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Mezzanine Finance and Preferred Equity Investment in Commercial Real Estate: Security, Collateral & Control

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MEZZANINE FINANCE AND PREFERRED EQUITY INVESTMENT IN COMMERCIAL REAL ESTATE: SECURITY, COLLATERAL & CONTROL

*Jon S. Robins, David E. Wallace, Mark Franke **

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I. INTRODUCTION

The current equity gap in private equity real estate (commercial real estate not owned by public companies), or the tranche between an asset's current outstanding senior loan balance and a new senior loan balance achievable via a refinancing or a new purchase money loan in connection with a purchase and sale, is primarily driven by three factors: the maturity wall, depressed valuations, and conservative lending practices.

The maturity wall results from the explosion of transaction activity that took place from 2005-2007. A large number of these loans were for five-year terms, and this number is even higher if loans of three years with borrower extension options are included.¹ In addition, as a result of the recent crash in real estate values, many loans that were scheduled to mature in 2009, 2010, and 2011 have been extended by one to three years.² As a result of these factors, a large amount of debt originated during the market peak is set to mature in 2012 and 2013 (and a staggering \$1.2 trillion of maturities is scheduled through 2015).³ Depressed valuations are evident: as of the second quarter of 2011, the Moody's/REAL Commercial Prop-

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1. DELOITTE, REAL ESTATE SERVICES, COM. REAL ESTATE OUTLOOK: GENERATING MOMENTUM FOR RECOVERY 7 (2010), available at http://www.deloitte.com/assets/Dcom-Luxembourg/Local%20Assets/Documents/Whitepapers/2010/us_wp_realestatetop10issues_04112010.pdf.

2. *Id.*

3. *Id.*

erty Price Index (CPPI) was down approximately 40% from the market peak (from Q2 2007 through Q1 2008).⁴ Lastly, senior lenders are employing more conservative lending practices that restrict proceeds by lower loan to values ratios and tighter loan covenants that focus on in-place cash flow and current as-is property valuations, rather than upside potential and asset appreciation (based on aggressive lease-up assumptions, expected rent increases or anticipated improved market conditions).⁵

In addition to holding assets with distressed capital structures (with/defined by equity gaps), private equity real estate faces operational liquidity issues due to longer than anticipated hold periods with less cash flow (due to increased vacancies and lower rents) to fund increasing capital and leasing cost requirements. With a lack of reserves, inability to call capital, and lack of access to the public equity markets, commercial real estate often requires third party capital to refinance, hold, and manage their assets in order to recoup value lost during the financial crisis. In addition, with the first mortgage lenders offering loan proceeds based on lower valuations and using tighter underwriting standards, buyers acquiring real estate often need additional or third party capital to bridge a shortfall between the acquisition price and the sum of the first mortgage loan proceeds and available sponsor equity.

The aforementioned third party capital will be subordinate to the senior loan due to senior mortgage covenants, yet senior to legacy equity and to new sponsor equity. Preferred equity and mezzanine debt are alternative financing techniques that fit perfectly into these equity gap tranches; they typically currently fund into the 60%-90% loan to value range,⁶ or between a senior loan and subordinate equity. While preferred equity and mezzanine debt remain popular alternative financing techniques for new acquisitions, they also now play such a vital role in recapitalizing private equity real estate's legacy assets that new funds are forming to take advantage of their increased demand (and their bolstered returns and yields in a low interest rate environment). Consequently, it is an appropriate time to review and examine the subtle and yet important differences between these two alternative financing techniques.

This article will review both the genesis and the rise in popularity of preferred equity and mezzanine debt, examine their legal and structural differences, and provide some exposition as to how these financing techniques work from security, collateral and control standpoints. We do not undertake in this article to address the differences in tax and accounting

4. MIT CENTER FOR REAL ESTATE, MOODYS/REAL COMMERCIAL PROPERTY PRICE INDEX (CPPI) (Nov. 7, 2011), <http://web.mit.edu/cre/research/credl/rca.html>.

5. JONATHAN D. MILLER, PRICEWATERHOUSECOOPERS, EMERGING TRENDS IN REAL ESTATE 2011 17-18 (2010), available at <http://www.pwc.com/us/en/asset-management/real-estate/assets/emerging-trends-real-estate-2011.pdf>.

6. See, e.g. CUSHMAN & WAKEFIELD SONNENBLICK-GOLDMAN, CAPITAL MARKETS UPDATE (Apr. 30, 2012), available at <http://www2.cushwake.com/sonngold/upload/documents/MarketReport.pdf>.

treatment between mezzanine loans and preferred equity investments both for either the mezzanine lender or preferred equity investor on the one hand, or for the mezzanine borrower or the common equity investor, on the other hand. In deciding upon which structure to use, transaction participants should consult with their independent tax and accounting advisors to ensure that the transaction is appropriately structured to best meet their individual needs, subject to such compromise as may be necessary to effect a desired transaction.

We proceed as follows: Section II outlines the legal principles of, and the practical realities that have shaped, real estate finance from common law to modernity. Section III begins with an exposition of the preferred equity instruments and mezzanine debt that form the subject of this study. It will start by outlining their qualities and follow with a delineation of the organizational structures used in deals in which they form part of the capital structure. Lastly, it will proceed through theoretical and practical issues for legal counsel to consider. Section IV will address an open issue, never, to the authors' knowledge, having been before a court: whether these funding mechanisms should be treated as equitable mortgages according to the common law equitable tradition to treat mortgage-like agreements as mortgages. This Section will argue that these funding mechanisms should not be treated as equitable mortgages. Finally, we will set forth our conclusion in Section V.

II. COMMERCIAL REAL ESTATE FINANCE: FROM COMMON LAW MORTGAGES TO EQUITY GAP FINANCING

In order to understand how the need for equity gap financing arose, the reader must first understand the economic and legal realities of commercial real estate finance. The most essential building block of real estate finance is the mortgage.⁷ The mortgage typically provides the largest proportion of capital and, through the authority ceded to the mortgage lender in exchange for holding the risks inherent in such proportion, defines the contours of the project's capital structure through the covenants contained in the mortgage agreement.⁸

A. Mortgage Law

A mortgage is a promise by one person, the mortgagor, to perform obligations, usually the repayment of money loaned to the mortgagor and memorialized in a promissory note, to another, the mortgagee.⁹ The mort-

7. See 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) (noting that mortgages intended for inclusion in commercial mortgage backed securities are typically capped at 65%-75% loan to value ratios).

