Sills Cummis & Gross P.C.

As Seen In **Law360** October 7, 2020

Alternative Financing Options For Retail And Hotel Properties

Over the last few months, the commercial real estate finance market has slowed down considerably given the underwriting risks and uncertainty inflicted by the COVID-19 pandemic. This is especially true for mortgage loans to be secured by retail shopping centers and hotels.

Shuttered storefronts and travel restrictions have reduced cash flows to such an extent that these properties cannot be underwritten by traditional capital markets lenders who are required to adhere to certain financial benchmark requirements. Further, mortgage lenders that may be closing transactions, could be unwilling to lend as much as the borrower may want or need to complete its business plan.

As a means of addressing this issue, borrowers may begin to look more to mezzanine loans and preferred equity investments as an alternative way of financing the gap between the amount a mortgage lender is committing to lend and the amount needed by the borrower. Like the mortgage lending industry, the mezzanine loan market has seen its share of recent workouts.

Recently, it was announced that a $60 million mezzanine loan secured by equity interests in the PUBLIC hotel in New York City's Lower East Side would be marketed by its lender, Shinhan Investment Corp. A few weeks prior, a junior mezzanine lender, The Bluestone Group, filed a Uniform Commercial Code foreclosure on a development site in Williamsburg, Brooklyn, seeking to dispose of its interest and recoup its loan.

While these actions are not particularly promising for the real estate market as a whole, it certainly does bring to light that borrowers will need to explore alternatives in financing their assets.

Mezzanine debt and preferred equity investments each evolved out of necessity, as capital markets mortgage lenders did not favor second mortgage liens on the property (i.e. the mortgage lender's collateral), or additional indebtedness of the mortgage borrower, as opposed to debt of its holding company in the case of a mezzanine loan.

Mark Levenson

Jeffrey Gaskill

Mark Levenson *is member and co-chair of the real estate department at Sills Cummis & Gross P.C.* **Jeffrey Gaskill** *is an associate at the firm.*

The opinions expressed are those of the author(s) and do not necessarily reflect the views of the firm, its clients, or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.

Unlike second mortgage loans, a mezzanine loan would not be secured by the property, but rather by a perfected pledge of the holding company's equity interest in the mortgage borrower, and a preferred equity investment would be unsecured with the preferred investor maintaining limited takeover and, potentially, forced-sale rights.

Typically, mezzanine debt would sit second in the capital stack, subordinate to the mortgage loan, and a preferred equity investment or investments, would be subordinate to both the mortgage debt and the mezzanine debt. It is for this reason that mezzanine debt and preferred equity are each significantly more expensive than mortgage debt, with mezzanine debt being less expensive than preferred equity given its position in the capital stack.

This article will explore some of the customary features and mortgage lender requirements of both mezzanine debt and preferred equity as they may become more versatile financing vehicles for the foreseeable future.

Mezzanine Debt Financing

As stated, mezzanine debt sits second in the capital stack behind a mortgage loan. Capital markets lenders generally require that the mezzanine borrower be the sole member/equity interest holder in the fee owner. This affords the mezzanine lender the ability, during the continuance of an event of default, to foreclose on the interest and takeover ownership and control of the fee owner without negotiating with other equity holders.

It should be noted that certain capital markets lenders may be less inclined to permit mezzanine debt if it would have an impact on their ability to securitize, or otherwise sell, the loan, in which case preferred equity may be a more viable option.

Similar to the mortgage loan, the mezzanine loan would be evidenced by a set of loan documents, but instead of a mortgage filed in the county of the property's location, a pledge of the mezzanine borrower's interest in the mortgage borrower would be executed and evidenced by a Uniform Commercial Code financing statement.

It is in the sponsor's — the entity or individual contributing common equity and controlling the mezzanine borrower and mortgage borrower and often serving as a nonrecourse guarantor — best interest to ensure that the mortgage loan documents and mezzanine loan documents are as identical as possible so as to avoid breaches in any covenants such as financial reporting requirements, lease approvals and prohibited equity transfers.

Assuming the mortgage loan and mezzanine loan are each nonrecourse loans, the nonrecourse carveouts or exceptions should also be generally identical for the same reason.

The mortgage loan and mezzanine loan are also usually coterminous which limits the exit risk to both the mortgage lender and mezzanine lender at maturity (i.e., the sponsor will find it more difficult to obtain a refinancing of the mortgage loan if the mezzanine loan extends beyond the term of the mortgage loan).

The existence of either mezzanine debt or preferred equity presents an inherent risk to the mortgage lender in that the sponsor which the lender has underwritten for the loan may lose control of the mortgage borrower. In a mezzanine loan, this concern is addressed in an intercreditor agreement between the mortgage lender and mezzanine lender.

