

# **MEZZANINE FINANCING**

**BUSINESS CONTEXT**

**VARIATIONS**

**RISKS**

**STRUCTURING**

Joshua Stein  
Finance and Real Estate Department August 12, 1998

1

## **What is Mezzanine Financing?**

- First Mortgages
- Second Mortgages
- Mezzanine Financing

Joshua Stein  
Finance and Real Estate Department August 12, 1998

2

## **Why Do Rating Agencies Hate Subordinate Mortgages?**

- Interference by Subordinate Mortgagee
- Claims, Theories, Defenses
- Bankruptcy Complexity (Another Class)
- Workout Complexity (Three-Player Chess Game)
- What About "Soft Seconds"?
- See Real Estate Review Article (Handouts)

Joshua Stein  
Finance and Real Estate Department August 12, 1998

3

## **Purposes of Mezzanine Financing**

- Additional Dollars to Borrower
- "Keeping Up with the Market"
- Higher Rewards (for Higher Risks)
- Loan to Own
- Quasi-Equity Pure Mezz Investments
- Other

Joshua Stein  
Finance and Real Estate Department August 12, 1998

4

## **Link Between Mezz Financing and Loan Pools**

- Can Cement Relationship with Good Borrower
- Particularly Attractive for “Pools” of Single-Asset Deals
- Tool to Assure Deal Flow
- Mezz Complexity Justified by Larger Deal Size of Pool

Joshua Stein  
Finance and Real Estate Department August 12, 1998

5

## **Types of Mezzanine Financing**

- “Pledge” of Equity in Mortgage Borrower
- “Preferred Equity” in Mortgage Borrower
- Unsecured Note with Hard Lockbox and Conversion Upon Securitization
- Participation in Cash Flow or Capital Proceeds
- Other Variations

Joshua Stein  
Finance and Real Estate Department August 12, 1998

6

## **Advantages of “Pledge” Structure**

- Clearly a “Debt” Position
- Relatively Plain Vanilla Security
- UCC Provides Foreclosure Mechanism
- Simpler Structure and Documentation
- In Bankruptcy, “Debt” Rather Than “Equity”

Joshua Stein  
Finance and Real Estate Department August 12, 1998

7

## **Disadvantages of “Pledge” Structure**

- Fragile Collateral
- Risk of More Mortgage Debt at Property Level
  - Possible “Fraud”
  - Moral Hazard
  - Nonrecourse Carveouts
- Few Completed Foreclosures
  - But No Reason to Think They Wouldn’t Work

Joshua Stein  
Finance and Real Estate Department August 12, 1998

8

## **Advantages of “Preferred Equity” Structure**

- No “Extra Step” Necessary to Obtain Collateral
- “Equity” Role Justifies Involvement in Borrower Affairs, Reduces Risk of Lender Liability
- Avoids UCC Filing (But May Require Other Filings)

Joshua Stein  
Finance and Real Estate Department August 12, 1998

9

## **Disadvantages of “Preferred Equity” Structure**

- Invites Recharacterization Theories and After-the-Fact Legal Creativity (i.e., Litigation)
- Suretyship Theories and Defenses
- Little Experience with Rights and Remedies
  - But a “Preferred” Equity Position Is a Known Concept Generally (e.g., Corporate Law)
- “Soft” Equity-Type Role, No Lender-Type Remedies
- Promises, Promises -- Not a Property Interest

Joshua Stein  
Finance and Real Estate Department August 12, 1998

10

## Proceeds, Pricing, Protections

- Up to 95% of Value of Underlying Real Estate
- Typical at 85% of Value:
  - LIBOR Plus 550 bp
  - 1% Loan Fee; 1% Exit Fee
  - Possibly an Equity Kicker
- Lockboxes Extremely Common

Joshua Stein  
Finance and Real Estate Department August 12, 1998

11

## Useful Tool to Make Loans Work

- “Locked” Securitized Loans Preclude Other Financing
- Warehouse Financing Is Available
- Up to 20% Return, Sometimes Kicker
- Can Work with Any Loan Type, Including Construction
- No “Standard” Format for Mezz Loans, Very Customized

