Lisa Brill Shearman & Sterling

The (Re)Emergence of Preferred Equity

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Preferred equity has been used in real estate structures for years, but recently we have seen an emergence of preferred equity as a popular financing tool in real estate development projects. This is mainly in two scenarios – one where a mezzanine loan already exists (or is contemplated) and the developer needs additional equity to complete the project, and the other where an institutional lender does not want a mezzanine loan for underwriting reasons, or because it wants to reserve the right to split its loan into mortgage and mezzanine components in the future.

Lenders that are used to filling a mezzanine position may be wary of making a preferred equity investment since it is just that – equity – and as equity lacks one defining loan feature – collateral. Unlike a mezzanine loan where the lender can foreclose on a pledge of equity interests via the Article 9 UCC foreclosure process, removing a defaulting developer in a joint venture does not benefit from a streamlined, statutory process. However, since equity vehicles in the U.S. (mainly limited liability company and limited partnership structures) offer significant flexibility, a preferred equity investor has the means of structuring a transaction that is very similar to mezzanine debt while still being equity.

This article will explore the differences between mezzanine financings and preferred equity investments – in particular how a typical mezzanine lender may want to approach a preferred equity investment – and in that regard will focus on what you can get as a preferred equity investor to put yourself in a position as close to that enjoyed by a mezzanine lender as possible, what you should get as a preferred equity investor to ensure similar rights to a mezzanine lender and some key considerations as you navigate the world of preferred equity investing.

Subordination

To start, preferred equity is subordinate to any mortgage or mezzanine loan, but senior to common equity; however, just as there can be multiple levels of mezzanine financing in a structure, there can also be multiple levels of preferred equity, such as subordinated preferred and senior preferred. Having subordinate and senior preferred equity is not unusual, for example, in a situation where EB-5 financing takes the form of preferred

equity or where receipt of preferred equity is linked to contributions made to cure defaults by a defaulting investor. Because preferred equity is subordinate to both the mortgage loan and any mezzanine loan, it is a riskier investment and therefore generally commands a higher return.

Documentation

A lender that typically makes mezzanine loans will need to wrap its head around a different set of documents when making a preferred equity investment. To begin with, the preferred equity investor is effectively a joint venture partner with the developer or operator and therefore needs to acquire, or have issued to it, interests in the venture. The preferred equity investor may execute and deliver a contribution agreement or purchase and sale agreement with the developer whereby the developer agrees to assign ownership interests in the venture to the investor in exchange for payment of a purchase price, or whereby the investor agrees to contribute cash and the developer agrees to contribute land (or ownership interests in an existing property owner) to a new venture. A contribution agreement may also act like a de facto commitment (not unlike a loan commitment) whereby the investor agrees to contribute cash upon the satisfaction of certain conditions precedent (and during which time the developer agrees to be bound by certain pre-closing covenants whereby if the developer fails to comply in any material respect, the investor would not be required to close). In addition, like a lender, the preferred equity investor should receive representations from the developer with respect to the property, project and applicable entities. The representations will, like everything else, be negotiated on a deal-by-deal basis, but unlike a common equity investor, who may be accepting of representations limited by a survival period or a cap on the developer's liability, a preferred equity investor that is looking to be in a position similar to a mezzanine lender, may push back on these limitations.

The joint venture agreement will govern the relationship between the developer and the preferred equity investor (typically either a limited liability company agreement or limited partnership agreement depending on the applicable transaction). If the representations and provisions related to contribution are not set forth in a separate contribution or purchase and sale agreement, they should be set forth in the joint venture agreement. To the extent guaranties are required, and we will discuss them in more detail later in this article, they should be delivered as a condition to closing the preferred equity investment, though in some cases a completion guaranty is not issued until a construction loan is in place and then the completion guaranty is often on substantially the same terms as the one provided to the construction lender.

Foreclosure versus Removal

As mentioned, the main difference between mezzanine financing and preferred equity investing is the lack of collateral securing a preferred equity investment. This means that if the developer breaches its obligations to the preferred equity investor under the joint venture agreement, foreclosure is not an available remedy. With respect to a mezzanine loan, the mezzanine lender, absent litigation brought by the borrower and subject to any applicable intercreditor agreement, can feasibly accomplish a UCC foreclosure within 45-60 days after accelerating its loan. Upon the consummation of the foreclosure, the mezzanine lender will own 100% of the property owner and will have effectively removed the developer from the structure. In addition, the mezzanine lender will likely have priority over any unsecured creditors of the mezzanine borrower, and so will prime any of their rights upon foreclosure (though a mezzanine loan foreclosure does not extinguish any liens against the real property).

