Strafford

Presenting a live 90-minute webinar with interactive Q&A

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

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

TUESDAY, NOVEMBER 22, 2016

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

Today's faculty features:

Loryn D. Arkow, Partner, **Stroock & Stroock & Lavan**, Los Angeles

Diana M. Brummer, Partner, **Stroock & Stroock & Lavan**, New York

Jon S. Ziefert, Special Counsel, **Stroock & Stroock & Lavan**, Los Angeles

The audio portion of the conference may be accessed via the telephone or by using your computer's speakers. Please refer to the instructions emailed to registrants for additional information. If you have any questions, please contact **Customer Service at 1-800-926-7926 ext. 10**.

Tips for Optimal Quality

FOR LIVE EVENT ONLY

Sound Quality

If you are listening via your computer speakers, please note that the quality of your sound will vary depending on the speed and quality of your internet connection.

If the sound quality is not satisfactory, you may listen via the phone: dial **1-866-755-4350** and enter your PIN when prompted. Otherwise, please **send us a chat** or e-mail **sound@straffordpub.com** immediately so we can address the problem.

If you dialed in and have any difficulties during the call, press *0 for assistance.

Viewing Quality

To maximize your screen, press the F11 key on your keyboard. To exit full screen, press the F11 key again.

Continuing Education Credits

FOR LIVE EVENT ONLY

In order for us to process your continuing education credit, you must confirm your participation in this webinar by completing and submitting the Attendance Affirmation/Evaluation after the webinar.

A link to the Attendance Affirmation/Evaluation will be in the thank you email that you will receive immediately following the program.

For additional information about continuing education, call us at 1-800-926-7926 ext. 35.

Program Materials

FOR LIVE EVENT ONLY

If you have not printed the conference materials for this program, please complete the following steps:

- Click on the ^ symbol next to “Conference Materials” in the middle of the left-hand column on your screen.
- Click on the tab labeled “Handouts” that appears, and there you will see a PDF of the slides for today's program.
- Double click on the PDF and a separate page will open.
- Print the slides by clicking on the printer icon.

INTRODUCTION

- Introductions of Loryn D. Arkow, Diana M. Brummer, and Jon S. Ziefert
- 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

(i) "Hard" Preferred Equity

(ii) "Soft" Preferred Equity

e) Benefits and Risks of Preferred Equity Structures

(i) Preferred Equity vs. Mezzanine Debt

(ii) Preferred Equity vs. Common Equity

f) Defaults, Change in Control

g) Key Provisions

(i) Joint Venture Agreements

(ii) Sample Distribution Waterfalls

(iii) Other

h) Certain Preferred Equity Protections

i) Intercreditor Issues

j) Certain Tax Matters

k) Fiduciary Issues

l) Distribution Risk

m) Recharacterization

n) Conclusion

Preferred Equity Structures

- Term “Preferred Equity” is broad and can mean different things. Sometimes it refers to what is effectively a mezzanine loan equivalent (“hard”). Other times it refers to equity with a priority preferred return, but that is in all other ways the same as common equity (“soft”).
- Preferred equity structures span a continuum with debt-like preferred equity on the one end and common-equity-like preferred equity on the other.

Basic Building Blocks of the Capital Stack

Basic Building Blocks of the Capital Stack – Mortgage Loan

Mortgage: Loan to property owner secured by a first mortgage lien on real property.

(Typically 50-70% of capital stack)

Mortgage Loan Structure Chart

Basic Building Blocks of the Capital Stack – Mezzanine Loan

Mezzanine Loan: Loan to equity owner(s) of property owner, secured by a pledge of equity interests in property owner.

(Typically 5-20% of capital stack)

Mezzanine Loan Structure

76414426v1

Basic Building Blocks of the Capital Stack – "Hard" Preferred Equity

"Hard" Preferred Equity:	Equity investment in property owner (or in direct or indirect equity owner of property owner). Preferred equity investment is structured much like a loan where (i) "interest" in the form of a preferred return on the investment is required to be paid monthly by the sponsor regardless of available property cash flow; (ii) the entire investment is required to be paid by a certain maturity date; (iii) default rate "interest" and penalties are assessed against the sponsor in the event payments are not made timely; and (iv) a default in the repayment of investment potentially results in the loss of management and/or ownership control by the sponsor in the company in favor of the investor or other third-party. An "interest" reserve or letter of credit is sometimes used to insure the preferred return is paid. (Typically 5-25% of Capital Stack)
Common Equity:	Equity with a priority of payment subordinate to the preferred equity and payment dependent on available cash flow (Typically 10-30% of Capital Stack)

