any rights it has to obtain control without resultant delay. The mezzanine lender, on the other hand, would need to obtain relief from the automatic stay, but, in the absence of other creditors of the financing vehicle, the mezzanine lender should be capable of obtaining such relief. Consequently, as a practical matter, bankruptcy concerns should not be a major factor in determining the relative efficacies of a preferred equity structure and a mezzanine loan structure.

Marketability

Mezzanine loans, governed by separate loan documents, UCC filings and customary intercreditor agreements, are relatively marketable, even engendering their own commercial mortgage-backed securities (CMBS) sub-market. There are certainly no market or standard form preferred equity documents, and the variety and complexity of equity structures almost by definition makes any particular preferred equity investment less liquid.[3] If a potential buyer of a mezzanine loan knows the loan's principal amount, interest rate and maturity date, the buyer more or less knows enough to understand the business terms of the loan. Far more information—and a detailed review of the applicable documentation—is needed to understand a complicated preferred equity structure. Due diligence and legal costs for the capital provider can be significantly higher for a preferred equity structure, and execution of the transaction may take longer. Of course, if preferred equity becomes a more commonly used structure for junior capital investments, one result might be more uniformity in preferred equity documentation, and therefore better liquidity.

Flexibility

For the reasons discussed above, in terms of flexibility in structuring the transaction, clearly preferred equity wins the day. While mezzanine loans must meet the strictures of UCC Article 9, preferred equity can be structured in a multitude of ways, with a variety of default triggers, repayment priorities and remedy mechanisms possible. Preferred equity investments can also be structured more as a true equity investment or as tantamount to a loan, depending on the business understanding of the parties. In addition, it is often possible to develop a preferred equity structure that is permissible under senior mortgage loan documents, where a mezzanine loan would be prohibited; for this reason alone, many would-be mezzanine loans have been consummated as preferred equity investments.

Conclusion

Given the foregoing, there are some advantages and disadvantages to each approach, and both traditional mezzanine loans and preferred equity contributions can be useful approaches to subordinate financing. While preferred equity holders may structure their investment and remedies with greater flexibility, mezzanine lenders may have greater certainty in the exercise of their remedies and hold a more liquid investment. Some of the traditional disadvantages of preferred equity can be mitigated through the implementation of 'bad boy' guaranties in preferred equity structures. It would behoove potential capital providers not to overlook the potential benefits of flexibility and remedies that preferred equity contributions can present when structured appropriately.

1. In theory the financing vehicle in a preferred equity investment can be the property owning entity itself. However, in practice, due to mortgage loan restrictions (as well as the desire to maintain financing flexibility in the future), the financing vehicle is typically at least one level above the property owner in the structure.

2. Note too that since the creation of the ALTA 16 endorsement and UCC Article 9 insurance products, a mezzanine lender can obtain a similar measure of title insurance protection as a preferred equity holder (which can avail itself of an owner's policy with a non-imputation endorsement).

3. Similarly, the rating agency requirements with respect to mezzanine loans are fairly uniform and well known, while standards for preferred equity are less developed and may depend on the specific rights and remedies of the capital provider.