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Structuring Preferred Equity Investments in Real Estate Ventures: Impact of True Equity vs. "Debt-Like" Equity

Negotiating Deal Terms, Investor Return, Change in
Control Provisions; Assessing Remedies, Tax, Bankruptcy Issues

THURSDAY, AUGUST 27, 2015

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

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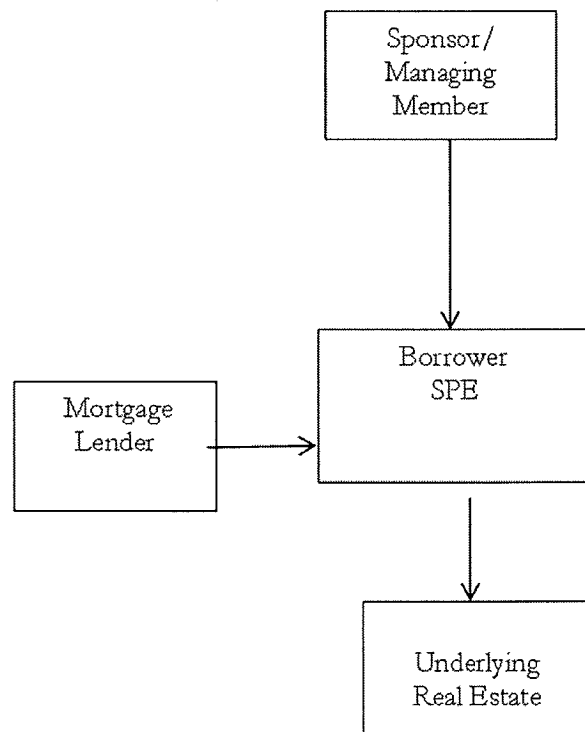
INTRODUCTION

- Introductions of Jon S. Robins and Jennifer A. O’Leary
- Outline of the Presentation:
 - a) Basic Building Blocks of Capital Stack
 - b) Need for Preferred Equity and Mezzanine Loans
 - c) Structural Subordination
 - d) Preferred Equity Structures
 - e) Benefits and Risks of Preferred Equity Structures
 - (i) Preferred Equity vs. Mezzanine Debt
 - (ii) Preferred Equity vs. Common Equity
 - f) Certain Tax Matters
 - g) Defaults, Change in Control
 - h) Bankruptcy
 - i) Key Provisions
 - (i) Organizational Documents
 - (ii) Loan Documents
 - (iii) Other
 - j) Certain Preferred Equity Protections
 - k) Intercreditor Issues
 - l) Fiduciary Issues
 - m) Recharacterization
 - n) Distribution Risk
 - o) Conclusion

Basic Building Blocks of the Capital Stack - 1

- Mortgage: Loan to Property Owner
Secured by a lien upon the
Property.
Traditionally 50-75% of Capital
Stack

