Are Mezzanine Loans Really the Lesser of Two Evils?

Marianne Ajemian is a partner in the Real Estate and Finance Department and was a member of Nutter McClennen & Fish LLP's Management Committee for nine years. Her practice is focused on the representation of clients locally and nationally in complex transactional matters. She represents financing institutions, real estate investment funds, developers, real estate investors and advisors, pension fund advisors and their institutional investors, REITs, healthcare and senior housing companies, and nonprofit institutions. She has significant expertise in sophisticated investment and financing transactions of all types, including joint venture, preferred equity and partnership transactions, construction, permanent, revolving credit, mezzanine loans, letter of credit facilities, sale/leaseback transactions, intercreditor arrangements, loan acquisition and dispositions, and workouts and debt restructurings. In addition, she advises clients on all aspects of commercial real estate acquisitions, development, dispositions, and leasing involving a broad range of projects, including mixed-use and transit-oriented developments, downtown and suburban office buildings, research and development properties, retail and industrial properties, multi-family housing projects, hotels, restaurants, and institutional uses. Marianne has particular experience in representing owners, operators, investors, management companies, and lenders in the healthcare and senior housing industries. She also has extensive experience in the negotiation, supervision and management of complex portfolio transactions, and has served as the lead transactional counsel for various publicly held entities.

This article is based on a paper the author prepared for the Spring 2015 ACREL Papers.

Marianne Ajemian

IN LIGHT OF the rapid growth of mezzanine loans and preferred equity transactions into significant components of the commercial real estate finance market during the past two decades, numerous articles have been written about these financing alternatives.[1] Most of the articles analyzing mezzanine loans and preferred equity transactions (and their respective structures, rights, remedies, risks and returns) have done so primarily, and not surprisingly, from the perspectives of the potential subordinate capital provider and the project's sponsor. Recent experience has shown that mezzanine loans are more widely utilized than preferred equity transactions as a form of subordinate financing. Yet, from the senior lender's perspective, is a mezzanine loan the more desirable transaction structure for subordinate capital?[2] After reviewing the basic features of mezzanine loans and preferred equity transactions, this article will exam-

[1] Examples of such articles include Andrew R. Berman, *Once A Mortgage, Always A Mortgage the Use (and Misuse of) Mezzanine Loans and Preferred Equity Investments,* 11 Stan. J.L. Bus. & Fin. 76 (2005); Andrew R. Berman, Risks and Realities of Mezzanine Loans, 72 Mo. L. Rev. 993 (2007); Jon S. Robins, David E. Wallace, Mark Franke, *Mezzanine Finance and Preferred Equity Investment in Commercial Real Estate: Security, Collateral & Control,* 1 Mich. J. Private Equity & Venture Cap. L. 93 (2012); J. Dean Heller, *What's in A Name: Mezzanine Debt Versus Preferred Equity,* 18 Stan. J.L. Bus. & Fin. 40 (2012).

[2] Understandably, senior lenders would actually prefer to reduce transaction risk even further by eliminating subordinated financing all together, if that were possible.

ine what do (or should) senior lenders think about preferred equity transactions.[3]

STRUCTURE OF MEZZANINE LOANS • Mezzanine loans and preferred equity transactions involve capital provided to finance a real estate project that is subject and subordinate to a senior mortgage loan. A mezzanine loan is typically made to a single purpose entity (the "Mezzanine Borrower" or "Parent Entity") that is the holder of all of the ownership interests (collectively, the "Ownership Interests") in another single purpose entity (the "Property Owner") that, in turn, owns the applicable real estate project (the "Property" or the "Project"). As security for the senior loan, a mortgage encumbering the Property is granted to the senior lender (the "Senior Lender").[4] The Ownership Interests in the Property Owner are pledged by the Mezzanine Borrower to the mezzanine lender (the "Mezzanine Lender") to secure the mezzanine loan. Consequently, the mezzanine loan is structurally subordinate to the senior mortgage loan. The Mezzanine Borrower's only source of funds to repay the mezzanine loan will be cash distributions from the Property Owner. Likewise, the value of the equity collateral for the mezzanine loan will be totally dependent upon the underlying value of the Project. Setting aside recourse, under applicable circumstances, to a creditworthy affiliate pursuant to a recourse carve-out guaranty and/or an environmental indemnification, the Mezzanine Lender's main remedy for a breach under the mezzanine loan will be to conduct a commercially reasonable private or public non-judicial foreclosure of the Ownership Interests in the Property Owner that were pledged as collateral for the mezzanine loan. Such a foreclosure sale would be conducted under the Uniform Commercial Code, as enacted in the applicable jurisdiction (the "UCC"). [5]

---

[3] This article is intended to be a companion to the analysis set forth in the paper entitled *Mezzanine Loans: The Lesser of Two Evils?* by William G. Rothschild, Esq. of Sutherland Asbill & Brennan LLP, appearing in the Spring 2015 ACREL Papers.