With a preferred equity investment, if there is a default by the developer under a joint venture agreement, the primary remedy available to the preferred equity investor is removal of the developer as the managing member (or general partner) of the venture. In addition, unlike in a mezzanine loan foreclosure where upon completion the mezzanine lender owns the property owner outright, post-removal the developer remains a member of the joint venture, though it should at that point be a passive member with limited approval rights. Since removal is a contractual right, any limitations on the developer's rights under the joint venture agreement post-removal would need to be negotiated at the time of, and expressly set forth in, the joint venture agreement. Often the preferred equity investor will also have the right to exercise forced sale provisions, a buy-sell or a put option in the event of developer bad acts so the investor also has an exit option.

So what does it take to remove a developer as the manager of a joint venture? As mentioned, it is a contractual right, so the events which would give rise to removal need to be expressly set forth in the joint venture agreement. They will, as with every aspect of the agreement, be negotiated on a deal-by-deal basis, but as with defaults under a loan, developers will typically require notice and cure periods. Removal events

typically include bad acts such as fraud, gross negligence and willful misconduct, but also may include breach of obligations under the joint venture agreement and any development agreement, criminal acts, bankruptcy and defaults under loan documents or other material agreements. Developers will likely insist on removal only being for events which are solely caused by the developer – since the preferred equity investor will have certain approval rights (as discussed in more detail below) the developer will want to make sure that the reason for the removal is not linked to a decision made in cooperation with the preferred equity investor.

Once a removal event has occurred, a developer will not typically allow itself to be removed without having its day in court. Proceeding with a cause of action in the court system may take years to resolve, so is not realistic for a development transaction. Because of this, expedited arbitration is the most typical means for resolving disputes related to whether a removal event has occurred. With expedited arbitration, whether pursuant to the American Arbitration Association, JAMS or any other agreed tribunal, the parties can have their day in court and a determination as to whether the removal event has occurred within a period of several months, rather than years.

Preferred equity investors (or really any equity investor) will often say that they want to be able to remove the developer for a bad act prior to any judicial process. While this is of course ideal, in our experience, it is not realistic. First, third parties that deal with the joint venture and its subsidiaries have a relationship with the developer and not the investor. Accordingly, if they receive a notice from the investor that it is now "in charge" and directing that they take direction only from the investor, they are unlikely to comply. Second, the investor likely does not have access to the joint venture's or its subsidiaries' bank accounts and therefore may not have the resources to take over the project. Expedited arbitration, while not immediate, will allow the preferred equity investor to have an award that it can enforce to be able to effectively step into the shoes of the developer.

But the preferred equity investor cannot just rest on expedited arbitration to remove a defaulting developer. Most loan documents will require the developer to remain in control of the day to day operations of the joint venture and will not permit the preferred equity investor to take control without lender approval. Ideally, during negotiation of the joint venture agreement, the preferred equity investor will meet with any senior lender or potential senior lender (and mezzanine lenders, if any) to make sure that the senior loan agreement permits the change of control that will occur with the removal. This negotiation is not really any different from the negotiation of mezzanine lender foreclosure rights in an intercreditor agreement. In our experience, the market on this removal or foreclosure right is varied, with some lenders permitting removal or foreclosure in their sole discretion, others agreeing to abide by a reasonableness standard and still others permitting removal or foreclosure only for a class of qualified transferees that meet certain net worth and liquidity requirements and have a requisite level of experience (or have hired someone with that experience). All lenders will require that replacement guarantors meet any applicable net worth and liquidity requirements and the lender's know your client standards. Suffice it to say, without the lender on board for the removal, it cannot happen.

If the preferred equity investor is able to remove the developer as the managing member of the joint venture, it also needs to make sure that it can terminate any affiliate agreements with that developer and make sure that it has the means to pay any replacement developer. Again, these rights are contractual such that the joint venture agreement should expressly provide for what happens after removal. One way to address this is to specify that after removal, distributions would be pro rata in lieu of a promote being paid to the developer. This frees up capital for the preferred equity investor to pay a promote or fee to the replacement developer (which may or may not be the preferred equity investor itself depending on the lender's requirements). Again, this provision tends to be highly negotiated because the developer will likely want to get paid for work it has done to date, the argument being that if removal is later in the development process, the developer should continue to get the benefit of any promote since the bulk of the work has been completed.