Mortgage Loan Structure

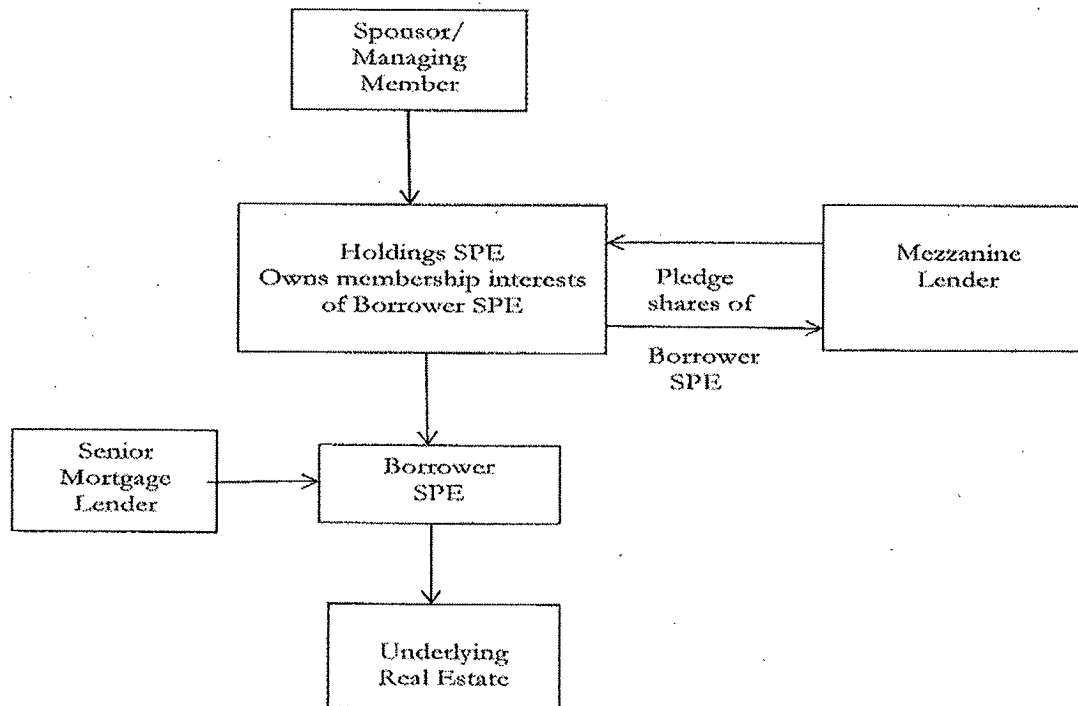


Basic Building Blocks of the Capital Stack - 2

Mezzanine

Loan: Loan to Equity Owner of Property
Owner Secured by a Pledge of
Equity in Property Owner
Traditionally 5-25% of Capital Stack

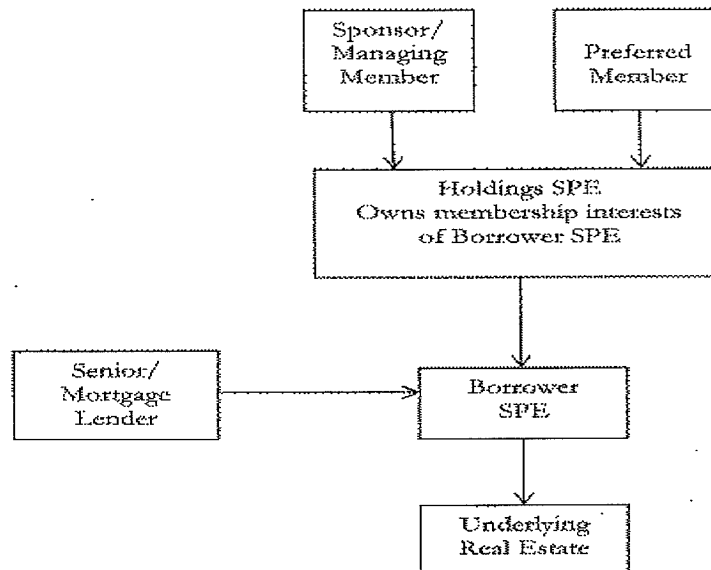
Mezzanine Loan Structure



Basic Building Blocks of the Capital Stack - 3

- Preferred Equity: Equity Investment in Property Owner or in Direct or Indirect Equity Owner of Property Owner. Preferred Equity Not Secured, but enjoys some level of preferred return or priority of payment and other rights (Traditionally 5-25% of Capital Stack)
- Common Equity: Equity with a priority of payment subordinate to the preferred equity (Traditionally 10-30% of Capital Stack)

Preferred Equity Structure



Need for Mezzanine Loans and Preferred Equity

- Equity or Value Gap: Over leveraged properties to be refinanced
- Prohibitions And Restrictions: CMBS and other mortgage lender prohibitions on junior mortgages
- Sponsor Desire for Greater Leverage: Acquiring the asset with minimum of equity or cash out

Structural Subordination - 1

- Mortgage: Senior Position. Behind only pre-existing liens and super priority liens (e.g., local real estate taxes)
- Mezzanine Loan: Subordinate to all property owner debt. Senior to other debt of mezzanine lender (at least with respect to pledged equity collateral)

