

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

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 15, 2019

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

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Preferred Equity Investments in Real Estate Joint Ventures

(How to Structure and how they differ
From Mezzanine Debt)

Date: August 15, 2019

Mark S. Fawer, Carolyn Austin and James Mann

GreenspoonMarder_{LLP}

Part I – Preferred Equity vs. Regular Equity

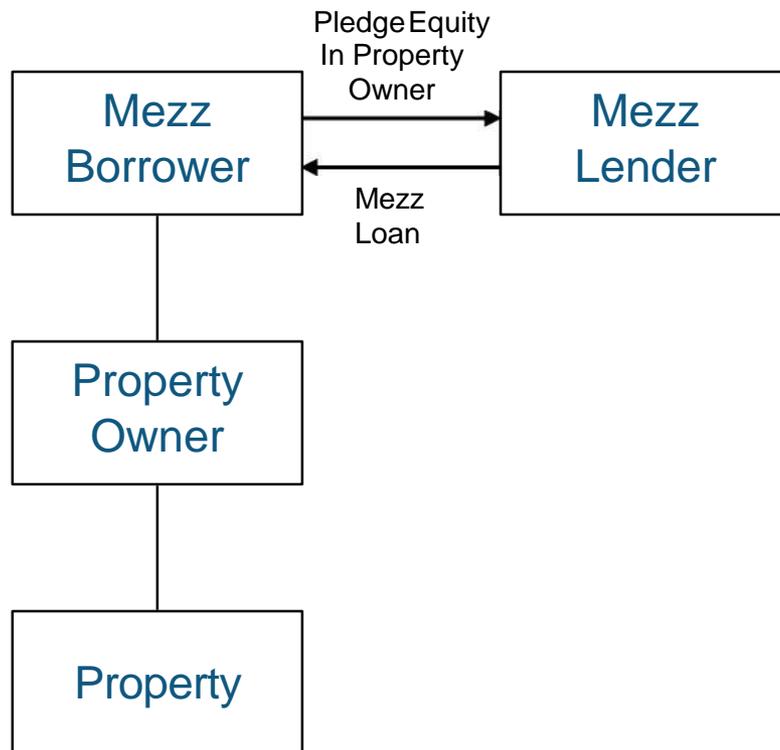
- ❖ Basics: A preferred investor (referred to herein as the “Preferred Investor”) contributes \$ to a special purpose property-owning company and receives, in exchange, an equity interest that receive distributions before other investors and approval rights over various major decisions.
- ❖ Remaining equity will be provided by a sponsor/operating member (referred to herein as the “Sponsor”) and may also be provided by other passive common equity investors.
- ❖ Ideally, the parties will use a new limited liability company to minimize the Preferred Investor’s exposure to pre-closing liabilities.
- ❖ The preferred investment is unsecured and is structurally subordinate to the mortgage loan and other debt, if any.
- ❖ The Preferred Investor will only receive payments from (a) excess cash flow available for distribution after property-level expenses and reserves and/or (b) funds contributed by the Sponsor and other common investors for that purpose.

Part I – Preferred Equity vs. Regular Equity (cont.)

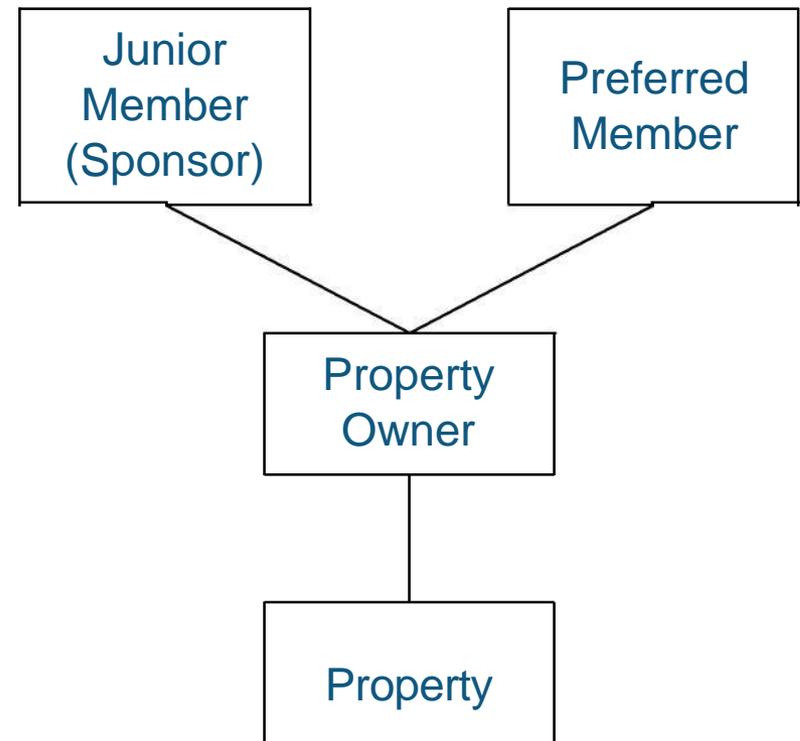
- ❖ The Sponsor must obtain the Preferred Investor's approval for many major actions and decisions. The extent of these approval rights will vary based, among other things, on the expertise of the Sponsor and the sophistication and availability of the Preferred Investor.
- ❖ Remedies for a Sponsor default will vary by transaction, but can include a change in economics (e.g., to increase the Preferred Investor's yield or further subordinate payments to the Sponsor and common equity), the Preferred Investor having the right to appoint a new managing member for the project and, in some cases, even the Preferred Investor having a right to force the sale of the underlying Project.
- ❖ Specific features can range on a continuum from a simple equity interest with a modest priority on distribution, on one hand, to a debt-like instrument with management rights and upside participation, on the other hand.