8. *Id.* at 100 (noting that most senior commercial mortgages intended for securitization contain negative covenants against junior mortgages because rating agencies discouraged subordinated security interests in the underlying asset properties).

9. RESTATEMENT (THIRD) OF PROPERTY (MORTGAGES) § 1.1 (1997).

gator conveys, or, where the mortgagee is the seller, the mortgagee retains, an interest in real property¹⁰ as security for the mortgagor's performance of its obligations.¹¹ Often, the main obligation is the repayment of a loan lent by the mortgagee for the purpose of acquiring, refinancing, constructing or renovating the mortgaged property.¹² Today, the most common mortgage form is where the mortgagor has the direct ownership interest in the subject property, while conveying a security interest, or lien, to the mortgagee in the property that will be released once the obligation to repay the debt evidenced by the promissory note has been performed.¹³

The mortgagee's primary remedy against the mortgagor for failure to perform obligations is the process known as foreclosure. Upon default and after the expiration of any cure period, the mortgagee may foreclose on its lien on the real property.¹⁴ The process is called "foreclosure" because it forecloses the mortgagor's right to redeem the property.¹⁵ The mortgagor's right to redeem has its origins in courts of equity and will be discussed more below.¹⁶

The time required to foreclose the mortgagor's redemption right and the methods for accomplishing the foreclosure vary by jurisdiction. In some states, no judicial action is required, and the mortgagee may sell, at a sheriff's sale, the property pursuant to a power of sale contained in the mortgage or deed of trust.¹⁷ Typically, in these states the mortgagor's right to redeem is limited by statute to a short period after written notice is given by the mortgagee and the sale forecloses all rights to redeem.¹⁸ In others, where judicial action is required, the time period required to fore-

10. The technical nature of this interest varies by jurisdiction. Most jurisdictions consider the mortgage to be a lien upon the mortgagor's fee estate. Other jurisdictions consider the grant to be a conveyance of title. In either case, under modern law, the practical effect for most if not all purposes under each theory is that of a lien.

11. *Id.*

12. *See id.* (noting that the obligation is usually payment of money under a promissory note); *See also id.* at 1.4 (providing that no matter the terms of the obligation, the obligation must be measurable in monetary terms).

13. *Id.* §1.1.

14. GLENN G. MUNN, *ENCYCLOPEDIA OF BANKING AND FINANCE* 243 (Bankers Pub. Co., 5th ed. 1949).

15. *Id.*

16. *See* the discussion of the equity of redemption doctrine, *supra* in the current section and *infra Section IV*, for more on the mortgagor's right to redeem.

17. *See, e.g.*, TEXAS TITLE EXAMINATION STANDARDS, Std. 16.10 (outlining the elements that an examiner must establish to verify power of sale).

18. *See, e.g.* In re Grant, 303 B.R. 205 (Bankr. D. Nev. 2003) (holding that under Nevada law, transfer of foreclosed property becomes final upon sale, not filing of title with registry). *See also* MARIA MILANO, *COMMERCIAL REAL ESTATE FINANCING: THE BORROWER'S PERSPECTIVE TOUGH TIMES NOTWITHSTANDING, THERE ARE WAYS FOR THE COMMERCIAL REAL ESTATE BORROWER TO USE THE LENDING PROCESS TO ITS ADVANTAGE*, *Prac. Real Est. Law*, 39, 47 (2009) (noting that under Washington state law, a mortgagee has up to 11 days before the foreclosure sale to redeem).

close is not defined by statute, but is determined by the time necessary for the consummation of the judicial process.¹⁹ The practical effect of the judicial foreclosure process is often to extend the period during which the mortgagor may redeem the property.²⁰ There are many jurisdictional variations of the foreclosure process, but the judicial sale versus the non-judicial sale is the primary point of differentiation.

Mortgages touch and concern real property and, therefore, belong to property law. Mortgages are also contracts between parties memorializing promises and, therefore, also belong to contract law. Early in the evolution of English common law, there were unsettled tensions between enforcing the terms of a contract and the greater protections against forfeiture afforded under property law.²¹ More often than not, courts would enforce the terms of an agreement, even where it would result in inequitable ends.

As more and more unsuspecting mortgagors were forced to forfeit their estates under the terms of mortgage contracts, courts of equity grew suspicious of such intrusions on the traditional protections afforded under property law.²² Recognizing that the mortgagee was essentially providing capital to prospective landowners for purchases of real property, courts began to treat these arrangements as creditor-debtor relationships and to limit recourse for creditors to a claim for money.²³ Courts of equity also began to recognize a title in equity vested in the mortgagor.²⁴

These equitable innovations underpin the equity of redemption doctrine. The equity of redemption doctrine allows borrowers to avoid the formal contractual provisions that require them to forfeit their land in the

19. See, e.g., NEW YORK REAL PROP. ACTS §1352.

20. See Grant S. Nelson & Dale A. Whitman, *Reforming Foreclosure: The Uniform Nonjudicial Foreclosure Act*, 53 DUKE L.J. 1399, 1403 (2004) (outlining the “time-consuming and costly” judicial foreclosure process). A survey of foreclosure information websites shows that most predict a New York foreclosure to take anywhere from 3 months to 18 months. See, e.g., *How Long Does the Typical Foreclosure Process take in New York?* LAW INFO (last visited Mar. 25, 2012), available at <http://resources.lawinfo.com/en/Legal-FAQs/Foreclosure/New-York/how-long-does-the-typical-foreclosure-process.html> (suggesting 6-18 months); see also, e.g. *New York Foreclosure Laws*, RealtyTrac (last visited Mar. 25, 2012), available at <http://www.realtytrac.com/foreclosure-laws/new-york-foreclosure-laws.asp> (suggesting 15 months); *New York Foreclosure Laws*, FORECLOSURE.COM (last visited Mar. 25, 2012), available at http://www.foreclosure.com/statelaw_NY.html (suggesting an uncontested foreclosure takes 120-180 days).