Structural Subordination - 2

Preferred

Equity: Subordinate to all debt

Common

Equity: Subordinate to all debt and to the extent provided by its terms
Preferred Equity

Rewards:

Risk reward. Risks and returns are highest for common equity, then preferred equity, then mezzanine loans and lastly, mortgage loans

Preferred Equity Structures- 1

- Term Preferred Equity covers a lot of ground. Sometimes it refers to what is effectively a Mezzanine Loan equivalent. Other times it refers to a equity with a stated preferred return but that is in all other ways the same as common equity.
- One way to think about preferred equity structures is as a continuum with debt like preferred equity on the one end and common equity like preferred equity on the other

Preferred Equity Structures- 2

- Debt Equivalent. Looks and acts a lot like a mezzanine loan:
 - A) Fixed Monthly Distributions – To be paid regardless of cash flow B)
 - B) Fixed, Mandatory Redemption Date
 - C) Carve-out Guaranty and Environmental Indemnity
 - D) Preferred Equity Investor has removal right (including for failure of timely distributions)
 - E) Major decisions requiring Preferred Equity Investor vote mimic Mezzanine Loan covenants
 - F) Removal results in loss of all management rights by sponsor (may (though atypical) result in forfeiture of sponsor's interest)
 - G) Failure of timely distribution or other default results in default preferred equity rate (20+% not atypical)
 - H) Generally no share in residual
 - I) Generally no share of losses (outside of reversal of prior allocated income)
 - J) Preferred Investor has no obligation to contribute additional capital
 - K) Preferred Investor may be entitled to early redemption premium

Preferred Equity Structures- 3

- “True” Equity. May have any number of different features:
 - A) Often a stated preferred return, paid first but only out of cash flow/available capital proceeds (sponsor may have similar stated return which may be subordinate or even pari passu)
 - B) After stated return, cash flow/capital event proceeds allocated based upon percentage interests. Preferred Investor shares in the residual. Typically sponsor receives a promote
 - C) Promote may be paid before all capital returned (but after stated return paid) or only after all capital returned and stated return paid. Guaranteed return of promote if Preferred Investor does not receive stated return
 - D) Preferred Equity Investor participates in losses
 - E) Major decisions may be longer or shorter list. Budget approval
 - F) Removal right for “bad acts” may also be performance standard based. Removal leads to loss of management rights of sponsor (but not forfeiture). Sponsor may retain consent rights over certain major decisions (e.g., sale of the Property). Sponsor needs to protect against self dealing transactions.
 - G) Deadlocks – (i) one member has tie-breaker vote; (ii) buy-sell provision; (iii) maintenance of status quo
 - H) Preferred Equity Investor put or forced sale right after stated period

Benefits and Risks of Preferred Equity -1

- (i) Preferred Equity vs. Mezzanine Loan
 - (a) Benefits to Operator:
 - Easier to obtain Mortgage Lender Consent
 - Depending on structure of PE, (x) no fixed payments or maturity, (y) potential additional capital source
 - (b) Risks to Operator: (x) No protection of UCC (potential for expedited loss of control); (y) operator is typically sole carve-out guarantor; and (z) cost of funds may be higher

Benefits and Risks of Preferred Equity -2

- (ii) Preferred Equity vs. Common Equity
 - (a) Benefits to Operator: (x) Promote structure, and (y) often financial wherewithal of investor
 - (b) Risks to Operator: (x) Investor member's major decision and potential control rights, (y) potential forced sale

Benefits and Risks to the Investor:

- (a) Vis a Vis Mezzanine Loan: Benefits – potentially greater return; potential efficiency of taking control; availability behind mortgage loan

Benefits and Risks of Preferred Equity -3

- Risks – No security; litigation risk; upon take-over, operator generally remains a partner/member
- (b) Vis a Vis Common Equity: Benefits – typically a preferred return and senior return of capital; management rights; ability to take control under defined circumstances; potential to exit via buy-sell, put or forced sale.
- Risks – potentially lower return; depending on structure, potentially less day to day control, and potential of being forced out of investment early (e.g., by a buy-sell or call provision)

