Financing Commercial Real Estate Projects

By John R. Orrick Jr.

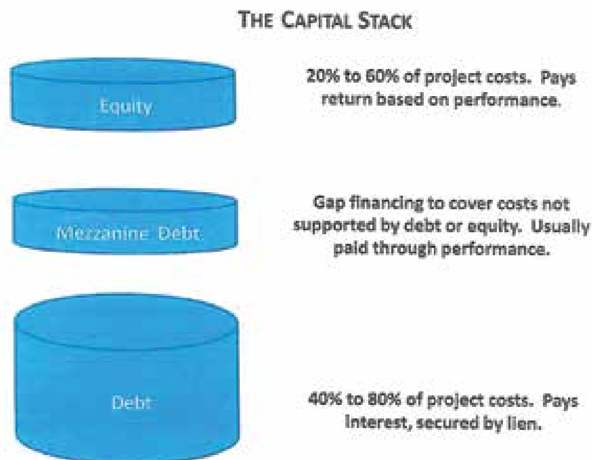
In today's financing environment, developers of larger commercial real estate projects must look to a variety of financing sources to obtain capital. Sources of capital vary, based on the risk profile of the capital providers and the quality and location of the project, but follow a consistent pattern. This article will review, in summary fashion, the nature of the primary financing vehicles available in commercial real estate projects and some of the important characteristics of each that developers of real estate projects must know.

The Capital Stack

The capital stack describes the layering of types of financing that are commonly available for real estate projects based on an increasing risk profile and opportunity for return. At the bottom of the stack is secured debt, generally provided by a bank, insurance company, or other financial institution looking for a steady return with minimal downside risk. The greatest security is provided to lenders with a first lien security interest in the real estate and other collateral. Debt secured by a secondary lien in the collateral yields a higher coupon percent rate to the lender because of the increased risk that the junior lienholder has if foreclosure occurs on the collateral.

Above the debt platform is mezzanine or performing debt, which is generally not secured by a direct lien on the real estate collateral but rather secured by a pledge of the member or partnership interests in the borrowing entity. This financing tool provides a higher return to the lender while maintaining some of the typical characteristics of debt, such as a fixed maturity date or right to redemption, covenant protection, and borrower guaranties.

At the top of the capital stack is the equity in the project. This layer may include preferred equity, which has a higher priority on distributions from the venture entity than the common equity. Common equity is typically provided by the promoter of the project and has the last priority on distributions after payments to the capital providers lower in the capital stack. The return on equity is driven by the project's performance rather than the protections afforded by the security interest in the collateral and, therefore, stands to earn the greatest return if the project succeeds.



Secured Debt

In most commercial real estate projects, the bulk of the capital is provided through a secured loan from a financial institution that records a mortgage or deed of trust against the real property, with an additional security interest in personal property owned by the borrowing entity. The security interests in the real and personal property provide the lender with priority repayment if the borrower becomes subject to bankruptcy or insolvency proceedings and provide legal recourse under state foreclosure laws. The priority of the liens is governed by state law, which generally provides for a first-in-time, first-in-priority regime; however, lenders can enter into subordination agreements with other creditors whereby the priority of the obligations can be modified. Lenders are restricted to making loans at a certain loan-to-value ratio that varies according to the size and characteristics of the lender, location of the property, the type of real estate asset, and the track record of the sponsor. In most commercial real estate ventures, the debt does not exceed 65% to 75% of the underlying value of the real estate.

Secured debt may be of a recourse or nonrecourse basis to the borrowing entity. A nonrecourse loan simply means that the lender is limited solely to realizing on the value of the assets pledged as collateral and not to any other assets of the borrowing entity, but a recourse loan allows the lender to attach other assets of the borrowing entity. In today's environment, in which most lenders look for borrowers to be single-purpose, "bankruptcy remote" entities, this distinction does not have a great deal of meaning, because the borrowing entity generally will not have significant assets besides the assets pledged as collateral.

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A lender, however, will look for third parties, such as the parent entity, other affiliates, or the individual principals of the borrowing entity to provide certain guaranties for loans made to the borrowing entity. A common form of guaranty is the nonrecourse carve-out guaranty, under which the guarantor provides a guaranty against the borrower's having engaged in certain bad acts or other activities that may jeopardize the value of the real estate and other collateral to the lender. Other forms of guaranties include guaranties for environmental liabilities, construction completion guaranties, and guaranties of repayment.