Part II — Preferred Equity vs. Mezzanine Loan

Mezz Loan



Preferred Equity



Part II — Preferred Equity vs. Mezzanine Loan (cont.)

<u>Mezz Loan</u>		v.	<u>Preferred Equity</u>	
<u>Pros</u>	<u>Cons</u>		<u>Pros</u>	<u>Cons</u>
<ol style="list-style-type: none"> 1. May wipe out junior equity in a UCC foreclosure upon credit bidding 2. Generally has senior mortgage purchase option at par (and broader rights with senior lender) 3. Generally has greater rights in franchisor comfort letter [hotel loans only] 	<ol style="list-style-type: none"> 1. While faster than mortgage foreclosure, not immediate (generally, 45 days minimum, barring judicial intervention) 2. No right to deprive property-owning entity from filing for bankruptcy (until control is taken over property owner) 		<ol style="list-style-type: none"> 1. Can take control upon notice and lapse of any applicable grace period (barring any judicial intervention) 2. May be able to deprive property-owning entity from filing for bankruptcy (if economic interest is sufficiently significant) 	<ol style="list-style-type: none"> 1. Can't wipe out junior equity, just erode with default rate preferred return, etc. (imposing forfeiture not recommended) 2. May theoretically be subject to breach of duty claims from a junior member 3. Generally lacks senior mortgage purchase option 4. Generally has fewer rights in franchise comfort letter [hotel deals only]

Part II — Preferred Equity vs. Mezzanine Loan (cont.)

Major Documents Comparison: Overview

	Mezzanine Loan	Preferred Equity Investment
1.	Note	Operating Agreement
2.	Loan Agreement	Principals Agreement
3.	Pledge Agreement	No Equivalent Document
4.	Recourse Guaranty	Recourse Guaranty
5.	Completion Guaranty [construction only]	Completion Guaranty [construction only]
6.	Intercreditor Agreement	Recognition Agreement [built-into senior loan agreement or in separate letter agreement]

Part III – Structuring the Preferred Equity Deal

Overriding principle is flexibility; options range from (x) passive equity with a priority with respect to certain distributions to (y) full debt-like features (which could even include collateral) plus an active role in management plus upside participation

❖ Economic Terms

- ❖ Priority Return of Capital (from capital event proceeds or possibly from all available cash)
- ❖ Priority Return on Investment (w/set coupon as a required minimum or as total return)
- ❖ Accrual of preferred return if not paid when due / compounding
- ❖ May include payment of a promote to the Sponsor after the Preferred Investor achieves a specified return hurdle
- ❖ Preferred Investor's interest may be redeemable, with timing and minimum price to be negotiated
- ❖ Fees to Preferred Investor: Up-front fee; exit fee on redemption or on sale of underlying Project; and/or servicing/administration fee

Part III – Structuring the Preferred Equity Deal (cont.)

- ❖ Fees to Sponsor and/or its affiliates: finder's fee; property management fee; leasing fee; development fee; and/or asset management fee
- ❖ Investor Member may even require a right of first opportunity to participate in future Sponsor-led investments
- ❖ Timing of Distributions
 - ❖ Fixed monthly/quarterly coupon vs. as and when funds are available
 - ❖ Remedies for non-payment: accrual at a higher rate; loss of management rights; right to force third-party sale
- ❖ Management/Approval Rights
 - ❖ Major Decisions (see Annex A for a sample listing)
 - ❖ Right to act for the company if the Sponsor failed to act as and when required (may require advance notice)
 - ❖ Preferred Equity often does not have a right to propose major decisions but can only respond to proposals by the Sponsor

Part III – Structuring the Preferred Equity Deal (cont.)