Reporting

The preferred equity investor – if it removes the developer as manager or acquires the property in a buy-sell – will take over the venture subject to the rights of any secured or unsecured creditors. In order to protect the preferred equity investor from unexpected creditors, the preferred equity investor should limit the incurrence by the venture and its subsidiaries of debt financings or other liabilities, or make sure it has approval rights over such obligations. Quarterly reporting, the right to examine books and records and the right to request information about the joint venture and its business are the best ways for a preferred equity investor to monitor the obligations and liabilities of the venture and its subsidiaries. Like a lender, staying on top of the

performance of the underlying asset or the company through review of reporting materials can assist a preferred equity investor in identifying issues and addressing them before they become damaging to its position.

Decision-making

Unlike with a mezzanine loan where a lender must proceed with caution when exercising its approval rights, even in the case of a default, because of potential lender liability claims, a preferred equity investor does not have the same concern. It is an equity owner of the venture and as such can have the rights of an owner, and exercise them, without the risk of lender liability type claims from its partner. (We will discuss fiduciary obligations shortly.) Preferred equity also comes with the flexibility of structuring an equity transaction – there is no market standard, one size fits all approach and terms can be tailored to each transaction.

The developer will be responsible for the day to day operation of the joint venture and development of the project, but the preferred equity investor will negotiate certain "major decision" rights where the developer cannot proceed without its consent. For a preferred equity investor who is trying to replicate a mezzanine position, these major decision rights should mimic the affirmative and negative covenants in a loan agreement. The scope of the major decision rights will vary based on the applicable deal terms. For example, contribution of a more significant amount of the equity required for a transaction often allows for more significant approval rights.

Protecting the preferred equity position

Accepting that preferred equity does not come with collateral is the threshold decision for lenders considering a preferred equity investment. After that, there are a number of terms the preferred equity investor can require that are consistent with a mezzanine loan. A preferred equity investor may require fees such as an origination fee and monitoring fee to cover the expenses of any third parties engaged by it to service its investment or monitor the development project. Although the developer will argue that the preferred equity investor should not receive guaranties since it is equity and should get comfort from the guaranties provided to the project's lenders, preferred equity investors often do require guaranties, such as completion, environmental and non-recourse carveout guaranties consistent with those given to the senior lender.

The distribution waterfall in the joint venture agreement should make clear that the preferred return and return of capital will be paid prior to any common equity distributions. If the developer fails to pay the preferred return when due, it would not be unusual for default interest to accrue. It is important to note that if the preferred equity investor wants the preferred return paid on a current basis, it will need to get approval upfront from the senior lender. Like a lender, the preferred equity investor will want to make sure that there is a date certain as to when it will receive its preferred return, effectively setting a mandatory redemption date for the preferred equity investment. On the other side, the developer may want the option to pay off the preferred investor earlier than expected, in which case it would want to negotiate for an early redemption right, though the preferred equity investor may not permit this without payment of an early redemption fee (similar to a prepayment premium).

One of the biggest issues we often see in development projects is when a project is not ready for prime time – the developer does not yet have entitlements, a GMP or a final budget so it cannot yet secure a construction loan, but it still needs additional capital to keep the project moving forward. Here, preferred equity is often a good solution for the developer – it does not need to share the upside of the deal with the investor and can show a senior lender that the requisite equity is in place. And a preferred equity investor, after taking a close look at the developer and project, may get comfortable with this risk – up to a point. At some point, however, the developer will need to put (no pun intended) its money where its mouth is. A careful preferred equity investor may require a put option or early redemption right to the extent the developer does not deliver a final GMP, budget and construction loan by a certain date. For example, if the developer does not close on a construction loan for the project within six months after the funding of the preferred equity investment, the preferred equity investor may require the developer to buy out the preferred equity investment either at par or with a minimum return. This put or redemption right is often backed by a guaranty from a creditworthy entity.

Many of the rights a preferred equity investor should receive in a joint venture agreement are the typical "market" protections for equity investments generally. But for a preferred equity investor who would ultimately prefer a mezzanine position, extra care should be taken to ensure that the package of rights offers the most protection possible. For example, it should be made clear that the preferred equity investor has

access to the property and the right to attend meetings with the developer and the general contractor with respect to the status of construction. Agreements with the developer and its affiliates should also be required to be approved in advance by the preferred equity investor, and the preferred equity investor should have the right to enforce such affiliate agreements on behalf of the joint venture and its subsidiaries.