21. Berman, *supra* note 7, at 119. See also Tamar Frankel, *The Legal Infrastructure of Markets: The Role of Contract and Property Law*, 73 B.U. L. REV. 389, 395 (1993).

22. Berman, *supra* note 7, at 119.

23. Charles J. Reid, Jr., *The Seventeenth-Century Revolution in the English Land Law*, 43 CLEV. ST. L. REV. 221, 298 (1995). See also Ann M. Burkhart, *Lenders and Land*, 64 MO. L. REV. 249, 260-61, 264 (1999) (noting that the repeal of a prohibition on charging interest by the English parliament led to lenders allowing borrowers to retain their interest in the land, and eventually led to a re-characterization of the mortgagor-mortgagee relationship to a debtor-creditor relationship).

24. Reid, *supra* note 22, at 298.

event of default.²⁵ Originally, the equity of redemption doctrine required mortgagors to show fraud or other equitable grounds for the recovery of their property, but by the earlier part of the 17th century, courts afforded any mortgagor the doctrine's protection.²⁶ Courts began to view mortgages as loans collateralized by real property.²⁷

During this time period, the rights available to a mortgagee upon default began to reflect the rights they have today. In the event of default, the mortgagee can realize upon the property, but only after going through the necessary process to foreclose the mortgagor's equity of redemption. Until that process is completed, the mortgagor retains the right to redeem its property through fulfilling its obligations under the mortgage agreement.²⁸

Once any cure period under the mortgage document has expired, the mortgagee is entitled to accelerate the secured debt. In most jurisdictions, once the debt has been accelerated, the mortgagor must pay all obligations in full in order to redeem the property.²⁹ However, in some jurisdictions, where a power of sale process is used, the mortgagor may need only cure the underlying default to redeem.³⁰ In most jurisdictions, the period for redemption of the mortgage ends upon the foreclosure sale,³¹ but in several jurisdictions statutes define a period after the foreclosure during which the mortgagor's right to redeem continues to exist.³²

With the rise of the equity of redemption doctrine, mortgagees began attempting to secure waivers of the mortgagor's right to redemption or to

25. See GEORGE E. OSBORNE, HANDBOOK ON THE LAW OF MORTGAGES § 6, at 12 (West 2d ed. 1970) (1951); see also Berman, *supra* note 7, at 86.

26. See Burkhart, *supra* note 23, at 264 (1999). Note, however, that the attachment of the equity of redemption to a mortgage is different than finding an alternative loan structure an equitable mortgage. See also, Laurence G. Preble & David C. Cartwright, *Convertible and Shared Appreciation Loans: Unclogging the Equity of Redemption*, 20 REAL PROP. PROB. & TR. J. 821 (1985) (showing that for an equitable mortgage finding to attach, there must be some equitable ground, not a mere resemblance to a mortgage).

27. Burkhart, *supra* note 23, at 264 (1999).

28. *Id.*

29. See e.g., N.Y. REAL PROP. ACTS §1341 (McKinney 1962) (requiring the "defendant [to pay] into [the] court the amount due for principal and interest" plus costs and administrative expenses in order to dismiss the foreclosure action or stay the sale).

30. See, e.g., CAL. CIV. CODE § 2924 (West 2011) (providing that if the amount is curable under § 2924c, then that is sufficient to redeem). See also CAL. CIV. CODE § 2924c (West 2011) (providing that the amount necessary to redeem is that amount which is due on account of the default "other than the portion of principal as would not then be due had no default occurred").

31. See, e.g., NEW YORK REAL PROP. ACTS §1352 (providing that a judgment shall fix the amount of time during with the right to redeem the property exists).

32. See Grant S. Nelson & Dale A. Whitman, *Reforming Foreclosure: The Uniform Nonjudicial Foreclosure Act*, 53 DUKE L.J. 1399, 1404 (2004) (showing that in some statutorily defined redemption periods, the mortgagor may redeem for up to a year after foreclosure sale). See, e.g., MICH. COMP. LAWS ANN. §600.3140 (providing for a right to redeem for six months following foreclosure sale).

craft agreements intended to hide their nature as a mortgage in order to avoid the protections afforded to borrowers under the doctrine.³³ Recognizing this, courts would always look to the substance of the agreement to determine whether it was a mortgage. Where a court determined it was a mortgage, the court would unequivocally limit mortgagees' recourse according to the equity of redemption doctrine.³⁴ As Chaplin put it:

"[There were] several forms of conveyance in use, no one of them professing to create a mere lien, all diverted from their original office, all warped away in operation from their language, all nevertheless, diverse as they were, resulting in one and the same contract."³⁵

The trend to look to the substance of the agreement led to the popular adage, "once a mortgage, always a mortgage."³⁶

As time passed, the mortgagor's equitable title in land independent of the legal form of the agreement gained traction in more courts and eventually became unassailable, even if the contract did not vest legal title in the mortgagor. With this recognition of title, mortgagors were able to secure loans subordinated to their original mortgage with the property.³⁷ Thus arose junior mortgages.

B. *Junior Mortgages*

A junior mortgage acts like a first mortgage in that the mortgagee takes a security interest in the underlying property, but it is second to the first mortgage in lien priority.³⁸ Where the mortgaged property is sold at foreclosure, the purchaser takes the property free of the foreclosed mortgage and any junior mortgages (subject to redemption rights in those jurisdictions providing for any post-foreclosure statutory redemption period). Following the foreclosure sale, a junior mortgagee will only receive any proceeds remaining after the obligations secured by the senior mortgage are paid in full.

