Mezzanine Loan and Preferred Equity Comparison Chart

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A Chart comparing the primary differences in the legal structure, transaction terms, and default remedies of mezzanine loans and preferred equity investments for real estate transactions.

This Chart compares the basic structural differences between a mezzanine loan and a preferred equity investment.

Preferred equity is an alternative financing mechanism for real estate investments that is structured as an equity investment rather than a loan. It is typically provided:

- In addition to a mezzanine loan when a developer (sponsor) needs additional funds to complete a construction project.
- In lieu of a mezzanine loan when the mortgage lender does not permit the sponsor to incur a mezzanine loan because:
  - the mortgage lender's underwriting prohibits it; or
  - the mortgage lender wants to reserve the right to split its loan into mortgage and mezzanine components in the future.

Except for certain structural similarities, there is no market standard for the terms of preferred equity transactions (see Practice Note, Key Issues in Real Estate Preferred Equity Investments: Characteristics of PE Structure (W-013-5541)). The business terms are negotiable and tailored to each transaction. Depending on the particular deal terms, preferred equity transactions fall on a spectrum from looking like traditional equity investments to having many of the characteristics of a debt transaction. The more mezzanine loan characteristics and protections the preferred equity investor (PE Investor) negotiates, the closer to debt the investment appears to be. This Chart describes preferred equity terms that generally favor the PE Investor and approximate a debt structure.

Mezzanine loans, on the other hand, are documented on fairly standard forms of loan documents and include widely-accepted requirements in the industry regarding:

- The collateral.
- Due diligence.
- Closing deliveries.

For both a mezzanine loan and preferred equity, this Chart includes a description of:

- The primary documentation.
- Customary material terms.
- Default remedies.
- Tax treatment.
- Bankruptcy risks.

For more information on preferred equity investing, see Practice Note, Key Issues in Real Estate Preferred Equity Investments (W-013-5541). For more information on mezzanine financing, see Practice Note, Mezzanine Loans in Commercial Real Estate Finance (2-600-7787).

	Mezzanine Financing	Preferred Equity
Relationship of Parties	Borrower/Lender.	Equity partners in a joint venture (JV) commonly formed as a limited liability company (LLC). Limited partnerships (LPs) are also used.
Primary Documentation	Loan documents, including: ■ Note. ■ Loan agreement. ■ Pledge agreement. Forms are fairly standardized in the industry.	LLC or LP agreement (JV agreement) and contribution or purchase agreement. No standard forms. Terms are flexible and open to negotiation.
Collateral	Equity interest in the property owner.	None, but sometimes the PE Investor negotiates to receive a pledge of the sponsor's equity in the JV.
Subordination	Subordinate to mortgage loan. Senior to preferred equity.	Subordinate to mortgage loan and any mezzanine loan. Senior to common equity.
Payment Terms:	Customary fixed or floating rate loan terms, with monthly payments of debt service and the balance of the debt due on maturity date.	Payments are made to PE Investor through priority distributions in the JV distribution waterfall, before distributions are made to any common equity investors. The PE Investor may also negotiate to receive additional profit participation.
Interest	Typically higher rate than mortgage loan. Usually payable in monthly installments until loan maturity.	Higher rate than mortgage and mezzanine loans due to: ■ Increased risk. ■ Lack of collateral. Timing of payments is subject to negotiation and senior lender approval and can be structured as: ■ Accrual only until redemption date. ■ Payable currently in periodic installments. ■ Partial current pay and partial accrual. ■ Payable only to extent of available cash flow.
Principal/Capital Repayment	For an interest only loan, entire principal is payable on maturity date. If loan is amortizing, partial principal payments are made together with periodic interest installment payments, with remaining principal balance payable on maturity date. No profit participation.	At stated mandatory redemption date, typically no earlier than maturity date of mortgage and mezzanine loans. The sponsor sometimes negotiates for right to extend the redemption date. PE Investor sometimes negotiates for interim mandatory partial redemption dates.
Prepayment	May be permitted subject to a lockout period, prepayment premium, or both.	Early redemption of PE Investor may be permitted subject to a lockout period, early redemption fee, or both.
Approval Rights	Lender has rights under loan documents to approve material actions taken by the borrower, but due to the potential for lender liability claims the lender must not become too actively involved in managing the borrower's business.	PE Investor negotiates approval rights over major decisions that may track a borrower's affirmative and negative covenants in a loan agreement, but can have more expansive rights than a lender because it does not have lender liability concerns.
Transfer Rights	Lender typically has an unrestricted right to transfer the loan. In a loan with future advances, borrower may negotiate a qualified transferee standard for the lender's transferee.	PE Investor may be subject to restrictions or conditions on transferring its interest in the JV. Once all preferred equity is contributed, transfers may be permitted.

