Hunting For the Perfect Subordinate Debt Tool? Mezzanine Financing and Preferred Equity Financing: Suitable Ammunition

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This article evaluates the overall enforcement likelihood and the treatment of preferred equity and mezzanine loans as subordinate financing tools by examining the ease or difficulty of enforcement, the relative cleanliness of enforcement, and the customary timeline of enforcement.

In the midst of the current economic uptick, many lenders and institutional investors are again becoming comfortable with subordinate debt financing tools and asking themselves which tool presents the best avenue to secure their investment. Two popular options are mezzanine loans and preferred equity interest. At their most basic level, mezzanine loans are indirectly secured by the investment property through equity interests in the mortgage borrower.[1] Preferred equity is a direct ownership interest in the mortgage borrower with a preferential return that is senior to the common equity interest in the mortgage borrower. This article evaluates the overall enforcement likelihood and the treatment of preferred equity and mezzanine loans as subordinate financing tools by examining the ease or difficulty of enforcement, the relative cleanliness of enforcement, and the customary timeline of enforcement.

Brief History of Preferred Equity and Mezzanine Loans

Preferred equity is a subordinate debt financing tool in which the preferred equity holder, in exchange for an infusion of capital, receives an ownership interest in the mortgage borrower. The terms and provisions of the preferred interest structure are laid out in the organizational documents of the mortgage borrower. Further, a preferred equity holder has a right to a preferred distribution. If the borrower fails to make the preferred distributions, the preferred equity holder's remedy would be to exercise specific control rights against the common equity holders of the mortgage borrower. Following such seizure of control, the preferred equity holder could force a sale of the underlying property.

Mezzanine financing involves a loan to the mortgage borrower's parent company secured by 100% of the equity interests in the

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mortgage borrower. Unlike conventional mortgage loan financing, mezzanine loan financing does not involve a lien on the underlying property. Rather, the value is generated from the intrinsic value of the underlying property in excess of the amount of the mortgage loan.

Despite the fact that a mezzanine loan and a mortgage loan are distinct from one another, each lender's rights, remedies and, more importantly, actions, affect the other. Consequently, their relationship must be properly articulated and governed. Enter the intercreditor agreement. Intercreditor agreements typically provide that the mezzanine loan is subordinate to the mortgage loan. Buyer beware, however, as negotiation of an intercreditor agreement between the mezzanine lender and the mortgage lender can be one of the most time consuming aspects of documenting a mezzanine loan.

Ease of Enforcement

Due in large part to the popularity of mezzanine financing, over the past several years the subordinate debt financing market has created a set of form mezzanine loan documents.[2] Additionally, the Uniform Commercial Code ("UCC") provides specific and efficient non-judicial procedures to enforce security interest. Conversely, the preferred equity market has not yet delivered form documents or, outside of the Delaware courts, a specific judicial avenue for enforcement. In fact, displaying a healthy level of heterogeneity, preferred equity structures are increasingly dissimilar and distinct from one another.

Preferred Equity

Despite the erraticism of the organizational documents creating preferred equity financing structures, an argument exists that the enforcement process for preferred equity financing is easier and more direct than its counterpart. Upon the mortgage borrower's failure to meet its obligations under the organizational documents, the preferred equity holder may assume management control of the mortgage borrower. Once the preferred equity holder assumes control, it is often entitled to receive all free cash flow and capital event proceeds, to the exclusion of the other equity owners, until all of its accrued preferred return has been paid and the full amount of its equity investment has been returned.[3] Additionally, following the seizure of control, the preferred equity holder can force a sale of the underlying property.

Mezzanine Debt

In contrast, the enforcement process in mezzanine financing structures is more convoluted. When the parent company of the mortgage borrower defaults on its mezzanine debt, the mezzanine lender may foreclose on the security interest it maintains on the ownership interests. In the event of a UCC foreclosure of the mezzanine loan, and provided that the oft unnavigable waters of bankruptcy protections are properly navigated, the mezzanine lender becomes the owner of the mortgage borrower and, ultimately, the indirect owner of the mortgaged property. Following the foreclosure, the mezzanine lender must auction off the ownership interest at a commercially reasonable sale. If the mezzanine lender is unable to find a suitable buyer for the pledged interests (which often occurs), it is forced to buy the interests itself.[4] As a result, the mezzanine lender effectively steps into the shoes of the property owner.[5]

Each of the above remedies results with

either the preferred equity member or the mezzanine lender controlling the property owner, as applicable. However, the mezzanine lender extinguishes the mezzanine borrower's rights and interest in the asset as it takes ownership of 100% ownership interests of the property owner.[6] On the other hand, the preferred equity member generally does not extinguish the economic rights of the other ownership interests; it just garners control of the property owner.[7]