[4] As used in this paper, the term "Senior Lender" will refer to the holder of a non-securitized senior loan secured by a mortgage or deed of trust. While admittedly this will leave out the commercial mortgaged back securities ("CMBS") market, a major sector in commercial real estate finance, an analysis of the concerns and requirements of CMBS transactions is beyond the scope of this paper. Likewise, an analysis of the competing motivations of administrative agents and lenders in syndicated senior loan transactions (and the conflicts of interest that may arise among those parties) is also beyond the scope of this article.

[5] A public sale under the UCC is designed to create a meaningful opportunity for competitive public bidding for the Ownership Interests. The UCC requires that the sale must be conducted in commercially reasonable manner; however, other than certain technical requirements that must be complied with, the UCC does not contain many specific requirements prescribing what would constitute a commercially reasonable sale pertaining to this type of collateral. Under §9-627(b) of the UCC, "a disposition of collateral is commercially reasonable if it is made: in the usual manner on any recognized market; at the price current in any recognized market at the time of disposition; or otherwise in conformity with reasonable commercial practices among dealers in the type of property that was the subject of the disposition." In the context of a foreclosure of the Ownership Interests, those UCC provisions provide little practical guidance. Presumably, all aspects of the marketing of the sale, as well as the conduct of the sale itself (including, the method, manner, timing, place and other terms) could impact the determination as to whether a sale is commercially reasonable. Considerations that would be taken into account in determining whether a sale of the Ownership Interests was commercially reasonable include: Was a marketing agent used? Where, when and how often were advertisements of the sale published and/or distributed through electronic mail? Was the sale marketed on-line and/or through social media? What information relating to the Property, the Project Owner and the Mezzanine Borrower was made available for review (i.e., operating agreements, underlying senior loan documents, market studies, financial statements, leases, rent rolls, vendor contracts, title, survey, environmental reports, property condition reports, etc.)? Was the Property available for inspection? Was an auctioneer used? The requirement to conduct the sale in a commercially reasonable manner also applies to private sales; however, under §9-610(c)(2) of the UCC, a foreclosing Mezzanine Lender may not bid in and acquire the Ownership Interests at a private sale unless "the collateral is of a kind that is customarily sold on a recognized market or the subject of widely distributed standard priced quotations," which is a standard that the Ownership Interests would not likely satisfy. Strict foreclosure is also an available remedy under the UCC. Strict foreclosure

As a condition of the closing of the mezzanine loan, an intercreditor agreement between the Mezzanine Lender and the Senior Lender is normally executed. Each lender enters into the intercreditor agreement recognizing that the terms of the intercreditor agreement will become most important if, in the future, the Project fails to meet the financial projections that served as the basis for the underwriting of the financing of the Project (whether because of a general market downturn or factors more specific to the Project), resulting in defaults under either or both loans. The Senior Lender's primary motivation in negotiating the intercreditor agreement is to try to avoid any significant delays or interference with its exercise of remedies that could lead to a continued deterioration of the Property and make a bad situation even worse, while at the same time increasing the likelihood that the value of its collateral can be enhanced (and the Senior Lender's potential losses minimized or perhaps even eliminated) if the Mezzanine Lender is allowed rights to cure defaults under the senior loan and exercise remedies under the mezzanine loan documents; such events could ultimately result in a knowledgeable, reputable and creditworthy entity (i.e., either the Mezzanine Lender or other qualified transferee (the "Qualified Transferee"))[6] taking ownership and control of the Project in order to try to turn things around. The Mezzanine Lender's chief motivation in negotiating the intercreditor agreement is to obtain those rights so that it is able, if it so elects, to protect its interest in the Project and avoid being wiped out by a mortgage foreclosure if the senior loan goes into default. However, the Mezzanine Lender will exercise those rights and infuse even more capital into an already troubled situation only if, after taking into account the additional anticipated enforcement and other costs that the Mezzanine Lender likely will be required to expend (including, operating shortfalls, development costs, other capital costs, lease-up costs, etc.), the Mezzanine Lender believes that a worthwhile amount of equity remains in the Project or that there is a realistic opportunity for the Project to appreciate in value within a reasonable time (based upon a sensible turn-around strategy to be put into place by the Mezzanine Lender or other Qualified Transferee).