Joshua Stein  
Finance and Real Estate Department August 12, 1998

12



## **Threshold Issues for Mezz Lending**

- “The Last Few Dollars” of Financing May Be Too Small for Some Lenders’ Tastes
- Restrictions in Underlying Mortgage Documents
- New Deals: Higher LTV’s for First Mortgages May Not Need Mezzanine Financing
- Rating Agencies

Joshua Stein  
Finance and Real Estate Department August 12, 1998

13

## **Rating Agency Concerns with Mezzanine Financing**

- Maximum Amount
- Who’s the Equity?
- No Increase in Risk of Mortgage Default
- Absolute Priority of Payments
- Preservation of SPE Status for Mortgage Borrower
- Staggered Maturity Dates?
- Equity Pledge vs. Preferred Equity

Joshua Stein  
Finance and Real Estate Department August 12, 1998

14

## Maximum Amount Limitations

- S&P Prefers No Higher Than 80% Total Mortgage and Mezz
- If Higher Than 80%, Will Include Mezz Payments in Model and Assume First Mortgage Defaults As Soon as Mezz Defaults

Joshua Stein  
Finance and Real Estate Department August 12, 1998

15

## Who's the Equity?

- S&P Requires Confirmation of No Rating Downgrade, Withdrawal or Qualification Based on Identity of Mezz Lender
- Same Requirement for Foreclosure or Any Transfer of Mezz Loan or Collateral
- Effectively Limits Open Bidding at Mezz Foreclosure Sale
- May Be Possible to Pre-Approve Certain Classes of Mezz Loan Holders

Joshua Stein  
Finance and Real Estate Department August 12, 1998

16



## **No Increase in Risk of Mortgage Default**

- No Burdensome Consent Requirements
- No Restrictions on Refinancing of Mortgage Debt
- No Impairment of Mortgage Borrower Operations
- No Injurious Control Rights
  - Right to Replace Manager Is Probably Acceptable

Joshua Stein  
Finance and Real Estate Department August 12, 1998

17

## **Absolute Priority of Payments**

- Must Pay Mortgage Loan Debt Service First
- Also Any Mortgage Loan Reserves, Escrows, Etc.
- Even Unexpected Capital Expenses Should Come Ahead of Mezz Loan Payments
- Possible Issues Regarding Amortization of Mezz Loan While Mortgage Loan Outstanding

Joshua Stein  
Finance and Real Estate Department August 12, 1998

18

## **Preservation of SPE Status for Mortgage Borrower**

- General Partner (or Managing Member) of Borrower Cannot be Mezz Borrower or Pledgor
- Limited Partner (or Passive Member) of Borrower Can
- So Can Owner of 100% of Shares of Corporate General Partner (or Managing Member)
- In Any Event, Mezz Lender Wants a “Lien on Everything” at the End of the Day

Joshua Stein  
Finance and Real Estate Department August 12, 1998

19

## **Upper-Upper-Upper Tier Mezz Financing**

- Rating Agencies Want to Know at Any Level
- Even Five Levels Up, They Will Consider It in Ratings
- Mezz Financing at Any Level Should Be Disclosed to Rating Agency

Joshua Stein  
Finance and Real Estate Department August 12, 1998

20

## **Staggered Maturity Dates**

- Rating Agencies May Prefer to Avoid Simultaneous Maturities
- Staggered Maturities: Lower Risk of Default?
- Staggered Maturity Date
  - Two Years Before Mortgage Loan
  - Three Years After Mortgage Loan
- But Not Hard and Fast
- Depends on Circumstances

Joshua Stein  
Finance and Real Estate Department August 12, 1998

21

## **Choice of Structure: Pledge vs. Preferred Equity**

- No Strong Preference or Rigid Guideline
- “Preferred Equity” Is More Equity-Like, Kinder, Gentler
- “Equity Pledge” May Create Greater Risk of Cataclysmic Events at the Borrower Level, Increasing the Likelihood of Default
- Case by Case Analysis