We discussed earlier in this article that a preferred equity investor should be prepared to negotiate with the senior lender if it wants the right to remove the developer as managing member of the joint venture. The same is true for cure rights. A careful preferred equity investor will negotiate the right to cure developer defaults and may even obtain extra cure periods, similar to those available to a mezzanine lender, as otherwise there is a risk that the lender may not accept a cure from someone it knows is not the developer or a developer affiliate.

Transfers

Lenders often have broad rights to transfer interests in their loans, though borrowers often insist that the assignees meet certain qualified transferee requirements. This is especially true for loans with future advances. Transfers of participation interests are often less restricted since the original lender remains on the hook with the borrower. To the extent all of the preferred equity investor's funds are contributed to the project in one lump sum, it is easier for a preferred equity investor to take the position that it should be permitted to transfer its interest without the developer's consent. However, both the developer and the senior lender will likely subject any transfers to completion of a customary know-your-client review. When a preferred equity investor's contributions are made over time, both the developer and senior lender tend to pay closer attention to the creditworthiness of the preferred equity investor and its identity generally, and thus will likely require any transferee to meet certain net worth and liquidity requirements. They may even require that the initial preferred equity investor remain in control and retain ownership of a certain percentage of the investment. Since the ability to transfer all or a portion of the preferred equity interest may be an important part of the exit strategy for a preferred equity investor, paying close attention to the transfer provisions is important.

Fiduciary Duties

Another difference between a mezzanine loan and a preferred equity investment is fiduciary duties. While a borrower would not (whether as a matter of law or contractually) owe any fiduciary duties to a lender, the managing member of a joint venture would have fiduciary duties to the other members of the joint venture (which fiduciary duties may vary in scope by state of formation). Under the laws of many states, fiduciary duties are assumed to exist between partners or members unless waived. While in most states the duties of good faith and fair dealing cannot be waived among partners and members, joint venture partners often agree to a specific standard of care for the managing member of the joint venture. For a preferred equity investor that has insisted on receiving many mezzanine lender type protections, the argument that the developer should owe fiduciary duties to the preferred equity investor is often met with resistance. This tension is especially apparent when the preferred equity investor wants to make sure that it does not owe any fiduciary duties itself. A negotiated "prudent developer" or similar standard is often a happy medium.

Indemnities

Indemnities are negotiated provisions in both mezzanine loans and joint ventures; however, the scope of the lender's indemnity tends to be broader and includes indemnification for costs associated with enforcement of remedies and losses associated with third party claims against the lender that relate in any way to the project or the loan. Joint venture partners, including preferred equity investors, should get the benefit of limited liability protection with respect to third party claims (absent their bad acts), with the joint venture agreement making it clear that, other than for non-waivable provisions of applicable law, the members of the venture would not have exposure for more than their respective investments with respect to any third party claims, absent a reason to pierce the corporate veil. The preferred equity investor will also want to be indemnified for bad acts of the developer or operator, including for material breaches of the joint venture agreement. Absent this, there is always the right to sue for a breach, but without indemnification legal fees of the prevailing party would not necessarily be covered (unless the agreement expressly provides for such legal fees to be paid).

Tax Considerations

As with any investment, tax advisors should be consulted to discuss tax considerations when structuring an investment as preferred equity. The parties should keep in mind that preferred equity is equity, so corporate blockers may be needed to maximize tax efficiency for non-U.S. investors.

Conclusion

In the end, one of the best protections for any lender or investor is to know its partner and know the nature of the investment. Though not foolproof, we always recommend that any investor look closely at the developer's track record prior to investing. Does the developer deliver projects on time and within budget? Has it ever defaulted on a loan or been removed as manager? Preferred equity will never be a perfect substitute for a mezzanine loan. It does not come with collateral or allow for foreclosure. And while there is no risk of a lender liability claim, the preferred equity investor must understand which fiduciary obligations may apply to it. The considerations we have mentioned in this article are not new to equity investors generally. Preferred equity will always be equity, but with careful attention to the agreement with the developer, it can have many features which provide protections that are similar to those of a mezzanine loan.

Lisa Brill is a partner at Shearman & Sterling

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