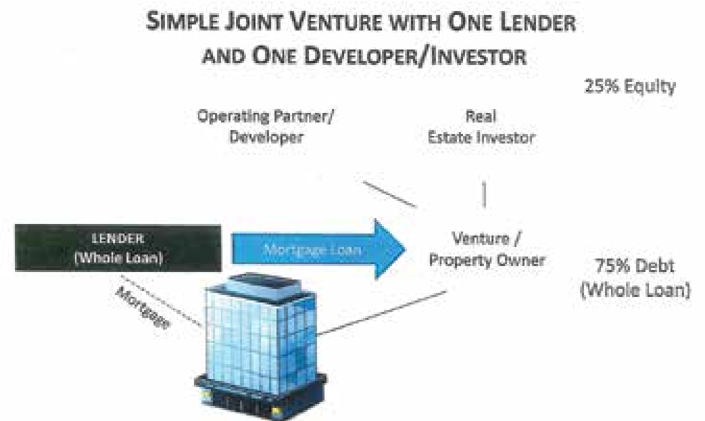
Other characteristics of secured debt are that the amounts borrowed generally will accrue interest at a stated rate (whether fixed or tied to an index), will have regular periodic payment obligations unless structured as an accrual bond, and will have a fixed maturity date. Often there are penalties for late payments and the right to accelerate the loan if a borrower default occurs. Lenders can include affirmative and negative covenants in the loan documentation that restrict the ability of the borrower to manage the property, incur additional debt, and pay fees to service providers without lender consent.

In today's lending environment, loans on larger commercial properties are often pooled into mortgage-backed securities and sold to third-party investors. The structure for commercial mortgage-backed securities requires that loan documents be standardized, with borrowers required to adhere to certain single-purpose entity provisions in their organizational documents that prevent them from undertaking other real estate investments, incurring other debt, and failing to observe general organizational formalities. Once mortgages are pooled into mortgage-backed securities, interests can be sold in tranches that range from highly rated instruments to unrated, less secure instruments.

The terms for secured loans may change over time as the general level of interest rates rises or falls, the banking regulatory environment loosens or tightens, and economic conditions vary.

Mezzanine Loans

Mezzanine loans are financing instruments that occupy a middle ground between secured debt at the bottom of the capital stack and equity investments at the top. The mezzanine lender makes its loan to a parent entity of the entity that owns the real property and receives as collateral a pledge of the membership (or partnership) interest in the real-estate-owning enterprise by the parent entity. Mezzanine loans are structurally subordinated to senior debt, which, as described above, has a security interest in the real property and other, personal property of the borrower. Mezzanine loans provide the lender with the ability to exercise certain control rights if a default occurs under the mezzanine loan documents, including foreclosing on the pledged collateral and assuming ownership of the borrowing entity. The source of funds to repay the mezzanine loan, however, is limited to cash distributions from the property owner, at least until the secured debt has been satisfied.



Typically, mezzanine loan documents are similar to senior loan documents and include a promissory note that requires the repayment of the debt at a stated time and at a stated interest rate and a pledge agreement that grants a security interest by the mezzanine loan borrower in the membership interest in the property owning entity. Affiliates of the mezzanine loan borrower may provide guaranties that are similar to guaranties provided to senior lenders. In addition, mezzanine loans can include certain equity participation rights, including warrants or convertibility features that give the lender the opportunity to participate in performing the real estate project.

Because the collateral for a mezzanine loan is personal property, governed by the Uniform Commercial Code (UCC), care must be taken to perfect the security interest granted in the membership interests. The methods for perfecting such a security interest include the issuance of certificated membership interests under UCC Article 8, which can be perfected through possession, through a control agreement entered into with a financial institution, or through filing a financing statement under UCC Article 9. Lenders may want to avail themselves of a relatively recent product developed by title insurers known as "UCC insurance," which, similar to title insurance policies for real estate, protects the lender against claims brought by other creditors that may have a security interest in the same collateral.