The same is true in a liquidation under bankruptcy law. Where a borrower becomes insolvent and files for a liquidation form of bankruptcy,³⁹ a junior lender would be paid only to the extent that there are residual funds left over after payment in full of the senior mortgage obligations.⁴⁰ Any outstanding amount of the junior mortgage beyond the residual amount after the senior mortgage is paid would be considered unsecured and,

33. See Osborne, *supra* note 25, §21 for one interesting example of mortgagor's attempts to avoid the equity of redemption doctrine, the "trust deed mortgage."

34. *Id.*

35. H. W. Chaplin, *The Story of Mortgage Law*, 4 HARV. L. REV. 1, 11 (1890) (alteration in original).

36. See Berman, *supra* note 7, at 87.

37. *Id.* at 89.

38. See *In re Midway Partners*, 995 F.2d 490, 495 (4th Cir. 1993) (outlining the process of curing loans of different priority).

39. Possible under chapter 7 or chapter 11.

40. *In re Midway Partners*, 995 F.2d at 495.

therefore, would only be repaid to the extent that other unsecured creditors are paid through the pro rata distribution of the estate proceeds.⁴¹

As explained in a moment, with the rise of structured finance, rating agencies began to disapprove of junior liens upon properties securing the loans included in mortgage-backed securities. This set the stage for the widespread adoption of the funding mechanisms that are the subject of this study, preferred equity investments and mezzanine loans.

C. Credit Ratings and the Rise of Preferred Equity Investments and Mezzanine Debt Financing

Securitization of mortgages first came to widespread use as a method to increase liquidity in the housing market, first by government-sponsored enterprises (GSE) and later by “private label” securities issuers as well.⁴² The GSEs and “private label” issuers buy mortgages from originating lenders, sell them to investors, and then take money from these sales to buy more mortgages, thus providing a continual, robust source of liquidity for the housing market beyond the traditional funding model where banks made loans from the deposits they received from customers.⁴³

Commercial Mortgage Backed Securities (CMBS) grew in prominence in the wake of the savings and loans crisis that traversed the threshold between the 1980s and 1990s.⁴⁴ Congress created the Resolution Trust Corporation (RTC) to bail out the thrift institution industry, which was imperiled by a dive in commercial real estate values.⁴⁵ The RTC’s mission was to liquidate the assets of insolvent thrifts as quickly as possible.⁴⁶ To do so, the RTC began to pool commercial mortgages, which made up the majority of the insolvent thrifts’ balance sheets, into CMBS for sale to investors.⁴⁷ After the RTC wound up its business, a private market of CMBS issuers continued to generate and sell CMBS.⁴⁸

The mortgage-backed securities (MBS) market provides liquidity to the real estate market in three ways. First, a great number of institutional

41. For the calculation of secured and unsecured portions of an allowed claim, see 11 U.S.C. § 506(a)(1). For the rules on pro rata distribution amongst unsecured creditors, see 11 U.S.C. § 726(a)(2) (providing that allowed unsecured claims take lower priority than allowed secured claims). *See also* 11 U.S.C. § 726 (b) (providing that all members of a class of claims shall receive pro rata distributions from the proceeds of the estate property’s liquidation).

42. FIN. CRISIS INQUIRY COMM’N, 112TH CONG., *THE FIN. CRISIS INQUIRY REP.* 425 (Comm’n Print 2011), *available at* <http://fcic.law.stanford.edu/report> (last visited Apr. 26, 2011) [hereinafter FCIC Report].

43. *Id.*

44. *See* Yevgeniya Drobitskaya, *TALF and Revenue Procedure 2009-45: New Hope for the Commercial Mortgage-Backed Securities Market*, 29 *REV. BANKING & FIN L.* 41, 41 (2010).

45. FCIC Report, *supra* note 42, at 425.

46. *Id.*

47. *Id.*

48. *Id.*

investors are able to invest in them under their investment guidelines, because their guidelines allow for such investors to invest in bonds while prohibiting investment in individual mortgages.⁴⁹ Second, the risk-based capital and reserve requirements for banks and insurance companies require lower capital reserves for bond holdings than for actual mortgage loans.⁵⁰ Lastly, the due diligence requirements for purchasing MBS are generally lower and the transaction documentation is simpler and less thorough because of the perceived risk mitigation provided by pooling, diversification, and tranching.⁵¹ Low diligence requirements and minimal documentation lower transaction costs. All of these factors combine to provide and free up more capital to feed the mortgage origination and securitization machine.

MBS are not only a method to feed the liquidity needs of the real estate market, but also provide what is perceived as a safe investment opportunity (although the recent financial crisis has cast doubt on this perception).⁵² Safety is provided in three ways as well. First, the creation of a pool of mortgages in a security rather than just one mortgage decreases the risk of material loss, because in order for the security to lose a significant amount of its value, many of the mortgages in the pool would have to go bad.⁵³ However, large single mortgages, typically large commercial mortgages, may be securitized standing alone, so pooling is not

49. See Alan R. Palmiter, *Staying Public: Institutional Investors in U.S. Capital Markets*, 3 BROOK. J. CORP. FIN. & COM. L. 245, 267 (2009) (“The guidelines [for public pension funds, major institutional investors,] place restrictive caps on private assets (such as . . . private mortgages), given their greater illiquidity and risk.”) (alteration in original).

50. See Basel Committee on Banking Supervision, *International Convergence of Capital Measurement and Capital Standards*, at 120, 20 (Revised Edition, *Basel II*, June 2004) (showing that the risk weight for the purposes of determining capital requirements for a AAA rated asset-backed security is 20%, at 120, while claims secured by commercial mortgages typically justify a risk weighting of 100%, at 20), available at <http://www.bis.org/publ/bcbs107b.pdf>.

The Basel III requirements are in the process of implementation worldwide, which will increase capital requirements in general, but see Hansen, et al., *A Macroprudential Approach to Financial Regulation*, J. ECON. PERSPECTIVES, (forthcoming July 2011) (explaining the difference between liquidity regulation and capital requirements, supporting the notion that liquidity may not be affected by capital requirement holdings), available at www.economics.harvard.edu/%2Ffaculty/%2Fstein/%2Ffiles/%2FJEP-macroprudential-July22-2010.pdf.