"Hard" Preferred Equity Structure

Basic Building Blocks of the Capital Stack – “Soft” Preferred Equity

“Soft” 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, priority of payment and other rights. (Typically 5-25% of Capital Stack)
Common Equity:	Equity with a priority of payment subordinate to the preferred equity. (Typically 10-30% of Capital Stack)

“Soft” 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.
- HVCRE Regulations: Mortgage loan borrower must have contributed at least 15% of the real estate's "appraised as completed" value prior to advance of funds by the bank.
- Sponsor Desire for Greater Leverage: Acquiring the asset with minimum of equity or cash out.

Structural Subordination

- 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 borrower (at least with respect to pledged equity collateral).

Structural Subordination – Continued

- Preferred Equity: Subordinate to all mortgage and mezzanine debt. Senior to common equity.
- Common Equity: Subordinate to all debt, and, to the extent provided by its terms, Preferred Equity.
- Risks/Rewards: Risks and returns are highest for common equity, then preferred equity (varies), then mezzanine loans and lastly, mortgage loans. Note: “hard” preferred equity and mezzanine loans have similar returns.

Preferred Equity Structures – "Hard"

- Debt Equivalent. Looks and acts a lot like a mezzanine loan:

  A) Fixed monthly distributions to be paid regardless of cash flow.
  B) Fixed, mandatory redemption date.
  C) Sponsor carve-out guaranty and environmental indemnity in favor of Preferred Equity Investor.
  D) "Events of Default" (e.g., failure to pay preferred return or preferred equity investment when due; breach of guarantor financial covenants; other material covenant breaches.
  E) Preferred Equity Investor has removal right (including for failure of timely distributions).
  F) Major decisions requiring Preferred Equity Investor approval similar to mezzanine loan covenants.
  G) Insufficient cash flow or property's appraised value certain can trigger removal of Sponsor.
  H) Sponsor's interest pledged to Preferred Equity Investor – possible forfeiture of Sponsor's interest if Preferred Equity not redeemed by mandatory redemption date. Unusual. Removal as manager and forced sale more common.
  I) Failure of timely distribution or other default results in default preferred equity rate (20+% not atypical).
  J) Generally, Preferred Equity Investor has no share in residual income or increased property value.
  K) Generally, Preferred Equity Investor has no share of losses outside of reversal of prior allocated income, although often operating agreement may provide that the Preferred Equity Investor's interest is to be treated as debt for tax purposes.
  L) Preferred Investor has no obligation to contribute additional capital.
  M) Preferred Investor may be entitled to early redemption premium (i.e., a minimum preferred return).

Preferred Equity Structures – "Soft"

- "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 relative capital contributions. Preferred Equity 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. Clawback of promote if Preferred Equity Investor does not receive stated return.
  D) Preferred Equity Investor participates in profits and losses.
  E) Removal right for "bad acts"; may also have default or performance-based removal, but standards not as severe as "hard" preferred equity. 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) and voluntary bankruptcy following removal. Sponsor needs to protect against self dealing transactions by Preferred Equity Investor following removal.
  F) Deadlocks – (i) one member has tie-breaker vote; (ii) buy-sell provision; (iii) maintenance of status quo.
  G) Preferred Equity Investor may have put or forced sale right after stated lock-out period.

Benefits and Risks of Preferred Equity to Sponsor

(i) Preferred Equity vs. Mezzanine Loan

(a) Benefits to Sponsor:
- Easier to obtain mortgage lender consent to preferred equity
- Depending on structure of Preferred Equity, (x) no fixed payments or maturity and (y) limited sharing of upside with investor

(b) Risks to Sponsor:
- No protection of UCC (potential for expedited loss of control)
- Sponsor is typically sole carve-out guarantor
- Cost of funds may be higher

(ii) Preferred Equity vs. Common Equity

(a) Benefits to Sponsor:
- Promote structure
- Ability to operate within stated business plan and budget without undue interference

(b) Risks to Sponsor:
- Preferred Equity Investor member's major decision and potential control right
- Potential buy-sell or forced sale