One issue that mezzanine loan lenders must know of is that, under most state laws applicable to limited liability companies (LLC) and limited partnerships (LP), the ability to foreclose on a membership interest in an LLC or partnership interest in an LP by a creditor of a member or partner of such entity may be limited, and the primary remedy afforded under such state laws is a charging order. A charging order allows a creditor of a member or partner to obtain a right to receive distributions of cash that would otherwise be paid to such person by the LLC or the LP but not to exercise other rights of a member or a partner in such entity. Accordingly, the loan agreement entered into between the mezzanine lender and the borrowing entity should ensure that the lender is afforded the rights to participate in management and foreclose on such interest, with corresponding amendments made to the LLC

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agreement or LP agreement of the real estate owning entity, if necessary. If a default occurs under a mezzanine loan, a mezzanine lender seeking to foreclose on its security interest must conduct a commercially reasonable private or public nonjudicial foreclosure under the terms of the UCC in the applicable jurisdiction.

Intercreditor Agreements and Subordination of Debt

In commercial real estate transactions that involve one or more lenders with a secured interest in the same real property or a mezzanine lender with a security interest in the membership interests of the real property owner, the lenders need to address their respective abilities to exercise rights in the collateral and to take over management of the real estate owning enterprise through an intercreditor agreement.

Typically, a senior lender requires a standstill period for the other creditors to allow it to pursue an enforcement action in a default under the senior loan, the time of which will vary by loan size, type of collateral, and relative bargaining power of the lenders. The mezzanine lender, on the other hand, will want the right to exercise rights against the mezzanine loan borrower, provided notice is given to the senior lender and the senior lender is protected through the provision of substitute indemnitors, guarantors, or other parties that will allow it to protect its senior position in the collateral. In addition, the mezzanine lender may request rights to cure underlying defaults in the senior loan before the senior lender exercises its remedies. The mezzanine lender also may want the right to purchase the senior loan at par after the borrower has defaulted under the senior loan.

When two or more lenders each have a security interest in the underlying real estate collateral, an intercreditor agreement can govern the subordination of liens by one creditor to another creditor. Again, the senior lender generally wants to limit the ability of the junior lienholder to take actions to foreclose on the collateral without the senior lender's consent and participation and may limit the ability of the second lienholder to pursue foreclosure against the common collateral until the first lienholder is paid in full. Lenders secured by a junior lien must ensure that, like mezzanine lenders, they are afforded cure rights and rights to purchase senior debt following an event of default to avoid having their collateral rendered worthless by the actions of the senior lender.

In an intercreditor agreement, each of the lenders acknowledges the position of the other lender and requires notice and consent of the other lender to any amendment to the underlying loan documents. Further, the intercreditor agreement allows each of the lenders to preserve certain rights in insolvency proceedings involving the borrowing entity and the collateral.

Preferred Equity

Investors providing equity to commercial real estate projects often require a preferred return on their invested capital over that provided on capital invested by the developer or sponsor of the project to compensate them for the higher risk profile of equity to debt capital. Unlike debt, generally collateralized by security in real estate assets,

equity investments are unsecured and receive distributions only when all current payments on venture obligations have been satisfied. Sources of preferred equity can include private equity funds, real estate investment trusts, pension funds, wealthy individuals, and corporate investors.

Just as mezzanine loan instruments can contain certain equity-like features, preferred equity investments can be structured with certain debt-like features, including regular payment of distributions, rights of the investor to put its investment to the sponsor or have the venture redeem its interest, covenant and control rights, rights to force the removal or replacement of the manager of the property-owning entity, and certain minimum returns before payments are made on the common equity.

The terms of a preferred equity investment are governed by the operating agreement or partnership agreement of the venture, which can be the property-owning entity or a holding company that owns interests in lower-tier, subsidiary, property-owning entities. Joint venture agreements contain a waterfall provision that sets forth the terms under which distributions are to be paid to the owners following payment of all current expenses and debt service. The preferred equity owner receives a preference in payments of such distributions, which may be based on the achievement of certain

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investment return hurdles to the equity investors and which may involve several levels of distributions. Sometimes distributions to preferred equity investors may be bifurcated between operating returns and returns on capital events, such as a sale or refinancing of the underlying real estate.