51. Firms generally took the position that these securities did not require careful scrutiny. See FCIC Report, *supra* note 42, at 168 (noting that Morgan Stanley’s head of due diligence had only two to five outside contractors reporting to him on due diligence for securitization pools).

52. But see Azam Amed, *Bonds Backed by Mortgages Regain Allure*, N.Y. TIMES DEALBOOK (Feb. 18, 2012 1:30 PM) (suggesting that the MBS market may be rebounding), available at <http://dealbook.nytimes.com/2012/02/18/bonds-backed-by-mortgages-regain-allure/>.

53. FCIC Report, *supra* note 42, at 43.

always used.⁵⁴ Second, these pools are often structured to provide diversification of asset class, geography, and borrower demographic.⁵⁵ Third, tranching of the securities further mitigates risk. Tranching is a process by which a security is divided into classes according to payment priority. Lower priority tranches absorb losses from failing assets underlying the security first. Therefore, tranching allows for investors to choose the tranche they wish to invest in based on their risk aversion.⁵⁶ Tranching is especially important in the context of a security backed by a single mortgage because the security does not benefit from the first two risk mitigation techniques listed here.

Investors in CMBS relied heavily upon risk analyses of the major credit rating agencies.⁵⁷ Rating agencies published guidance on what risk mitigation mechanisms these agencies wanted to see in the mortgages documents governing the underlying mortgage loans that backed CMBS,⁵⁸ which in turn drove the financial structure of the individual deals.⁵⁹ These agencies strongly discouraged securities packagers from including mortgages with more than one lien on the underlying property. In order to comport with this guidance, the originators of commercial mortgages began to include negative covenants in the senior mortgage that prohibited junior mortgages.⁶⁰

At the height of the credit bubble, commercial mortgage lenders would generally provide 65-75% or more of the capital needed to complete deals.⁶¹ Together with the recommendation against junior mortgages, the remaining financing gap required dealmakers to seek alternative funding mechanisms.⁶² As noted in the introduction, the need to refinance properties in the wake of the financial crisis of 2008 has created a new equity gap, the difference between the outstanding balance of the existing senior loan and the amount available from an alternative lender under a first mortgage loan to refinance the existing loan or fund the acquisition of a mort-

54. See *Few Big CMBS Loans Set to Mature in 2009*, Commercial Mortgage Alert (Nov. 22, 2008) (providing a discussion of single loans and participation interests in large loans that were securitized), available at <http://www.cmalert.com/headlines.php?hid=138222>.

55. Cf. FCIC Report *supra* note 42, Dissent n. 7, at 439 (criticizing the “bad analytic models” used by rating agencies that assumed the impossibility of a correlated downturn in housing across regions); See also, *id.* at 425 (speaking to diversification, generally).

56. FCIC Report, *supra* note 42, at 43.

57. Berman, *supra* note 7, at 94.

58. *Id.* at 98 (indicating the rating agencies make their criteria known by way of various public mediums).

59. See FCIC Report, *supra* note 42, at 206.

60. *Id.* at 100-101 (noting that all the major rating agencies discourage junior debts of any kind by proclaimed their adverse credit effect on senior debt, but that the agencies “abhor” junior mortgages because the underlying collateral is identical to the senior mortgage collateral).

61. Berman, *supra* note 7, at 104.

62. Joseph Forte, *Mezzanine Finance: A Legal Background*, in COMMERCIAL SECURITIZATION FOR REAL ESTATE LAWYERS 441-42 (2005).

gaged property. The legal and practical treatment of these mechanisms will be the same, no matter the source of the demand.

In order to fill this gap in financing, real estate dealmakers must find mezzanine level financing mechanisms that comport with the negative covenants in the senior mortgage or that will otherwise be permitted by the mortgagee. This article will look at two types of such mechanisms that have received considerable attention in the past few years: preferred equity investments and mezzanine debt.

III. PREFERRED EQUITY INVESTMENTS AND MEZZANINE DEBT FINANCING

A. *Preferred Equity and Mezzanine Debt – Capital Structure and Characteristics*

Preferred equity and mezzanine debt occupy a structurally subordinate position to the senior mortgage lender in the capital structure of a deal.⁶³ If the capital structure were to include both mezzanine debt and preferred equity, the mezzanine debt holders would take priority over the preferred equity holders, but where there is only one or the other, either would be second in line to the senior mortgage with any common equity holders subordinated below either of them.⁶⁴

The term “preferred equity” is very broad, denoting instruments or investment positions that exist on a spectrum from more equity-like to more debt-like.⁶⁵ On the equity end of the spectrum, for example, preferred equity may simply refer to an equity position that is entitled to payment before other equity holders out of cash flow, capital events, or both. A preferred member may also be entitled to a share of residual cash flow at the sale of the property.

Often, a preferred member will sacrifice a greater return at exit in exchange for more certainty during the life of the project, which leads us to the more debt-like end of the spectrum. For instance, the preferred member agreement may call for monthly or quarterly distributions at a fixed rate regardless of whether or not there is cash flow to sustain the distribution. It may also require a fixed, mandatory redemption date.⁶⁶ Instruments on the debt end of the spectrum tend to be treated as economic equivalents to mezzanine loans by market participants.⁶⁷ At this end of

63. Berman, *supra* note 7, at 79.

64. See Berman, Symposium, *A Festschrift in Honor of Dale A. Whitman: Risks and Realities of Mezzanine Loans*, 72 MO. L. REV. 993, 1000 (2007) (indicating that the mezzanine debt will always be senior to equity interests in the mortgaged collateral and the mortgage borrower).

65. For a discussion of preferred stock and its flexibility under Delaware law, see Gregg Schoenberg, *Business Valuations*, HBS Delaware Corporation & LLC Blog (Mar. 21, 2012), available at <http://blog.delawareinc.com/2009/04/101-preferred-stock/>.