Pursuant to the intercreditor agreement, the Mezzanine Lender contractually subordinates the mezzanine loan to the senior loan and agrees that, notwithstanding anything to the contrary set forth in the mezzanine loan documents, the Mezzanine Lender will accept payments and/or exercise any of its rights and remedies only to the extent permitted under (and subject to the terms and conditions set forth in) the intercreditor agreement. In addition, the Mezzanine Lender agrees: (i) to re-

essentially mirrors a deed-in-lieu of foreclosure and constitutes an offer by the Mezzanine Lender to acquire the equity collateral in full or partial satisfaction of the mezzanine debt. If the Mezzanine Lender makes such an offer, the Mezzanine Borrower and the other parties required under the UCC to be notified of the offer would have 20 days to object to the offer. If no objection is made during that 20-day period, an offer of a full unconditional release will be deemed accepted. To the extent that the offer is made for a partial release or for a full release subject to any conditions, then, the Mezzanine Borrower would need to affirmatively assent to the strict foreclosure. Given that the Mezzanine Borrower will have has no assets other than the Ownership Interests and is not likely to have other creditors (assuming that it has complied with the single purpose entity and other covenants set forth in the mezzanine loan documents), offering a full release in order to obtain the deemed acceptance can make strict foreclosure a timely and efficient means of exercising remedies for the Mezzanine Lender.

[6] Typically, under the terms of the intercreditor agreement, a Qualified Transferee must (i) be an institution in the business of owning or investing in commercial real estate or making (and holding) commercial real estate loans, (ii) meet certain financial, experience and reputational criteria, (iii) not be engaged in any litigation or other significant dispute with the Senior Lender, (iv) meet OFAC and ERISA requirements and (v) be qualified to manage the Property or engage an experienced third party property manager. The Mezzanine Lender will want the intercreditor agreement to contain an acknowledgement that the Mezzanine Lender constitutes a Qualified Transferee.

strict its rights to transfer the mezzanine loan or the pledged Ownership Interests (upon the completion of a UCC foreclosure sale or pursuant to a strict foreclosure) to a Qualified Transferee; and (ii) that, upon the acquisition of the Ownership Interests in the Property Owner, the Qualified Transferee will provide the Senior Lender with a replacement guaranty from an acceptable replacement guarantor.[7] In return, the Senior Lender agrees to a limited standstill period and provides the Mezzanine Lender with (x) notices of default, the opportunity to cure senior loan defaults (on a limited number of occasions and for a limited period of time, so as to avoid the possibility of a continued downward slide of the Project without the Senior Lender being able to step in and take enforcement action, and excluding a right to cure a default caused by the Property Owner's failure to pay the senior loan at its maturity)[8] and (y) the right to purchase the senior loan.[9] Both the Mezzanine Lender and the Senior Lender agree to certain limitations on their respective rights to modify their loan documents without the consent of the other lender.

Structure of Preferred Equity Transactions

In contrast to the structure for mezzanine loans described above, the preferred equity investor (the "Preferred Member") will contribute its capital to the Parent Entity which will, directly or indirectly, own and control the Property Owner. In return for its capital contributions, the Preferred Member receives: (i) Ownership Interests in the Parent Entity; (ii) the right to receive a preferred rate of return and preferred distributions out of cash flow, refinancings and other capital events; and (iii) the right to receive an early return of its capital (by virtue of a required redemption of its Ownership Interests in the Parent Entity, either at a date certain or upon the occurrence of certain trigger events) and a share of the distributable proceeds from a sale of the Property. This structure typically allows the Preferred Member to share in the appreciation in the value of the Project, rather than just receive a negotiated return on its investment and a repayment of its capital. If desired, the economic terms of the preferred equity transaction can be structured more similarly to a debt transaction, including, for example, requiring regularly scheduled periodic distributions, regardless of whether there is sufficient cash flow from the Property to make such payments, as well as the payment of late fees, a default rate of interest applicable to late payments, and an early redemption fee payable in the event that the Ownership Interests of the Preferred Member are redeemed prior to the expiration of a lock-out period.

