Key Issues for Preferred Equity Investors in Real Estate Transactions

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Preferred equity is an alternate form of financing that is provided either instead of, or subordinate to, mezzanine financing in commercial real estate transactions. It is an equity investment in a joint venture, which is, typically, a direct or indirect owner of a property owning entity. Although preferred equity investments have attributes similar to mezzanine loans, they are not loans, and are (generally but not always) unsecured. Preferred equity investments are frequently structured as either "hard" preferred equity, if they are more debt-like, or "soft" preferred equity, if they are more equity-like. Many preferred equity investments fall somewhere in between.

The main characteristics of preferred equity investments include the following:

1. The preferred equity investor and the developer are joint venture partners. Their relationship is documented in a limited liability company agreement or limited partnership agreement. The agreement is often lengthy and complex, and in "hard" preferred equity deals, can resemble a loan agreement.
2. The developer is the managing member or general partner, as applicable.
3. The developer manages the daily activities of the company or partnership, often subject to the preferred equity investor's approval of certain agreed upon major decisions.
4. The preferred equity investor is repaid by priority distributions, which can be structured to either accrue or to have scheduled distributions, irrespective of cash flow.
5. The preferred equity investor's remedies for the developer's default typically include the contractual right to remove the developer from control of the joint venture, become the managing member or general partner, as applicable, and to make all property related decisions going forward. In the context of "hard" preferred equity, some preferred equity investors will negotiate for a pledge of the developer's equity in the joint venture, and upon the occurrence of a default by the developer, exercise its rights under the pledge and foreclose the developer out of the ownership structure.
6. The developer (or other partners, members or credit-worthy persons) may, depending on the parties' understandings, be asked to indemnify the preferred equity investor with a "bad boy" guaranty, completion guaranty and/or environmental indemnity, similar to a mezzanine loan.
7. The preferred equity investment will usually have a mandatory redemption date on which the equity investment must be redeemed in full, which will generally be co-terminus with the mortgage loan maturity date.

If the property is encumbered by senior mortgage debt, the preferred equity investor must ensure that its investment and remedies do not run afoul of the terms and conditions of the loan documents, including, by way of example, the anti-transfer provisions of a typical mortgage loan agreement. Accordingly, it is important that the preferred equity investor create privity with the senior lender through a recognition agreement (or otherwise have the rights drafted into and recognized in the mortgage loan documents). While there is no "standard" form of recognition agreement, recognition agreements are increasingly becoming quite similar to senior loan–mezzanine loan intercreditor agreements, as preferred equity investments are increasingly becoming more debt-like.

The following are some of the key rights that the preferred equity investor typically wants the mortgage lender to acknowledge in connection with the preferred equity investor's exercise of rights:

1. The preferred equity investor's right to remove the developer and take over the control and decision-making authority for the company or partnership, its subsidiaries and assets.
2. The preferred equity investor's right to force a sale of the underlying property (and/or all ownership interests in it) at a price and upon such terms and conditions as it may determine.
3. If there is a pledge, the preferred equity investor's right to realize upon the developer's interests and rights in the joint venture entity pursuant to a Uniform Commercial Code foreclosure action.
4. The preferred equity investor's right to receive notices of default from the mortgage lender and have an independent opportunity to cure defaults under the senior loan.
5. The preferred equity investor's right to cause the property owning entity to terminate the management agreement and any affiliate agreements, and to replace the property manager and other providers with third parties acceptable to the preferred equity investor.

Given that the preferred equity investor is seeking these specific recognition rights, mortgage lenders will separately underwrite the preferred equity investor and often require the preferred equity investor to meet certain standards as to financial strength and experience in real estate investment and management.

We hope you find this general summary of preferred equity investing in real estate transactions helpful. It is not intended to be exhaustive or include all aspects of a preferred equity investment. For example, recharacterization risks and tax considerations arising from preferred equity investments are beyond the scope of this alert and should also be analyzed before committing capital to a preferred equity opportunity.

If you have questions regarding preferred equity investor rights or recognition agreements, please contact Tim Davis (davist@whiteandwilliams.com; 215.864.6829), Steven Coury (courys@whiteandwilliams.com; 212.631.4412), or Rachel Schneidman (schneidmanr@whiteandwilliams.com; 212.631.1254).

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