66. See Berman, *supra* note 7, at 80.

67. See ACCOUNTING FOR CERTAIN FINANCIAL INSTRUMENTS WITH CHARACTERISTICS OF BOTH LIABILITIES AND EQUITY, Statement of Fin. Accounting Standards No. 150 (Fin.

the spectrum, a preferred equity instrument will have a rate of return similar to a mezzanine loan, but the preferred instrument may obtain a slightly better return because of its structurally subordinate position to any creditors of the entity in which the preferred equity member holds its interest and because they are likely subject to state law distribution constraints.⁶⁸

For the purposes of private equity real estate financing, mezzanine lending is “. . . lending to a borrowing entity or group of entities that directly or indirectly owns a real property-owning entity, which debt is secured by a perfected first security interest in the mezzanine borrower’s pledged ownership interests in the property owner. . . .”⁶⁹ While commercial real estate developers have long sought additional leverage beyond what is available through a first mortgage, with the advent of structured finance, combined with the danger of real estate bubbles followed by rapid devaluation in real estate values, lenders and rating agencies have sought additional protection for senior loans by avoiding second liens on real property.⁷⁰ The mezzanine loan is therefore intentionally not a mortgage, but a debt transaction secured by personal property interests, the membership interests in a lower level real property-owning entity.⁷¹

We now turn to an exposition of the organizational structures and relationship of entities in the capital structure of commercial real estate deals.

B. *Organizational Structures and Relationships*

Complex organizational relationships form the legal structure of commercial real estate projects with mezzanine loans and preferred equity investments in their capital structures. Typically, the senior lender requires the mortgage borrower to be a single purpose entity (SPE) that is bankruptcy-remote⁷² (hereinafter “Borrower SPE”) and that exists for the purpose of owning the underlying mortgaged property and to receive the senior mortgage proceeds from a lender (hereinafter “Senior Lender”) for the purchase of such property.⁷³ Where a mezzanine lender is part of the capital structure of a project, Senior Lenders will usually require an upper-tier entity to exist for the sole purpose of owning the membership interests

Accounting Standards Bd. 2003) (requiring firms to treat more debt like preferred instruments as debt on their balance sheets).

68. See *infra* Section III.G.2 for a discussion of distribution constraints and preferred equity positions.

69. James D. Prendergast, *Real Estate Mezzanine Lending Collateral Foreclosure Insurance Tailored to the Operation of the U.C.C. Is Not A Luxury - It's A Necessity*, PRAC. REAL EST. LAW 11, 12 (2011) (quoting DANIEL B. RUBOCK, MOODY’S INVESTORS SERV., US CMBS AND CRE CDO: MOODY’S APPROACH TO RATING COMMERCIAL REAL ESTATE MEZZANINE LOANS 3 (2007)), available at <http://dirt.umkc.edu/attachments/MDYMEZZ%20Loans.pdf>).

70. *Id.*

71. *Id.*

72. That is, the impact of such entity’s insolvency or bankruptcy has little or no effect on the other discrete entities in the organizational structure.

73. This article will assume that the SPEs are Limited Liability Companies (LLC).

in the Borrower SPE (hereinafter, "Owning SPE"). The Owning SPE then pledges the membership interests in the Borrower SPE as collateral for the mezzanine loan made directly to the Owning SPE.⁷⁴ Where the Borrower SPE is a limited partnership, generally the Owning SPE will own all of the limited partnership interests in the Borrower SPE and will own all of the shares or member interests, as applicable in the sole general partner of the Borrower SPE. In this way, the Owning SPE owns, directly and indirectly, 100% of the equity in the Borrower SPE.

In the case of preferred equity members, the Senior Lender will also generally require the Owning SPE structure described above. The preferred equity member will hold its preferred membership interests in the Owning SPE.⁷⁵ The existence of the Owning SPE has the effect of eliminating any direct recourse available to any Owning SPE investors or debt holders to the underlying property, which is owned by the Borrowing SPE, thus comporting with the prohibitions against junior liens on the property in the senior mortgage agreement.⁷⁶

Typically, a sponsor party (hereinafter, "Sponsor") will bring the transaction to the financing source, be it a mezzanine lender or a preferred equity investor. The Sponsor, or a wholly-owned subsidiary of the Sponsor, will generally be the managing member of the Owning SPE. The Sponsor will contribute capital at the common equity level and then seek out a preferred member or a mezzanine lender to contribute to filling the remaining gap in financing needed to consummate the project. Together, the preferred member and the Sponsor provide the capital to an Owning SPE, which, in turn, owns all the shares of the mortgage Borrower SPE.⁷⁷

Similarly, in the mezzanine financing scenario, the Sponsor owns and controls the Owning SPE that, in turn, owns all the membership interests of the Borrower SPE, and the mezzanine loan flows to the Owning SPE.⁷⁸ Thus, the highest tiers of the structure of these organizational relationships differ, while the foundations are generally similar. While there are many

74. See Prendergast, *supra* note 69, at 11-12 (defining mezzanine loan in a real estate context as "lending to a borrowing entity or group of entities that directly or indirectly owns a real property-owning entity, which debt is secured by a perfected first security interest in the mezzanine borrower's pledged ownership interests in the property owner"). See also Berman, *supra* note 64, at 999 (noting that the lenders require mezzanine borrowers to be special-purpose, bankruptcy-remote, entities).

75. *Id.* at 79.

76. Berman, *supra* note 64, at 1000 (showing that collateral for a mezzanine loan, though related to the cash flows and value of the property that forms the security interest for the senior mortgage, is the shares of the SPE and, therefore, recourse is limited to foreclosure on such shares. The same is true for preferred equity members, whose recourse for nonpayment is limited to the assumption of control of the SPE).

77. Many times, these capital sources will not fill the total gap. The remainder would in that case be filled by other debt or common equity investments.

78. Berman, *supra* note 64, at 1016 (noting that mezzanine lender owns "Equity Interests in special purpose entities with no assets other than equity ownership in yet another entity that may directly or indirectly own the underlying 1016 real property which is itself subject to a securitized first mortgage.").

variations in the structure of these deals, for the purposes of this article, the authors will assume the structures as outlined here. Figures 1 and 2 illustrate these structures and the actors involved in simplified form.