Cleanliness of Enforcement

Preferred Equity

Despite the fact that the preferred equity holder is not burdened by the same procedural and substantive limitations on its remedies as a mezzanine lender, such holder may owe fiduciary duties to the other equity owners.[8] The operative word here is: "may."[9] The last dozen years have seen a decided trend away from imposing corporate constraints on limited liability companies and their members.[10]

Mezzanine Debt

Absent some extraordinary circumstance, a lender has no fiduciary duty to borrowers. However, the road to enforcement can be riddled with obstacles. A mezzanine lender forced to foreclose on the equity interest should consider several factors. Among the most important are the potential foreclosure restrictions and requirements contained in the intercreditor agreement.[11] Additionally, the mezzanine lender should consider the effects of bankruptcy protections on its actions. If comfortable with the foregoing, the mezzanine lender must then determine how it will foreclose. The mezzanine lender's interests in the property owner will likely be classified as investment property under Article 8 of the UCC or as a general intangible under Article 9 of the UCC.[12] In either case, Article 9 remedies of foreclosure by sale and strict foreclosure will apply.[13]

Customary Timeline of Enforcement

Generally, the process required to execute a change of control by a preferred equity holder can take up to 180 days. However, once the preferred equity holder has control, the process to force a sale of the underlying property can take much longer. For example, the marketing process itself can require several months.[14] Compare this with the mezzanine lender's recourse in terms of timing: the mezzanine lender, governed by the applicable state law version of the UCC, must undergo a process for the public sale of the collateral.[15] Such a sale takes time and money to orchestrate.[16] Generally, depending on the jurisdiction, a UCC foreclosure can take between 30-120 days to complete after the exhaustion of applicable cure rights.

Conclusion

The decision between subordinate debt tools can be difficult. Lenders and institutional investors with clout in the market may be better served with preferred equity. Though the lack of formality with regards to the organization structure and the relative unfamiliarity with such financing from both mortgage lenders and Securitization Parties may present a daunting barrier, seasoned lenders and institutional investors are better suited to persuade the market to accept such novel financing. On the other hand, the overwhelming acceptance and the steadfast structure of the mezzanine loan market will likely present a better route for a smaller lender.

NOTES:

[1]The most common entities used are limited li-

ability companies and limited partnerships.

[2]*Stanford Journal of Law, Business & Finance*—What's In A Name: Mezzanine Debt Versus Preferred Equity. 18 Stan. J.L. Bus. & Fin. 40. (Fall 2012) at 45.

[3]*Michigan Journal of Private Equity & Venture Capital Law*—Mezzanine Finance and Preferred Equity Investment in Commercial Real Estate: Security, Collateral & Control, 1 Mich. J. Private Equity & Venture Cap. L. 93 (Spring 2012) at 108.

[4]*Id.* at 107.

[5]*Id.* at 107–108.

[6]*Id.* at 108.

[7]*Id.* at 108.

[8]The Delaware LLC Act provides that the company "may" provide penalties for breaching loyalty to the members in the entity's limited liability company agreement.

[9]*Stanford Journal of Law, Business & Finance*—What's In A Name: Mezzanine Debt Versus Preferred Equity, 18 Stan. J.L. Bus. & Fin. 40. (Fall 2012) at 56.

[10]*Stanford Journal of Law, Business & Finance*—What's In A Name: Mezzanine Debt Versus Preferred Equity, 18 Stan. J.L. Bus. & Fin. 40. (Fall 2012) at 56 referencing *Auriga Capital Corp. v. Gatz Properties*, 40 A.3d 839 (Del. Ch. 2012), judgment entered, 2012 WL 598121 (Del. Ch. 2012), judgment aff'd, 59 A.3d 1206 (Del. 2012).

[11]Business Workouts Manual § 36:2 (November 2013).

[12]*Id.*

[13]*Id.*

[14]*Stanford Journal of Law, Business & Finance*—What's In A Name: Mezzanine Debt Versus Preferred Equity, 18 Stan. J.L. Bus. & Fin. 40. (Fall 2012) at 51.

[15]*Michigan Journal of Private Equity & Venture Capital Law*—Mezzanine Finance and Preferred Equity Investment in Commercial Real Estate: Security, Collateral & Control, 1 Mich. J. Private Equity & Venture Cap. L. 93 (Spring 2012) at 108. (*See also Stanford Journal of Law, Business & Finance*—What's In A Name: Mezzanine Debt Versus Preferred Equity, 18 Stan. J.L. Bus. & Fin. 40. (Fall 2012) at 52).

[16]*Id.* at 108.