Joshua Stein  
Finance and Real Estate Department August 12, 1998

22

## **The Usual Caveats About Rating Agencies**

- “Requirements” Can Vary or Change
- Must Anticipate Likely Requirements
- At the Time of Securitization, May Be Able to Craft (or Sell) Exceptions or Solutions to Any “Rule”
- A Haircut Simply Implies a Higher Rate for the Mezz Loan
- Apparently No Rigid Set of Rules for Mezz Financing

Joshua Stein  
Finance and Real Estate Department August 12, 1998

23

## **Consequences of Noncompliance with Rating Agency Guidelines**

- For Single Asset, May Impair Rating
- For Pool, Agency May Require More Subordination (Allocations to Lower Classes)
- Reprice Mezz Financing Accordingly

Joshua Stein  
Finance and Real Estate Department August 12, 1998

24

## **Legal Investment Issues**

- What Entities Can Invest in Mezzanine Loans?
- Federal and State Regulations
- Are They Real Estate?
- REIT's
- May Vary Between Equity Pledge and Preferred Equity
- Scope of Eligible Investors Affects Exit Strategy

Joshua Stein  
Finance and Real Estate Department August 12, 1998

25

## **Documentation of "Preferred Equity"**

- Highly Tailored Partnership Agreement (\$\$\$)
- Replicate Debt Characteristics as Preferred Equity
- Anti-Dilution Concerns
- No Promissory Note or UCC Filing

Joshua Stein  
Finance and Real Estate Department August 12, 1998

26

## Documentation of "Equity Pledge"

- Promissory Note
- Pledge and Security Agreement
- UCC Filings
  - Where to File
  - Collateral Description
- Registration of Transfer (New Article 8)
- Absolute Assignment in Blank

Joshua Stein  
Finance and Real Estate Department August 12, 1998

27

## Miscellaneous Documentation Issues

- Estoppel Certificate (Lender Protections) from Entity
- Estoppel Certificate (Lender Protections) from Other Equity Owners
  - Aberrational
  - "There Shouldn't Be Any"
  - Depends on Deal Structure
- Legending of Mezzanine Note
- Intercreditor Agreement (More Protections)

Joshua Stein  
Finance and Real Estate Department August 12, 1998

28



## **Risks to Mezzanine Lender (Being “Subordinate”)**

- Subordinate to Senior Loan -- Can Be Wiped Out
- May Need to Advance Money to Cure Defaults
- Restrictions on Exercise of Remedies

Joshua Stein  
Finance and Real Estate Department August 12, 1998

29

## **Risks to Mezzanine Lender (Structural)**

- Lien is on “Equity” -- by Definition Junior to All Present and Future Secured and Unsecured Creditors (Including Bad-Faith Mortgages)
- Uncertainty About Enforcement -- What Do You Have at the End of the Day?
- Lender is “Buying in” to an Entity and its Management
- Liens on Less than Everything -- Disputes with Other Equity Owners

Joshua Stein  
Finance and Real Estate Department August 12, 1998

30

## Nonrecourse and Carveouts

- Fragile Collateral
- Misapplication of \$\$\$ by Entity
- Entity Mismanagement or Bad Faith
- Additional Real Estate Encumbrances
- Amendments, terminations, etc.
- Goal: As Close as Possible to a Reliable “Second Bite at the Real Estate”
- Depends Somewhat on LTV

Joshua Stein  
Finance and Real Estate Department August 12, 1998

31

## Pride of Ownership

- Mezz Lender Must Be Ready to Take Over Ownership of the Equity Upon Default
- No Real Estate Remedies Available
- It’s “Collateral That Eats”
  - Bring Your Checkbook
- First-Mortgage and Rating Agency Transfer Restrictions Impair Exit Strategy
- Do You Want to Own This Thing?

Joshua Stein  
Finance and Real Estate Department August 12, 1998

32

## **Tax Implications of Ownership**

- Mezz Lender's Basis in Equity Interest
- Consequences of Mortgage Foreclosure
- Phantom Gain?