Benefits and Risks of Preferred Equity to the Preferred Equity Investor

(i) Preferred Equity vs. Mezzanine Loan:

(a) Benefits to the Preferred Equity Investor

- Potentially greater return
- Potential efficiency of taking control
- Permitted by mortgage lender

(b) Risks to the Preferred Equity Investor

- No security
- Litigation risk
- Upon take-over, Sponsor may remain a partner/member
- Recharacterization for tax purposes

(ii) Preferred Equity vs. Common Equity:

(a) Benefits to the Preferred Equity Investor

- 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

(b) Risks to the Preferred Equity Investor

- Potentially lower return because there may be no participation in the residual upside
- Depending on structure, potentially less day to day control
- Potential of being forced out of investment early (e.g., by a buy-sell or call provision)

Material Defaults & Remedies

- A Preferred Equity Investor has certain remedies for various Sponsor defaults, including:
  (1) Failure to timely fund monthly payments and other time-sensitive payments
  (2) Loss of key officers of the Sponsor
  (3) Failure to fund required capital
  (4) Non-performance of obligations (for example, Sponsor not obtaining the necessary approvals)
  (5) Competing with the Project or usurping a business activity
  (6) Failure to meet specified performance criteria
  (7) Intentional misconduct, misappropriation, gross negligence or other bad acts
  (8) Causing a Project loan acceleration or occurrence of any default under the mortgage loan

Material Defaults & Remedies

- Remedies in the JV agreement include:
  (1)Loss of management control
  (2)Replacement of Sponsor affiliated property manager/development manager
  (3)Dilution of Sponsor compensation (loss of promote) and subordination of returns
  (4)Expulsion from the JV
  (5)Forced sale of property or buy-sell being triggered

Key Provisions

1. Joint Venture Agreements:
   - (a) Distribution Waterfall
   - (b) Additional Capital Contributions (who can call, who needs to approve)
   - (c) Default Loan/Cram Down Provisions
   - (d) Buy-Sell (when can it be exercised and under what circumstances)
   - (e) Put Rights
   - (f) Forced Sale
   - (g) Guaranties (whose responsible, how are payments treated)
   - (h) Removal Provisions
   - (i) Major Decision/Control Provisions (what decisions require consent)

Key Provisions – Continued

2. 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 or transfer)

(c) Notice

(d) Permitted Distributions

Key Provisions – Continued

SAMPLE "SOFT" PREFERED EQUITY WATERFALL

(i) First, 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;

(ii) Second, 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;

(iii) Third, 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;

(iv) Fourth, 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;

(v) Fifth, 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

(vi) Thereafter, in accordance with the Members' respective Promote Percentages.

Key Provisions – Continued

SAMPLE “HARD” PREFERRED EQUITY CAPITAL PROCEEDS WATERFALL

(i) First, to Investor Member, to the extent of the outstanding positive balance of Investor Member’s Preferred Return Account until the outstanding balance of Investor Member’s Preferred Return Account has been reduced to zero;

(ii) Second, to Investor Member, to the extent of Investor Member’s Unreturned Capital Contributions until the balance of Investor Member’s Unreturned Capital Account has been reduced to zero;

(iii) Third, to Investor Member, in the amount of the Exit Fee on any portion of the Investment being redeemed in connection with the Capital Event;

(iv) Fourth, to Investor Member, until Investor Member has received the Minimum Multiple, inclusive of prior distributions with respect to the Minimum Multiple;

(v) Fifth, to Managing Member, to the extent of Managing Member’s Unreturned Capital Contributions until the balance of its Unreturned Capital Account has been reduced to zero;

(vi) Sixth, to Managing Member, in the amount of the Disposition Fee;

(vii) Seventh, (i) twenty-five percent (25%) to Investor Member and (ii) seventy-five percent (75%) to Managing Member, until Investor Member has received the Participating Interest;

(viii) Thereafter, one hundred percent (100%) to Managing Member.