The Preferred Member customarily is not granted a security interest in any collateral. Its rights and remedies are specific contractual rights set forth in the Parent Entity's governing documents (collec-

[7] Carve-out guaranties are designed to discourage certain bad acts and allocate bankruptcy risks on the party that controls the Property Owner. Therefore, it is crucial from the Senior Lender's perspective to obtain a replacement carve-out guaranty in connection with a UCC foreclosure relating to the Ownership Interests (even if the original guaranty stays in place and the original guarantor remains creditworthy), because after the transfer of the Ownership Interests, the original guarantor will no longer be in control of the Property Owner.

[8] Care needs to be taken in negotiating cure rights. Certain defaults are personal and may not be susceptible to cure. It may also be necessary for the Mezzanine Lender to gain possession of the Property in order to effectuate a cure of other defaults (which will potentially impact the timing of the cure). Also, courts have found that in certain circumstances the Mezzanine Lender must pay the senior loan in full prior to exercising its remedies. See, *Bank of America N.A. v. PSW NYC LLC*, 918 N.Y.S.2d 396 (2010) (known as the Stuyvesant Town case), where the court found that because the senior loan was accelerated, full payment of the senior loan was required under the applicable intercreditor agreement (which was based upon the CMBS approved form) in order for the mezzanine lender to foreclose on the equity pledge.

[9] Whether prepayment fees and default interest must be paid and the time period within which the Mezzanine Lender may be granted a right to purchase the senior loan varies depending upon the terms of the applicable intercreditor agreement.

tively, the "Governing Documents"), which are tailored to the specific terms of the transaction. The holder of the common equity in the Parent Entity (the "Sponsor")[10] will have day-to-day management and control of the Parent Entity. The Sponsor will have fairly detailed reporting obligations to the Preferred Member and the Preferred Member will have approval rights over certain "Major Decisions" for the Parent Entity (and, its subsidiary, the Property Owner), such as: (i) business plans and budgets; (ii) the direct or indirect transfer of ownership or control of the interests in the Parent Entity held by the Sponsor, subject to certain permitted transfers; (iii) incurring indebtedness, except in accordance with an approved business plan or as specifically set forth in the Governing Documents, as well as modifying the terms of any approved indebtedness; (iv) incurring other obligations, except in accordance with an approved budget or the Governing Documents; (v) filing a voluntary bankruptcy petition; (vi) effectuating a merger, consolidation, re-organization, liquidation or dissolution; (vii) amending the Governing Documents; (viii) transferring the Property or any interest therein; (ix) entering into, and exercising rights and remedies with respect to, transactions with affiliates of the Sponsor (or amending the documents relating thereto); and (x) entering into other significant transactions, such as major leases, hotel franchise agreements, property management agreements, etc. (or amending the documents relating thereto).

Upon the occurrence of any "Control Trigger Event,"[11] the Preferred Member will be entitled to exercise rights and remedies under the Governing Documents, including: rights to take over the day-to-day management and control of the Parent Entity, to terminate all property management contracts and other agreements with affiliates of the Sponsor (which could require the Senior Lender's consent under the Senior Loan Documents) and to exercise all voting rights, with certain limited exceptions (such as filing for bankruptcy or authorizing any other action that could trigger liability under a recourse carve-out guaranty granted by the Sponsor or any of its principals or affiliates). The Sponsor may maintain its interests in Parent Entity after the Preferred Member exercises its remedies, but the Sponsor's interests could be diluted. Typically, the Preferred Member will have an option to acquire the Sponsor's interests in the Parent Entity at its then fair market value or, in some cases, for minimal consideration. The Preferred Member may also have the right to sell the Property. If the Sponsor retains any interest in the Parent Entity, the Sponsor will not be entitled to receive distributions until after the Parent Entity has received its preferred distributions, often with an increased rate of return, as well as a return of its capital.

Ideally, the framework set forth in the Governing Documents for the exercise of rights and remedies by a Preferred Member should allow for more flexibility and a quicker change in control than the foreclosure process under the UCC. In reality, however, whether those rights and remedies can be exercised in a timely and efficient manner depends in large part on the Sponsor. A Sponsor could be uncooperative in transitioning day-to-day control to the Preferred Member, which will present practical obstacles to the Preferred Member in taking over the Project.[12] Even more significantly, a Sponsor could challenge whether a Control Trigger Event has even occurred, which could result in a time-consuming arbitration or judicial process just to establish whether the Preferred Member has the right to act (and, often, also involve assertions of other claims between the parties that will need to

[10] The Sponsor may be a single real estate company or in complicated projects that require different types of expertise, a joint venture among two or more real estate companies.