In addition to receiving a preference on distributions, preferred equity investors often require certain control rights over the management of the venture. These control rights can include the right of the preferred equity provider to make decisions for the venture or to require that the manager of the venture obtain its consent before making certain major decisions, including sale of the property, financing decisions, engagement of property managers, leasing agents and other third-party vendors, filing for bankruptcy, and other major operational decisions, as well as fundamental decisions to merge or dissolve the venture. Often, if there is a breach under the terms of the organizational documents entered into with the venture, or a failure of the managing member of the entity to achieve certain financial benchmarks, the provider of the preferred capital will be given the rights to take over management of the venture. This is akin to the rights of a mezzanine lender to take over control of the borrowing entity through a UCC foreclosure and is governed by contract between the parties rather than the requirements of state law.

One form of preferred equity is the carried interest or "promote" interest, which is often granted to a member in the venture in exchange for that member's providing services or other benefits to the venture as opposed to the contribution of capital. Promote interests enable the member to receive distributions from the venture as structured under the terms of the waterfall in the venture agreement. They may have priority over distributions made to the equity holders or be subject to the venture's reaching a certain hurdle rate of distributions to the capital providers before payment.

Note that in real estate ventures, the opportunity exists for members or their affiliates providing services to the venture to obtain payments through service agreements involving payment of fees as opposed to distributions of profits. This is another way to provide a preference on payment to the members because fees will be paid before distributions of cash from the operations of the venture. The characterization of fees, as opposed to distributions from operations or sale of assets, can give rise to different tax treatment of the payments to the parties, which also needs to be considered.

Another possible characterization of payment to members is to structure the payments as repayment of member loans as opposed to equity distributions. Member loans should be clearly documented as debt with debt-like terms, including a stated interest rate and loan repayment provisions to avoid being recharacterized as equity.

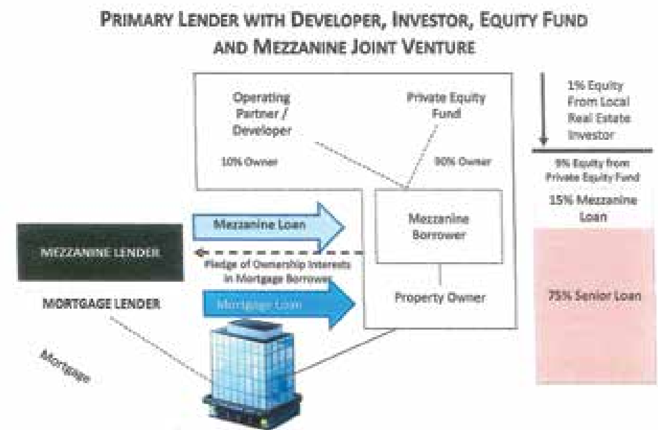
Partners in entities characterized as partnerships under the federal income tax laws, which include LLCs and LPs, are taxed on the income allocated to the partner, not the cash distributions actually made to that partner. Therefore, a partner that provides equity to a venture may consider whether a tax distribution clause should be included in the venture agreement. The purpose of the tax distribution clause is to require the venture to distribute cash to the partner each year in an amount linked to the income allocated to that partner for tax purposes so the partner has liquidity to pay its taxes.

Another important consideration for providers of preferred equity is that under the laws of most states pertaining to the organization of business entities, a member or partner with the ability to exercise control over the entity may owe fiduciary duties to the other members of that entity to exercise such control subject to a minimum standard of care and to not favor itself over other similarly-situated members in engaging in transactions with the entity. Under the laws of certain states, these fiduciary duties may be waived or limited; however, this area is far from settled and preferred equity investors that exercise control rights must take care they are not opening themselves to claims of breach of fiduciary duties by the other equity owners in the venture.

Because LPs and LLCs are organizations governed by contract, a wide variety of provisions can be negotiated between providers of capital in the organizational documents for the venture. These provisions are far too numerous to cover in this article. The documentation for preferred equity investments tends to be less standardized than that for secured debt and even mezzanine loan transactions.

Conclusion

Commercial real estate projects are increasingly funded through a combination of investments. These combinations typically include senior debt, mezzanine debt, and preferred equity investors, as illustrated in the accompanying diagrams of commercial



real estate projects. But complex transactions also can include sources not directly mentioned in this article, such as public/private partnership vehicles and government subsidies, investors seeking to take advantage of tax credits and other tax incentives for real estate development, and foreign investors seeking to diversify their portfolios or achieve other benefits. One of the keys to successful real estate development is to match the needs of the project for capital to the sources that provide it at the most affordable costs. ■

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