- ❖ If multiple tiers in structure, be sure approval rights apply at all levels
- ❖ The Preferred Investor should have the right to act for the company on all matters in which Sponsor or an affiliate is counterparty (e.g., to give notice of default under a service contract with an affiliate of the Sponsor)
- ❖ Dispute Resolution – Options for addressing a deadlock
 - ❖ Frozen, no relief until parties can agree
 - ❖ Right to initiate a buy-sell or forced sale
 - ❖ Preferred Investor decides (rare)
 - ❖ Submit to an expert or arbitrator
- ❖ Remedies if the Sponsor defaults
 - ❖ Severity often depends on nature of breach
 - ❖ Typical options
 - ❖ Increase in preferred return rate

Part III – Structuring the Preferred Equity Deal (cont.)

- ❖ Loss of managing member function
- ❖ Termination of service contracts with the Sponsor and/or its affiliates
- ❖ Loss of promote
- ❖ Put right (to require early redemption)
- ❖ Right to buy out the Sponsor and other common equity at FMV (or even at discount to FMV)
- ❖ Right to initiate forced sale or buy/sell
- ❖ Punitive dilution if the Preferred Investor funds additional capital
- ❖ Cure rights
 - ❖ None for fundamental breaches (e.g., prohibited transfer or failure to maintain insurance)
 - ❖ The Sponsor may be able to negotiate for a small window to cure monetary breaches

Part III – Structuring the Preferred Equity Deal (cont.)

- ❖ In most cases the Sponsor is able to negotiate more generous cure rights for covenant defaults; initial cure period may even be extendable if the Sponsor has commenced and is diligently pursuing cure and the extension will not cause any material harm to the company or the Preferred Investor
- ❖ Removal Rights/Change of Control
 - ❖ Upon stated triggers, the Preferred Investor can terminate the Sponsor's management right by mere notice; common triggers include:
 - ❖ Failure to make required distributions or other payments
 - ❖ Breach of the company's LLC agreement or equivalent
 - ❖ Failure to fund capital shortfalls
 - ❖ Failure to achieve specified results or to meet established performance benchmarks
 - ❖ Gross negligence, misconduct, misappropriation or other bad acts
 - ❖ Default/acceleration under mortgage debt or other arrangements

Part III – Structuring the Preferred Equity Deal (cont.)

- ❖ If default is disputed, the Sponsor may negotiate for a final determination (at law or in arbitration) before the removal becomes effective
- ❖ Speed and ease of removal is a significant benefit of the preferred equity structure
- ❖ Beware of claim that the preferred investment is really disguised debt (i.e., Sponsor seeking the benefit of creditor's rights)
- ❖ Beware of possible equitable challenges if remedies are over-bearing or inherently unfair (e.g., a right to buy the Sponsor's interest for \$1)
- ❖ Burden of management; assuming control (or appointing a new manager) is not necessarily a good solution – the Preferred Investor usually wants the Sponsor to perform
- ❖ Agreements should include covenants to cooperate for orderly transition; new manager will need access to information
- ❖ Even if senior lender pre-approved Preferred Investor as a control party, lender approval may be needed for change of property manager

Part III – Structuring the Preferred Equity Deal (cont.)

- ❖ Consider how Investor Member will take control of bank accounts
- ❖ Preferred Investor may require a lockbox or other cash management arrangement (or recognition in mortgage lender's disbursement system)
- ❖ Consider how subsidiary entities are managed (manager vs. member vs. officers) and be sure the Preferred Investor can replace at each level
- ❖ May need to address sponsor guarantees/indemnities
- ❖ Sponsor may request express right of reimbursement (i.e., subrogation) from the Company if it makes payment on a guaranty in favor of the mortgage lender or the Preferred Investor – should only be after payment of preferred return and should exclude guaranty payments necessitated by Sponsor bad acts
- ❖ Sponsor may seek release as a condition to change in management (but is release warranted?)
- ❖ Mortgage lender may insist that non-recourse carveout guaranty be given by new controlling member (or an affiliate with an appropriate credit profile)

Part III – Structuring the Preferred Equity Deal (cont.)

- ❖ Preferred Investor may include a “key man” requirement
- ❖ Preferred Investor may require that Sponsor refrain from competing within a radius of the project (or at least provide advance notice of any such competition)

Part IIIA – Tax Considerations

- ❖ Parties to transaction may agree to treat Preferred Equity as equity or debt for tax purposes.
- ❖ Tax treatment as equity or debt is determined under a facts and circumstances test.
- ❖ Allocation of LLC tax attributes – e.g., depreciation.