[11] Control Trigger Events are defined in the Governing Documents.

[12] A foreclosing Mezzanine Lender would also face similar obstacles in connection with a UCC foreclosure.

be resolved). Recognizing this, Preferred Members have attempted to incentivize the Sponsor to be cooperative after a Control Trigger Event occurs and to refrain from interfering with the Preferred Member's exercise of its rights and remedies (as well as to refrain from committing fraud, waste, misappropriation of funds and other bad acts) by requiring a "bad boy" guaranty or indemnity from the Sponsor or a creditworthy affiliate or principal of the Sponsor.[13]

After the Preferred Member has successfully exercised its rights and remedies under the Governing Documents to gain control of the Parent Entity, the Preferred Member must continue to deal with a Sponsor that has retained its interest in the Parent Entity (unlike a Mezzanine Lender that can wipe out the Parent Entity's interest in the Project altogether). Although many states will enforce express waivers of fiduciary obligations made in the Governing Documents, the Preferred Member will still owe certain statutory and common law duties to the Sponsor. Concerns about a recalcitrant Sponsor claiming that the Preferred Member has breached those duties can cause the Preferred Member to be overly cautious with respect to its exercise of rights and remedies under the Governing Documents and the actions it undertakes in its subsequent day-to-day management of the Project (as even claims without merit may require significant time and expense to address, diverting resources away from more productive uses in connection with the Project).

As a holder of Ownership Interests in the Parent Entity, the Preferred Member (unlike a Mezzanine Lender) is structurally subordinate to creditors of the Parent Entity. However, given that the Parent Entity will be a single purpose entity (as required by both the Senior Lender and the Preferred Member), that additional risk usually is not of any practical significance. Likewise, because the Parent Entity should not have creditors that are owed any significant debts, the risk of a bankruptcy of the Parent Entity should be remote.[14] Nevertheless, if a bankruptcy of the Parent Entity were to occur, a Mezzanine Lender would be a secured creditor of the Parent Entity and would need to obtain bankruptcy court approval to exercise its remedies, whereas the Preferred Member would be treated as an equity holder in the bankruptcy (absent a re-characterization of the transaction structure) and would not require relief from the automatic stay.

Recognition agreements between Senior Lenders and Preferred Members addressing the Preferred Member's exercise of rights and remedies after a Control Trigger Event have not been as common as intercreditor agreements. This is due, in part, to the fact that the senior loan documents can acknowledge that the Preferred Member may exercise its rights and remedies under the Governing Documents if a Control Trigger Event occurs (as a carve-out to the restrictions contained in the senior loan documents pertaining to transfers, change of control and changes in property management)[15] and set forth the conditions that the Preferred Member must meet relating thereto, including the delivery of a replacement carve-out guaranty by a suitable replacement guarantor.[16]

[13] This type of guaranty or indemnity is similar to the recourse carve-out guaranty given to a Mezzanine Lender since it addresses substantially similar risks and concerns, although the Preferred Member will have the added protection that the Governing Documents will require the authorization of the Preferred Member for the filing of any voluntary bankruptcy.

[14] As indicated earlier, under the Governing Documents a voluntary bankruptcy of the Parent Entity will require the Preferred Member's authorization.

[15] The Preferred Member can be made a third-party beneficiary of these provisions so that it can enforce them.

[16] The Senior Lender will be concerned with the knowledge, reputation, expertise and financial condition of the Preferred Member, especially if the Senior Lender agrees to allow the Preferred Member to exercise its rights to take control of the Project after a Control Trigger Event occurs. The conditions imposed by the Senior Lender would be designed to address those concerns.

