Do I Recognize You (Preferred Equity)?

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Preferred equity − what is it? The question confounds many who encounter this unique and flexible financing alternative because it generally exhibits features of both debt and equity. The range of structures and terms for a preferred equity investment, which can often prove chameleon-like and result in inconsistent treatment and expectations by the preferred equity holder and others in the capital stack, makes it tricky to deal with if you are a lender considering making a mortgage or mezzanine loan to a borrower with a preferred equity investor. Whether you provide special recognition rights to the preferred equity holder may, in fact, come down to whether you consider preferred equity to be − or, just as importantly, must require it to be treated as − debt or equity, among a host of other considerations.

But, Really, What Is It?

Preferred equity is often described as either being more “debt-like” or “equity-like,” depending on whether its most prominent characteristics are more similar to debt or equity structures. At one extreme, a preferred equity investment can look almost like a mezzanine loan, in which the return on the preferred equity investment accrues at a fixed or floating rate, pays a guaranteed monthly coupon, includes a debt service reserve or deferred and accrued (or PIK) interest feature, is secured by a pledge of equity interests by other investors, and is characterized as debt for tax purposes. At the other extreme, though, preferred equity can be almost indistinguishable from any other investment in a joint venture, except that the preferred equity investor is entitled to distributions ahead of other investors in the waterfall and may remove and replace the manager, general partner or other control party of the joint venture for specified defaults or other causes. These extremes produce a range of variety in between, with very few market expectations for what preferred equity investments must look like.

At a basic level, however, a preferred equity investment occupies the space in the capital stack below mortgage and mezzanine debt, but above common equity. The investment is made through a joint venture structure (often a limited liability company or limited partnership that is a bankruptcy remote, special purpose entity) and the terms of the preferred equity investment are included in the joint venture’s organizational documents, as well as certain ancillary agreements. The return on the preferred equity investment (or at least some portion of it), as well as the repayment of the investment itself, will be paid ahead of distributions to others in the waterfall, and is due regardless of whether cash flow is sufficient to pay it in full. If the entire preferred equity investment is not repaid by a specified redemption date, or there are other defaults that remain uncured beyond notice and cure periods by the other investors, then the preferred equity investor will frequently be entitled to remove and replace the control party and receive distributions and exercise other remedies in order to “make itself whole.”

Special Recognition Rights

To ensure that the preferred equity investor’s exercise of remedies will not result in a default or other adverse consequences under any mortgage or mezzanine loan and without the need to seek consent from any senior lender, the preferred equity investor may seek special recognition rights from the holders of mortgage and mezzanine debt ahead of it in the capital stack. These special recognition rights may include the right to receive notice of defaults under the mortgage and mezzanine debt and an additional time period in which to cure defaults (beyond the notice and cure periods to which the borrower is entitled under its loan documents); the right to remove and replace the control party within the joint venture; the right to sell or assign the preferred equity investment to a third party, in each case, without

lender's consent or the payment of any transfer or assumption fee or triggering of an event of default under the mortgage or mezzanine loan documents; the right to remove and replace the property manager without lender's consent; and/or the right to cause a sale of the property.

Lenders' responses to requests for special recognition rights by preferred equity investors, as well as the form and substance of these special recognition rights, if granted, are often as varied as the preferred equity structures and terms themselves. At one extreme, with a more "debt-like" preferred equity structure, it would not be unusual for the preferred equity investor and mortgage and mezzanine lenders to negotiate and enter into a recognition agreement that is substantially similar to an intercreditor agreement between mortgage and mezzanine lenders and which contains provisions governing a UCC foreclosure of any pledge securing the preferred equity investment, additional cure rights, the requirement for replacement of guaranties by the preferred equity investor upon a change in control, and provisions governing the sale or transfer of the preferred equity investment to third parties. These recognition agreements also establish privity of contract between the preferred equity investor and other lenders, allowing the preferred equity investor to enforce its rights under the recognition agreement directly against the other lenders (and not indirectly through the borrower's rights under the loan documents) in the event of a breach.

At the other extreme, especially with more "equity-like" preferred equity or where the parties have disparate negotiating leverage, senior lenders may refuse to deal with the preferred equity investor directly or at all, or opt to grant it any special recognition rights (or in certain circumstances, may even require that the preferred equity investment be expressly subordinated to the senior debt and the preferred equity investor agree to stand still). These lenders would argue that preferred equity *is* equity and should be treated as such and might agree to give the preferred equity investor courtesy copies of notices sent to the borrower, but no additional period in which to gain control of the borrower in order to cure defaults, and treat a change in control of the borrower as a permitted transfer only if allowed under the borrower's loan documents.

Additional Considerations

Senior lenders may have other considerations in mind when deciding whether to extend special recognition rights to a preferred equity investor, or approving the preferred equity investment in the borrower in the first place.

For example, in a construction loan context, if the preferred equity is too "debt-like," it may be a negative factor in the construction lender's HVCRE (high-volatility commercial real estate) analysis, causing its construction loan to be categorized as an HVCRE loan. In such cases, to limit the construction lender's HVCRE exposure, the construction lender may require that the preferred equity investment be restructured to have fewer "debt-like" features, if it permits the preferred equity investment at all.

Alternatively, if the preferred equity investment is being made by a strong institutional investor with experience comparable to the current sponsor in managing and operating commercial real estate, a senior lender may view the preferred equity investment as a net positive and even as additional credit support, especially if the senior lender is able to negotiate for replacement guaranties from a guarantor with reliable net worth and liquidity upon a change in control of the borrower.

Conclusion

Because there are no hard-and-fast rules about preferred equity, there also are no hard-and-fast rules about whether it must be accepted by senior lenders and, if so, how senior lenders must treat preferred equity investors. The range of how preferred equity investments are structured and their terms means that there will also be a range of how senior lenders respond to proposed preferred equity investments in their borrowers.