Part IV — Relationship to Mortgage Lender

- ❖ In the event of a default by the Company under the Operating Agreement, Senior Lender will allow the Preferred Investor to exercise all of its rights under the Operating Agreement, including assuming control of the Company from the Sponsor, without any approval by Senior Lender or the payment of any fee to the Senior Lender at the time the change of control is effectuated. Without Senior Lender recognition, there is a risk of Senior Lender acceleration and foreclosure upon a change of control to Preferred Investor.
- ❖ In the event a “change in control” occurs, Preferred Investor may have to become or provide an acceptable affiliate to become a supplemental guarantor under the non-recourse carve-outs and environmental indemnity provisions of the Senior Loan.
 - ❖ but only for the period of time that the Preferred Investor has control of the Company
 - ❖ so long as there is then no Event of Default under the Senior Loan, Preferred Investor would be released as a supplemental guarantor in the event the Sponsor reassumes control of the Company

Part IV — Relationship to Mortgage Lender (cont.)

- ❖ Preferred Investor should only incur liability under its non-recourse carve-out guaranty for wrongful acts, if any, committed by Preferred Investor or the Company during Preferred Investor's control of the Company and would not incur any liability for any wrongful acts that occurred prior to Preferred Investor taking control of the Company or subsequent to the Sponsor reassuming control of the Company.
- ❖ Senior Lender agrees to include the Preferred Investor in the "notice section" of the Senior Loan and to provide the Preferred Investor with a copy of all material notices sent to the Company and the Sponsor regarding non-compliance with the terms of the Senior Loan documents (including failure to comply with financial covenants and written default notices).
- ❖ Preferred Investor would be permitted to transfer all of its rights under the Operating Agreement to a third party approved in writing by Senior Lender or otherwise satisfying certain criteria in the event of a sale by Preferred Investor of its membership interests in the Company.

Part IV – Relationship to Mortgage Lender (cont.)

- ❖ Preferred Investor may transfer to affiliates without Senior Lender consent.

Can't Count On:

- ❖ Option to Purchase Senior Loan at Par
- ❖ Right to Consent to Certain Senior Loan Modifications

Preferred Equity Provider should seek from a Franchisor

- ❖ Pre-approval of change in control of franchisee to Preferred Investor (or its affiliate) in the event of a default by the Company under the Operating Agreement.
- ❖ Right to receive any notice of default or termination issued to franchisee and the right, not the obligation, to cure within applicable grace periods under the Franchise Agreement (some franchisors may grant longer grace periods, subject to satisfying certain conditions).
- ❖ Right to transfer Preferred Investors interest in the Company without charge (other than a nominal application fee), subject to satisfying certain conditions

❑ Can't Count On:

- ❖ Right to avoid liability for liquidated damages under Franchise Agreement if terminated by franchisee after the Preferred Investor takes control or by franchisor for franchisee default.
- ❖ Parties to transaction agree to treat Preferred Equity as equity (not debt) for tax purposes.

Thank You

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Annex A

Typical “Major Decisions”

- ❖ Incurring debt
- ❖ Granting/permitting any mortgage or other lien against Company property
- ❖ Incurring any expense not included in the approved budget
- ❖ Any sale or other disposition of any property (outside ordinary course)
- ❖ Entering/modifying/terminating any Material Contract (to be defined)
- ❖ Causing/permitting the Company to issue any additional equity interests
- ❖ Making any loans
- ❖ Initiating or settling litigation
- ❖ Settling any insurance or condemnation claim
- ❖ Making or changing tax elections
- ❖ Filing for bankruptcy
- ❖ Hiring/firing accountants, investment bankers, asset managers, counsel, architect, engineer or other professional advisors
- ❖ Hiring/firing a property manager
- ❖ Entering/modifying any agreement or arrangement with an affiliate
- ❖ Merging the Company with or into any other entity
- ❖ Creating/acquiring any additional subsidiary
- ❖ Taking any action that would be a default under the Company’s mortgage loan

Annex A (cont'd)

- ❖ Making any distribution “in kind” or any distribution other than in accordance with the distribution provisions of the Company’s organizational documents
- ❖ Dissolving or winding up the Company
- ❖ Seeking to modify or obtain a waiver in respect of the terms of any Company debt
- ❖ Entering or modifying/terminating any lease of Company property (unless in accordance with pre-approved guidelines)
- ❖ Acquiring or leasing any property from a third party
- ❖ Establishing or modifying the Company’s reserves
- ❖ Seeking to change the zoning or permitted uses of any Company property
- ❖ Selecting or modifying Company insurance
- ❖ Changing the purpose or nature of the business of the Company
- ❖ Accepting any contribution “in kind”
Causing the Company to have
- ❖ employees or become an employer
Committing the Company to do any of the foregoing