In addition, many Senior Lenders do not want to provide Preferred Members with additional cure rights beyond what is already set forth in the senior loan documents, reasoning that, as indirect equity holders in the Property Owner, Preferred Members should not have the proverbial "second bite at the apple" and should be incentivized to hold the Sponsor accountable to comply with the senior loan documents and to cure any senior loan defaults within the applicable notice and cure periods already provided to the Property Owner. That rationale, however, ignores the fact that it is not the role of a Preferred Member to be directly involved in the day-to-day operations of the Project and, as a result, a Preferred Member will not have the same knowledge of, or access to, information about the Property as does the Sponsor. As a practical matter, a Preferred Member may not be in a significantly better position than a Mezzanine Lender to cure a non-monetary senior loan default within the same time frame as the Sponsor. Since the Senior Lender risks relatively little and potentially benefits greatly by giving the Preferred Member cure rights, the Senior Lender can still encourage the Preferred Member to be diligent in its oversight of the Sponsor by giving the Senior Lender tighter cure periods than it would provide to a Mezzanine Lender. Even though the Preferred Member can be made a third party beneficiary of the applicable provisions in the senior loan documents, a recognition agreement allows the Preferred Member to have a direct contract with the Senior Lender. In entering into a recognition agreement, besides granting the Preferred Member cure rights, a Senior Lender: (i) may also be willing to agree to allow the Preferred Member to purchase the senior loan; and (ii) can require the Preferred Member to agree that, until the senior loan is paid in full, the Preferred Member waives all rights of subrogation and rights to seek contribution, indemnification or any other form of reimbursement from the Parent Entity or any other obligor that is primarily or secondarily liable for the senior loan obligations (or any part thereof). Those waivers can help assure that, except as expressly permitted under the recognition agreement or the senior loan documents, no monies will be paid by senior loan obligors to the Preferred Member while the senior loan is outstanding.

Should Senior Lenders Prefer Preferred Equity Transactions?

At first blush, one would expect that Senior Lenders would favor preferred equity transactions over mezzanine loans for subordinate capital. Both internally, within the financial institution that constitutes the Senior Lender, and externally, within the marketplace, a Project will be viewed as financially stronger (and therefore less risky) if the Project is subject to less debt. Even though the pricing of the subordinate capital provided in a preferred equity transaction is generally more expensive than mezzanine financing, consistent with the perceived additional risks to the subordinate capital provider that are inherent with preferred equity transactions, the higher cost of capital in a preferred equity transaction ultimately has more impact on the profitability of the Project to the Sponsor rather than on the overall financial feasibility of the Project (especially given that preferred equity transactions can be structured in a manner that will have less impact on the cash flow of the Project in the early years when cash flow needs may be particularly pressing). Also, quite importantly, because the Preferred Member will not be a secured creditor, the Senior Lender's exercise of remedies can be simpler in any bankruptcy scenario, even though the Mezzanine Lender will not be a secured creditor of the Property Owner. Outside of bankruptcy, the Senior Lender will retain the same variety of alternatives in a work-out situation and the negotiation of recognition agreements can be even more straightforward than the negotiation of intercreditor agreements (as cure rights can be more streamlined and many other provisions commonly found

in intercreditor agreements need not be addressed at all).

Nevertheless, in what remains an incredibly competitive market for capital providers, it is not surprising that Senior Lenders often will consent to a mezzanine loan as the source of the subordinate capital needed for a Project in order to cultivate or maintain a highly desirable customer relationship with a Sponsor, if that Sponsor prefers a mezzanine loan over a preferred equity transaction (particularly if the Project in question is greatly sought-after, but even if the Property presents financing challenges and complexities). A Sponsor may prefer mezzanine loan transactions for a variety of reasons. As with any transaction, tax considerations must be taken into account in the choice of the structure of the subordinate financing. Whether tax issues will be significant enough to cause the Sponsor to choose a mezzanine loan over preferred equity will vary depending upon the specific Project details, the nature of the Property use and the types of entities involved in the transaction. Quite frequently, Sponsors will elect to utilize mezzanine loans over preferred equity transactions for the most basic of reasons: the lower cost of capital. This is especially true where the Sponsor is willing to forgo the earlier distributions that it could receive in a preferred equity transaction and the Sponsor anticipates being able to pay a mezzanine loan in full within a shorter timeframe than it would take for the Sponsor to redeem a Preferred Member's Ownership Interests. Another noteworthy consideration factoring into the Sponsor's choice of structure for its subordinate capital is that a clear majority of capital providers strongly favor a mezzanine loan structure (or, in many instances, will only agree to provide the subordinate capital if it is structured as a mezzanine loan). Therefore, if the Sponsor's established sources of subordinate capital prefer mezzanine loans (and, based on past experience, they offer the most deal certainty and efficiency), or if the Sponsor can't find suitable capital sources willing to offer preferred equity on reasonably acceptable terms, then the Sponsor is going to utilize a mezzanine loan even if that was not part of its original financing plan.