The mezzanine lender’s relationship with the Owning SPE is memorialized in a loan agreement and the membership interests of the Borrower SPE are pledged through a pledge agreement. The mezzanine lender is also party to an inter-creditor agreement that defines the mezzanine lender’s relationship with the Senior Lender. The preferred member’s equity position is memorialized in the operating agreement of the Owning SPE.

FIGURE 1: SIMPLIFIED STRUCTURE WITH MEZZANINE LOAN

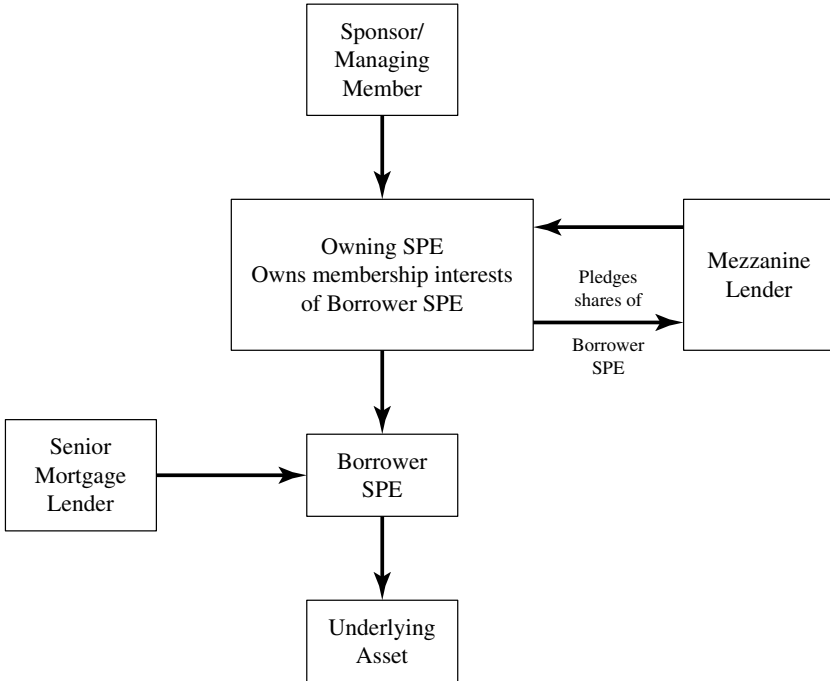
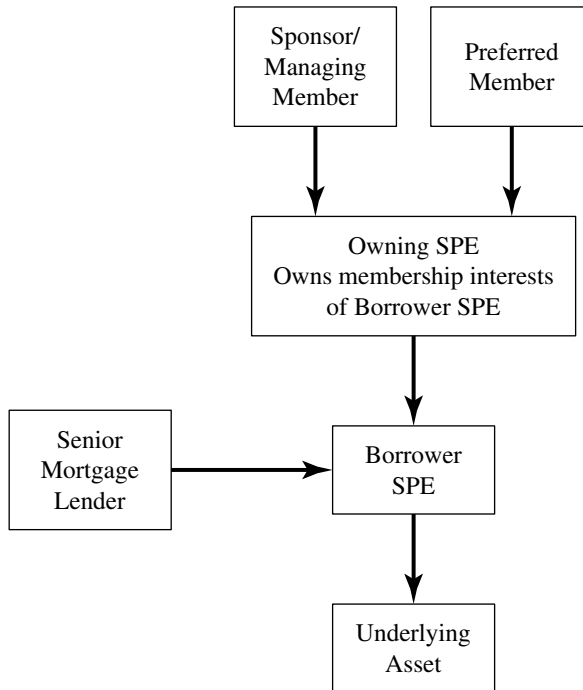


FIGURE 2: SIMPLIFIED PREFERRED EQUITY STRUCTURE



C. Remedies upon Default or Breach

In the event of default on the mezzanine loan agreement or breach of the preferred member rights under the operating agreement, the remedies differ in both procedure and substance.

In a case where the Owning SPE defaults on its mezzanine debt, the mezzanine lender may foreclose on the security interest it maintains on the Borrower SPE membership interests.⁷⁹ The mezzanine lender then must try to sell the membership interests to collect on its investment, usually through a collateral auction.⁸⁰ Alternatively, with the debtor's post-default consent, the mezzanine lender may simply retain the equity interests in full or partial satisfaction of the secured debt in accordance with procedures outlined by the UCC.⁸¹ Often the mezzanine lender is unable to find a buyer for the pledged interests at an acceptable price and is forced to buy them itself generally with a credit bid in an amount equal to some portion or, occasionally, all of the mezzanine loan debt amount. This results in the mezzanine lender effectively stepping into the shoes of the Owning SPE because the mezzanine lender takes over the membership

79. See Berman, *supra* note 7, at 108.

80. See DEL. CODE ANN. tit. 6, § 18-702 (2012) (providing that the membership interests in a limited liability company are assignable).

81. See U.C.C. § 9-620 (2000) for procedures for acceptance.

interests in the Borrower SPE through the UCC sale.⁸² Upon the sale of the security interests of the mezzanine lender to itself or the acceptance of the collateral as partial or full satisfaction of the obligations under the loan agreement, the Sponsor's indirect equity position in the Borrowing SPE (via its membership interest in the Owning SPE), along with any other equity holder's position is wiped out.

In the case of the preferred equity member, the process is more direct. Where the SPE fails to meet its obligations under the operating agreement, the preferred member usually assumes management control by replacing the Sponsor as the managing member of the Owning SPE and often the Sponsor loses all or almost all voting and other decisional rights.⁸³ While both the preferred equity member and the mezzanine lender end up controlling the Borrowing SPE, the mezzanine lender extinguishes the Sponsor's rights and interest in the asset because it takes ownership of membership interests of the Borrower SPE, which owns the asset property, through the UCC sale. The preferred member generally does not extinguish the Sponsor's economic rights. Under most agreements, after the change of management control, the preferred member is often entitled to receive all free cash flow and capital event proceeds, to the exclusion of the Sponsor, until all of its accrued preferred return has been paid and the full amount of its equity investment has been returned. Additionally, many agreements provide for an increased rate of return to the preferred member following a change of control event.