	Mezzanine Financing	Preferred Equity
Default Remedies	UCC foreclosure on equity pledge. Lender becomes 100% owner of property-owning entity.	Exercise of contractual remedies under JV agreement. Primary remedy is to remove sponsor as managing member and take over control. Sponsor remains a member of the JV. Other negotiated consequences of removal for sponsor can include: ■ Termination of agreements with sponsor affiliates (management, leasing, development). ■ Loss of promote or other economic incentives. ■ Loss of voting rights. ■ Loss of entire ownership interest. Other possible remedies: ■ Forced sale of property. ■ Buy/sell. ■ Put option.
Fiduciary Duties	None.	Varies by state. In Delaware, fiduciary duties are owed but can be waived. The implied covenants of good faith and fair dealing are not waivable in Delaware and most other states.
Guaranties	Loan guaranties typically include: ■ Nonrecourse carveout. ■ Environmental. ■ Completion (for a construction loan).	PE Investors often demand guaranties on substantially the same terms as the loan guaranties.
Senior Lender Approvals	Mortgage lender typically must pre-approve: ■ Identity of mezzanine lender. ■ Amount of mezzanine loan. ■ Financial ratios resulting from mezzanine loan (DSCR, LTV, debt yield). ■ Mezzanine loan documents. Mortgage lender approvals during the loan term are addressed in an intercreditor agreement entered into at loan closing (see below Intercreditor Documentation).	Mortgage and mezzanine lenders may need to pre-approve: ■ Identity of PE Investor. ■ Terms of preferred equity investment, including any payments to be made while loans are outstanding. In connection with the exercise of remedies by the PE Investor, mortgage and mezzanine lenders typically must approve: ■ Removal of sponsor as manager of JV and transfer of control to PE Investor. ■ Exercise of buy/sell if PE Investor acquires sponsor's interest. ■ Replacement of property manager or developer. ■ Replacement of loan guarantor. PE Investor can negotiate in loan documents or recognition agreement with senior lenders for pre-approval of transfers and criteria for replacement guarantor, manager, and developer.
Intercreditor Documentation	Intercreditor agreement with mortgage lender governs the mezzanine lender's rights to: ■ Approve certain material amendments to the mortgage loan. ■ Notice of and right to cure mortgage borrower defaults. ■ Purchase the mortgage loan before foreclosure on the property. ■ Foreclose on the mezzanine loan and assume the mortgage loan, including providing a replacement guarantor. ■ Transfer the mezzanine loan to defined qualified transferees.	It is becoming more common for the PE Investor to enter into a recognition agreement with the mortgage and mezzanine lenders to protect the PE Investor's interest if the mortgage or mezzanine loan documents do not allow: ■ Transfer of control of JV to the PE Investor. ■ PE Investor to cure borrower defaults.

	Mezzanine Financing	Preferred Equity
Tax Treatment	Borrower deducts interest as an expense. Lender recognizes interest as ordinary income.	Tax treatment of PE Investor's investment and distributions to investor may depend on factors such as: ■ Deal structure. ■ Facts of the transaction. ■ Tax attributes of the investor.
Bankruptcy Risks	If mezzanine borrower files bankruptcy, lender is subject to automatic stay.	If JV entity files bankruptcy, the preferred equity investment is subject to recharacterization as debt if: ■ Payments are required regardless of property performance. ■ Terms have other characteristics of debt. If treated as debt, PE Investor is in the position of an unsecured creditor and may potentially lose its management rights.

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