Sample "Hard" Preferred Equity Cash Flow Diagram

Certain Preferred Equity Investor Protections

- First Rights. Preferred Equity Investor may have a right of first opportunity to participate in Sponsor's future projects.
- Noncompete. Preferred Equity Investor may have restrictions/ non-compete as to Sponsor's business opportunities in a specific geographic area near the property that is the subject of the JV.
- Sponsor Loan Guaranties. JV Agreement may require Sponsor to provide certain guaranties of loans.
- Clawback. To the extent that Sponsor's economic projections are not met, JV Agreement may require Sponsor to make up the difference to the extent of distributions Sponsor received, or for its fee services (i.e., in the event, upon liquidation of the investment, it is determined that Sponsor received promote distributions or fees and Preferred Equity Investor did not receive a return of its investment plus a specified return on its investment).

Certain Preferred Equity Investor Protections - Continued

- Forced Sale. Right to require the sale of an asset (or all assets) on the open market. A forced sale right is, however, often subject to a ROFO in favor of the party not triggering the forced sale.
- Put and/or Call Rights. The Preferred Equity Investor can have an option to "put" its interest to the JV and compel a sale, or an option to "call" the Sponsor's interest and buy it. Empowers the Preferred Equity Investor to decide whether it will buy or sell, whereas in a Buy/Sell, the power is in the party who initiates the Buy/Sell (the recipient of a Buy/Sell notice can decide if it wants to buy or sell its interest).
- Buy-Sell. The Preferred Equity Investor (and the Sponsor) each have the right to offer to buy the other party out of its interest in the venture for a price set forth in the offer. The responding non-offering party has the right to either sell its interest for the price offered or buy the offering party's interest for that price. Pricing is based on what a party would have received had the venture's property been sold and the proceeds run through the distribution waterfall. Buy/sell arrangements have many highly negotiated details.

Intercreditor Issues

1. Mezzanine Loan
   (a) Typical to have an intercreditor agreement with the mortgage lender (mezzanine lender to have cure rights, loan purchase right, certain decision 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 – Continued

2. Preferred Equity

   (a) Typically no separate intercreditor agreement, although may include a recognition agreement.

   (b) Need provisions in mortgage loan documents permitting (i) management replacement by Preferred Equity Investor, and (ii) exercise of buy-sell.

   (c) Typically mortgage lender will require new guarantor upon such replacement. Sponsor needs to protect itself from actions taken by Preferred Equity Investor after takeover that trigger recourse liability.

Intercreditor Issues – Continued

3. Mortgage Lender Restrictions

Mortgage lender may not permit mezzanine financing. May or may not permit preferred equity. If permitted, may only permit if preferred equity is not similar to debt. In order to grant removal right, many lenders 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.

Certain Tax Matters

A) Parties to agreement may treat preferred equity as debt vs. equity

B) Lender cannot be Tax Matters Partner; Preferred Equity holder could be Tax Matters Partner (if not agreed to be treated as debt)

C) Tax Matters Partner: (i) who can serve, (ii) authority

D) College Endowments, Pension Funds and UBTI

E) Foreign Investors

F) Effects of Recourse (carve-outs guarantees, payment guarantees)

Fiduciary Issues

- Mezzanine Loan – Typically no fiduciary duties.

- Preferred Equity – Generally, duties of loyalty and care apply in DE, but may be 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/ standard of care in the JV Agreement. Preferred Equity Investor will want waivers of any fiduciary duties that may be implied should it take over management and control of the JV. In Delaware, implied covenant of good faith and fair dealing is not waivable. See Del. Code 17-1101(d) and 18-1101(e).

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: If transaction treated as debt, distributions within 90 days (longer if treated as an insider) potentially subject to forced return as a preference. If transaction characterized as equity, distributions potentially 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).

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 or even agreed to be treated as debt. The company would take interest deductions for payments to the Preferred Equity Investor but could also be liable for cancellation of indebtedness if the Preferred Equity Investor is not paid in full. Even so, this may not result in recharacterization for other purposes.

- 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.

Conclusion

- The decision to structure an investment in the capital stack with a priority between the senior lender and common equity requires the balancing of various trade-offs for the investor and the sponsor. Careful consideration should be given by both parties to structuring around the competing risks and rewards to each party.

Thank You

Loryn D. Arkow
Stroock & Stroock & Lavan LLP
larkow@stroock.com
Tel.: 310.556.5985

Diana M. Brummer
Stroock & Stroock & Lavan LLP
dbrummer@stroock.com
Tel.: 212.806.5441

Jon S. Ziefert
Stroock & Stroock & Lavan LLP
jziefert@stroock.com
Tel.: 310.556.5936