The vast majority of subordinate capital providers prefer a mezzanine loan structure for a variety of reasons, including, as indicated above, tax considerations. Quite notably, even among seasoned industry professionals, there is a more widespread understanding of the basic structure, characteristics and risks associated with mezzanine loans as compared to those associated with preferred equity transactions. All loans (whether subordinate or not) share certain important components that parties are accustomed to seeing. The factors differentiating a mezzanine loan from a mortgage loan are not difficult to grasp and relate to the type of collateral granted as security (i.e., Ownership Interests as opposed to the Property) as well as the risks attendant to the mezzanine lender's subordination to the senior loan and the mezzanine lender's role as a creditor of the Parent Entity. In contrast, one of the major strengths of a preferred equity transaction is its flexibility. Preferred equity transactions can be uniquely tailored to the specifics of each transaction including, as noted above, being tailored to more closely resemble debt transactions. Often, this can result in complicated arrangements relating to waterfall distributions and other required payments, governance (including, Major Decisions), cross-indemnities, buy-sell rights, mandatory and optional redemptions, Control Trigger Events, other defaults, cure rights, forced sale provisions and the exercise of remedies by the Preferred Member. In addition, even in the simplest of circumstances, the allocations of losses and profits, and the other Parent Entity tax matters that must be addressed can be daunting. Similarly, mezzanine loan documents commonly are viewed as being more standardized than the Governing Documents pertain-

ing to a preferred equity transaction.[17] Even though the quality of the drafting and complexity of the terms reflected in mezzanine loan documents may vary, there is a consensus as to what to expect in and what should be covered by mezzanine loan documents. There is no such consensus regarding the terms of Governing Documents pertaining to preferred equity transactions, which is partly due to the flexible nature of these types of transactions, and also to the fact that the use of preferred equity transactions has not been prevalent.

While UCC foreclosures require strict compliance with all of the technical requirements set forth in the UCC and can be more time-consuming than an exercise of remedies by the Preferred Member under the Governing Documents (assuming no obstructive behavior by the Sponsor), the UCC foreclosure process is viewed by many capital providers as having the benefit of being a standardized process. This viewpoint sets aside the uncertainty surrounding what constitutes a "commercially reasonable" sale; however, that may be practically correct. Without any access or investigation rights, third parties find it extremely difficult to assess the value of and risks associated with the acquisition of the Ownership Interests of a Parent Entity that indirectly owns a troubled Project that is subject to a senior loan (that may also be in default or soon go into default) relying mainly on the limited amount of information and due diligence materials relating to the Project that a foreclosing Mezzanine Lender can provide. Consequently, third parties have shown little interest in UCC foreclosure sales. As a result, more often than not, the Mezzanine Lender will acquire the Ownership Interests as a result of exercising its UCC foreclosure remedies (either through a strict foreclosure or by acquiring the Ownership Interests at a foreclosure sale where it is likely the only bidder).

The commonly held belief that the terms, documents and exercise of remedies relating to mezzanine loans are more standardized than those relating to preferred equity transactions make the Mezzanine Lender's interest in a mezzanine loan more marketable than a Preferred Member's Ownership Interests. Taking all of these issues into account, even though the argument that mezzanine loans are more standardized may be overstated and too much weight may be given to the additional risks intrinsic to preferred equity transactions, it is understandable why mezzanine loan transactions have been chosen more often by the subordinate capital providers and Sponsors as the structure for a Project's subordinate financing. While that would not necessarily be the choice most Senior Lenders would make, the selection of a mezzanine loan as the structure for a Project's subordinate capital will not cause a Senior Lender to walk away from a sought after Sponsor or Project on that basis. Despite the fact that mezzanine loans may not be the lesser of two evils for a Senior Lender, until more subordinate capital providers begin to share that viewpoint (by revising their risk/benefit analysis regarding preferred equity transactions), mezzanine loans will continue to dominate the subordinate capital market.

[17] Although even when starting with a CMSB-approved form of intercreditor agreement (which is also the most commonly utilized form of intercreditor agreement in transactions that do not involve any securitized debt), it is still quite a stretch to describe any intercreditor agreement as standardized or customary, as intercreditor agreements remain heavily negotiated and commonly misunderstood.

To purchase the online version of this article, go to www.ali-cle.org and click on "Publications."