Joshua Stein  
Finance and Real Estate Department August 12, 1998

33

## **Basic Priority Issues**

- Total "Subordination"
- Broad Definition of "Senior" and "Mezzanine" Loans
- Treatment of Claims in Bankruptcy
  - Assignment of Claims
  - Voting and Decisionmaking
  - Senior Lender Wants Everything. Can They Collect Twice?

Joshua Stein  
Finance and Real Estate Department August 12, 1998

34

## Priority as to Cash

- Priority of Regular Cash Flow and Distributions
- Reserves Before Mezzanine Payments
- Treatment of Casualty and Condemnation Proceeds
- Lockbox
- Rating Agencies, Again

Joshua Stein  
Finance and Real Estate Department August 12, 1998

35

## Lockboxes

- Double Waterfall
- Two Agreements
- Simplify Future Transfer of First Mortgage Loan
- Servicer Might Not Be Equipped or Inclined to Handle Mezz Disbursements

Joshua Stein  
Finance and Real Estate Department August 12, 1998

36

## Payment Blockages and Standstill

- Mezzanine Lender Defers Payment During Default on Senior Loan
- Outside Date?
- Standstill for Mezzanine Lender? Why?
- Possible Issues Regarding Mezz Amortization Even Before Default
  - Case by Case -- Rating Agencies May Require
  - If Borrower Could Distribute \$\$\$ to Partners, Why Not to Mezz Lender?

Joshua Stein  
Finance and Real Estate Department August 12, 1998

37

## Purchase Option

- Allows Mezzanine Lender to Control its Destiny and Protect Itself
- What About Prepayment Premium?
- Possible Prepayment of Senior Loan May Create Rating Agency Issue
  - But Arises Primarily After Default on Senior Loan
- Senior Lender: Mezzanine Lender Should "Fish or Cut bait" -- Exercise Option (If There's Value) or Else Abandon Position

Joshua Stein  
Finance and Real Estate Department August 12, 1998

38

## **Mezzanine Lender - Notice and Opportunity to Cure**

- Extra Time
- Conditions to Cure Rights (Keep Loan Current)
- Treatment of "Incurable" Defaults
- Effect of Borrower Bankruptcy

Joshua Stein  
Finance and Real Estate Department August 12, 1998

39

## **Other Protections for Mezzanine Lender**

- Right to Exercise Remedies
- "Permitted Transfer" under Senior Loan Documents
- Cross Defaults
- Limitations on Amendments of Senior Loan Documents
- Confirmation of Adequate Title Insurance?

Joshua Stein  
Finance and Real Estate Department August 12, 1998

40



## Senior Lender Protections

- Notice and Opportunity to Cure Defaults.
  - Why Required?
  - Monitoring
- Ability to Consummate Workouts Without Interference
- Loan Document Approvals (Tenants, etc.) Without Interference

Joshua Stein  
Finance and Real Estate Department August 12, 1998

41

## Other Issues

- Timing of Maturity Dates -- The Race to the Courthouse
- Differences in Collateral
- Each Lender's Comfort Level with the Other's Documents
  - Vagueness, Potential Disputes.

Joshua Stein  
Finance and Real Estate Department August 12, 1998

42

## **Bankruptcy Concerns of a Mezzanine Lender**

- Single-Purpose Bankruptcy Remoteness
  - Regardless of Exactly Which Entity the Borrower is
- Bankruptcy Court Skepticism re: Unmatured Interest
- Equitable Subordination
- Recharacterization as Equity
  - Include Absolute Promise to Pay
- Pledge Probably Better Than Preferred Equity

Joshua Stein  
Finance and Real Estate Department August 12, 1998

43

## **Miscellaneous Issues**

- Usury
- “Clogging the Equity of Redemption”
- Back-Door Mortgage Debt?
  - One Form of Action
  - Antideficiency Protections
  - State by State
- Control of Major Decisions Within Entity

Joshua Stein  
Finance and Real Estate Department August 12, 1998

44