Certain Tax Matters

- A) Guaranteed payments vs. Income Allocation
- B) Tax Matters Partner: (i) who can serve, (ii) authority
- C) College Endowments, Private Pension Funds and Fractions Rule
- D) Effects of Recourse (carve-outs guarantees, payment guarantees)

Default; Change in Control -1

- Defaults –
 - (a) Bad Acts: bankruptcy, withdrawal, criminal acts, fraud or theft, breach of the agreement, breach of carve-outs, mortgage loan defaults.
 - (b) Performance: additional capital required above a certain percentage of initial capital, operating or renovation cost overruns, returns below a defined threshold, failure to realize upon investment within specified time period

Default; Change in Control -2

- Change in Control and Other Remedies:
 - (a) Change in control for default – after notice and cure in certain cases
 - (b) Replacement of property manager/construction manager
 - (c) Loss of promote
 - (d) Change in capital contribution ratios for additional capital
 - (e) Rights After Change in Control

Bankruptcy

- Mezzanine Loan: (a) Property Owner, (b) Equity Owner, or (c) Sponsor. (i) SPE Provisions including independent director. (ii) Springing recourse.
- Preferred Equity: (a) Property Owner, (b) Equity Owner, or (c) Sponsor. Bankruptcy to be major decision requiring Preferred Investor vote. Reflect requirement of Preferred Investor vote in equity owner and property owner organizational documents. For debt-like preferred equity – springing recourse. In limited liability company agreement provide for termination of sponsor as a member upon filing (accords with DE law). Note courts are split on efficacy of provisions stripping management rights upon a bankruptcy.

Key Provisions -1

- (i) Organizational Documents:
 - Waterfall (sample on next slide)
 - Additional Capital Contributions (who can call, who needs to approve)
 - Buy-Sell (when can it be exercised and under what circumstances)
 - Put
 - Forced Sale
 - Guaranties (whose responsible, how are payments treated)
 - Removal Provision
 - Management Provisions (what decisions require consent)

Key Provisions - 2

- **SAMPLE SENIOR/SUBORDINATE WATERFALL**

- (i) First, to Investor Member, to the extent of the Preferred Return accrued during the calendar month immediately preceding the month in which the date of such distribution occurs on the Investor Member's Unreturned Capital Contribution until the full amount of such Preferred Return so accrued has been distributed to Investor Member;
- (ii) Second, to Investor Member, to the extent of the outstanding positive balance of the Investor Member's Preferred Return Account until the outstanding balance of Investor Member's Preferred Return Account has been reduced to zero;
- (iii) Third, to Managing Member, to the extent of the Preferred Return accrued during the calendar month immediately preceding the month in which the date of such distribution occurs on Managing Member's Unreturned Capital Contribution until the full amount of such Preferred Return so accrued has been distributed to Managing Member;
- (iv) Fourth, to Managing Member, to the extent of the outstanding positive balance of the Managing Member's Preferred Return Account until the outstanding balance of Managing Member's Preferred Return Account has been reduced to zero;
- (v) Fifth, pro rata to Investor Member and Managing Member based upon their respective aggregate Capital Contributions until each of Investor Member and Managing Member has received a cumulative return of thirteen percent (13%) per annum compounded annually on all of its respective Capital Contributions from the date such Capital Contribution was contributed to the Company to the date of any distribution under this paragraph (v) or, in the case of any Capital Contribution that has then been returned, through the date such Capital Contribution was returned to Investor Member or Managing Member, as applicable;
- (vi) Sixth, to Investor Member, to the extent of Investor Member's Unreturned Capital Contribution (including any additional Capital Contributions) until Investor Member's Unreturned Capital Account has been reduced to zero;
- (vii) Seventh, to Managing Member, to the extent of Managing Member's Unreturned Capital Contributions (including any additional Capital Contributions) until Managing Member's Unreturned Capital Account has been reduced to zero; and
- (viii) Thereafter, in accordance with the Members' respective Promote Percentages.