The intercreditor agreement will provide that the mezzanine loan is subordinate to the mortgage loan, but that payments under the mezzanine loan documents may be made by the mezzanine borrower provided no event of default is continuing under the mortgage loan documents.

By way of illustration, if the mortgage loan is subject to a cash management structure whereby all cash flows are deposited into a deposit account and then swept into a cash management account, allocations would be made in accordance with a negotiated waterfall whereby payments would be made first to the payment of property taxes, insurance, debt service on the mortgage loan, deposits to any other reserve accounts required under the mortgage loan documents, and only then to the payment of any debt service or reserve deposits then due under the mezzanine loan documents.

To the extent there is any excess cash flow following all such payments, such funds would either be released to the borrower or held by the mortgage lender as additional collateral for the mortgage loan.

The intercreditor agreement also governs the mezzanine lender's right to cure defaults of the mortgage borrower under the mortgage loan documents and to exercise its right to foreclose on the equity interests held by the mezzanine borrower.

As is also the case with preferred equity, the mortgage lender will need to either underwrite the mezzanine lender or preferred investor prior to closing, or prior to permitting a foreclosure of the pledged interests or a takeover of control.

One such requirement is that the mezzanine lender will need to appoint a guarantor to replace the existing guarantor (normally the sponsor) and the mortgage lender will need to confirm that such guarantor has the financial wherewithal and experience to meet its underwriting requirements.

Depending on the size of the loan, the mortgage lender may also require a nonconsolidation opinion letter and rating agency confirmation that the transfer of interest will not adversely affect the credit rating of the securitized loan.

Preferred Equity

An alternative debt financing arrangement to mezzanine debt is a preferred equity investment. While similar to mezzanine debt, preferred equity provides the sponsor greater flexibility in structuring the transaction, albeit at a higher interest rate. The preferred equity transaction is documented in the mortgage borrower's or holding company's operating agreement or partnership agreement between the sponsor (as a common equity holder) and the preferred investor.

Like a mezzanine loan agreement, this agreement will govern the rights and remedies of the preferred investor including consent rights over major decisions, events of default, required monthly payments and the redemption date, the equity equivalent to a maturity date. Depending on the structure of the preferred equity transaction, a guaranty of nonrecourse exceptions and environmental indemnity may also be required of the sponsor by the preferred investor.

Similar to a mezzanine loan, preferred equity investors are typically paid priority distributions of the excess cash flow of the mortgage borrower, after all payments due under the mortgage loan. This means that monthly or quarterly distributions of cash flow to the preferred equity investor are paid first in the cash distribution waterfall in the operating agreement over common equity investors. It is worth noting that the timing of payments and interest is also subject to negotiation and may require approval of the mortgage lender.

Preferred equity investments are categorized as either soft or hard structures. A soft preferred equity structure is most akin to an investment of common equity with limited decision-making power and even more limited takeover

rights. In contrast, hard preferred equity is more similar to mezzanine debt and is more likely to provide the preferred investor the right to take over management control or even sell the property.

Given the rights held by a preferred investor in a hard structure, the preferred investor may require a recognition agreement with the mortgage lender in order to efficiently exercise these rights with as little delay as possible. This agreement functionally operates the same as an increditor agreement for a mezzanine loan, in that it provides the preferred investor notice and cure rights during the continuance of a default and sets forth procedure for a changeover event, including appointing a replacement guarantor.

The remedies for default in a preferred equity structure differ from the remedies available to a mezzanine lender. While the default remedies for a mezzanine loan are governed by the Uniform Commercial Code and provide for a foreclosure on the interest, preferred equity investors are entitled to contractual remedies which may be negotiated between the parties in the operating agreement.

Generally, these remedies will include the right to replace the sponsor as manager of the entity, referred to as a changeover event, and assume control under the operating agreement.

Changeover events are subject to a great deal of negotiation, often occurring prior to the preferred investor's issuance of a commitment or term-sheet and may include a material breach of the operating agreement, acts of fraud or misappropriation and failure to make an installment payment of the return to the preferred investor.

The preferred investor may also be able to dilute the shares of the sponsor and, in a more debt-like structure, force a sale of the underlying property to recuperate its investment.

Mezzanine loans and preferred equity investments may very well come more into favor until the economic conditions of the nation begin to stabilize and mortgage lenders are more willing to lend. Each have advantages and disadvantages that will ultimately be reflected in the interest rate that the loan or investment may bear. Sponsors will need to be open to these types of alternative financing arrangements while the current market uncertainty persists.