Key Provisions - 3

- (ii) Loan Documents:
 - (a) Transfer Provisions
 - Change in Control
 - Transfer of interests in investor member entity
 - Transfer Fee
 - (b) Replacement Guarantor (in event of guarantor default)
 - (c) Notice
 - (d) Permitted Distributions

- (iii) Other:
 - (a) Franchise Agreements – Change in Control

Certain Preferred Investor Protections

- Apparent vs. Actual Authority of Sponsor
- Provisions in Certificate of Formation or Organization filed with Secretary of State (equity owner/property owner)
- Notice on the real estate records (Mortgage Lender's often prohibit)
- Signing Authority
- Know your partner

Intercreditor Issues -1

1. Mezzanine Loan: (a) Typical to have an intercreditor agreement with the mortgage lender (Mezzanine Lender to have cure rights, loan purchase right, certain decisional rights, and right to foreclose upon the pledged equity subject to compliance with requirements (e.g., delivery of new carveout guaranty). (b) Sponsor needs to protect itself from acts of mezzanine lender after any takeover.

Intercreditor Issues -2

2. Preferred Equity: (a) Typically no separate intercreditor agreement. (b) Need provisions in mortgage loan documents permitting (i) management replacement by preferred member, and (ii) exercise of buy-sell. (c) Typically mortgage lender will require new guarantor upon such replacement. Sponsor needs to protect from actions taken by Preferred Investor after takeover that spring recourse liability.

Intercreditor Issues -3

3. Mortgage Lender Restrictions: Mortgage lender may not permit mezzanine. May or may not permit preferred equity. If permitted may only permit if does not mimic debt. In order to grant removal right, many lenders (including FNMA) require Preferred Equity Investor to be underwritten at loan closing. Mortgage lender may require springing guaranty at closing. Whether or not required at closing mortgage lender may impose net worth and liquidity tests on proposed replacement guarantor.

Fiduciary Issues

- Mezzanine Loan – Typically no fiduciary obligations
- Preferred Equity – Duties of loyalty and care may apply in DE unless waived. See *Auriga Capital Corporation v. Gatz Properties, LLC* C.A. No. 4390 (Del. Nov. 7, 2012). Prudent for parties to specify standards of expected conduct in the preferred equity agreement. Preferred Investor will want waivers of any fiduciary duties that may be implied should it take over. Implied covenant of good faith and fair dealing likely not waivable.

Recharacterization

- Preferred Equity subject to recharacterization as debt. Where the investment has required payments regardless of property performance and other characteristics of debt, recharacterization is possible. In such case, for tax or accounting purposes, the preferred equity may need to be treated as debt. Even so, this may not result in recharacterization for other purposes or to a particularly painful result if it does.
- Recharacterization cases generally involving another creditor or taxing authority seeking to recharacterize debt as equity and not the equity as debt. However, should such recharacterization apply, the equity holder would be in the same position as an unsecured creditor. The main potential risk appears to be that management rights could be lost or recharacterized as loan covenants as opposed to entity power and authority requirements. While such recharacterization may have an adverse effect, particularly if it were to permit an otherwise unauthorized bankruptcy filing, in general, there is no clear reason why the basic covenants should not remain enforceable as contractual provisions as between the parties.

Distribution Risk

- Mezzanine Loan: Payments within 90 days (longer if an insider) of bankruptcy filing, potentially subject to forced return as a preference
- Preferred Equity: Distributions within 90 days (longer if treated as an insider) subject possibly to forced return as a preference. Subject to challenge as a fraudulent conveyance. In DE, a distribution is potentially subject to return if the company's liabilities exceeded its assets at the time the distribution was made (Del. Code Ann. Title 6 Sec. 18-607)

Conclusion

- Mezzanine Loans and Preferred Equity Investments can help fill the equity gap in a capital stack.
- Mezzanine Loans and Preferred Equity Investments have significant similarities and differences, including in the rights and risks to the parties and how they are viewed by mortgage lenders.
- The term preferred equity covers a gamut of structures from debt like structures to structures that look a lot like common equity.

Thank You

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