Compare this with the mezzanine lender's recourse in terms of timing: the mezzanine lender, governed by the applicable state law version of the UCC, must undergo a process for the public sale⁸⁴ of the collateral. Such a sale takes time, and money to orchestrate. In both the cases of a preferred equity investment and a mezzanine loan, the holder of the investment instrument is likely to be an outsider to the day-to-day management of the Owning SPE and the Borrower SPE and therefore will have limited information on the details of the company. As result of its potentially limited information, such holders may want to do additional due diligence on environmental compliance and other strict liability regimes prior to assuming control of the Borrower SPE.⁸⁵

Moreover, there may be additional administrative costs to ensure that the sale of the collateral is commercially reasonable under UCC § 9-610(b). Factors considered for the reasonableness of the sale include:

82. *Id.*

83. Forte, *supra* note 62, at 442 (commenting that foreclosure on the shares is unnecessary because the preferred equity member already owns the shares).

84. See Berman, *supra* note 64, at 1016 for a discussion of why the mezzanine lender chooses to sell the collateral at a public sale.

85. See *e.g.*, RESOURCE CONSERVATION AND RECOVERY ACT, 42 U.S.C. § 6901 (1976). See BROWN, ET.AL, 1 RCRA AND SUPERFUND: A PRACTICE GUIDE § 5:30 (3d ed. 2011) (noting that the standard is strict liability, codifying an expanded version of the common law public nuisance standard).

whether it was disposed of “in the usual manner on any recognized market,” “at the price current in any recognized market,” or the sale is “otherwise in conformity to commercial practices,”⁸⁶ or is approved by creditors or the judiciary.⁸⁷ The issue of price can be particularly vexing for the mezzanine lender in this context because there is a small market for the membership interests in the Owning SPE. Therefore, as Berman notes, the mezzanine lender “is left with the circular definition that a commercially reasonable sale is one that is ‘otherwise in conformity with reasonable commercial practices.’”⁸⁸

Where the proceeds received from the UCC auction—whether from a third party bidder or, as a result of a credit bid from the mezzanine lender—are less than the outstanding amount of the debt, the mezzanine lender may be able to seek a deficiency judgment against the mezzanine borrower or any guarantor to attempt to recoup more of its investment. But this would depend on whether the mezzanine loan agreement provided for recourse or, as is more typical, non-recourse.⁸⁹ A non-recourse loan is one where the lender is limited to the collateral pledged for satisfaction of the obligations under the agreement.⁹⁰ Under a non-recourse loan, therefore, the mezzanine lender could not look to the Owning SPE itself for satisfaction of the mezzanine loan obligations, foreclosing the opportunity to seek a deficiency judgment. In the world of single asset real estate mezzanine lending, the Owning SPE will generally not have any assets other than the pledged equity in the Borrower SPE, and so the personal recourse to the Owning SPE is generally meaningless as a practical matter.

Often, the mezzanine loan documents will provide for recourse for certain acts or certain types of liabilities. To make this recourse meaningful, the mezzanine lender will require that such recourse liabilities be guaranteed by someone other than the Owning SPE. If the non-recourse loan or preferred equity investment has a non-recourse carve-out, it will be guaranteed by specific people for amounts resulting from specified acts.⁹¹ The goal of non-recourse carve-outs is to provide incentive against filing for bankruptcy⁹² and other bad acts specified in the carve-out guaranty by

86. U.C.C. § 9-627(b) (2007).

87. *Id.* § 9-627(c) (2007).

88. Berman, *supra* note 64, at 1017.

89. See Glenn G. Munn, *Recourse*, *ENCYCLOPEDIA OF BANKING AND FINANCE* 578, available at <http://hdl.handle.net/2027/mdp.35112101457119?urlappend=%3Bseq=586>, for a standard definition of recourse.

90. See *Geyer v. Ingersoll Publications Co.*, 621 A.2d 784, 793 n. 6 (Del. Ch. 1992).

91. “Non-Recourse Carve-out” is a misnomer, though widely used in the industry. The mechanism in fact carves out a portion of a larger non-recourse loan and provides recourse to the lender for a specified amount from specified guarantors, which would cut in favor of calling it a “recourse carve-out.” See *In re Extended Stay Inc.*, 418 B.R. 49, 54 (Bankr. S.D.N.Y. 2009) (describing a “non-recourse carve-out” as a guaranty agreement entered into with respect to a non-recourse mezzanine loan).

92. *Id.* at 60.

ensuring the guarantors' liability on debts of a bankrupt entity is not discharged with the debtor's personal liability for the debt.⁹³

If the mezzanine loan document provides for recourse, or to the extent that there was a non-recourse carve-out, the mezzanine lender will have to show commercial reasonableness of the sale in order to seek a deficiency judgment and to enforce it against the guarantor.⁹⁴ Many pledge agreements for mezzanine loans contain safe harbor provisions that provide for an agreed process for the UCC sale that, when followed, parties will deem the sale per se commercially reasonable. Such a safe harbor is intended to forestall the debtor from challenging the commercial reasonableness of the sale and to provide an indication of what the parties agreed to be commercially reasonable terms. In all cases, however, a sale must be commercially reasonable, and any challenge to the commercial reasonableness of the sale made in any action brought by the mezzanine lender upon any deficiency or in any other challenge to the sale would certainly, even if unsuccessful, add to litigation costs performed under the billable hour of counsel.

D. *Perfection of Mezzanine Loan Collateral*⁹⁵

One issue particular to mezzanine loans is the perfection of the security interest in the collateral shares of the Borrower SPE. The collateral shares of the Borrower SPE will be governed by Article 9 of the Uniform Commercial Code (UCC) unless they are considered investment securities, in which case they will be governed by Article 8 and by Article 9.

In order to be considered an investment security and therefore be governed under Article 8, the issuer (for our purposes, the Borrower SPE) must expressly opt for its equity interests to be governed by Article 8 in its constitutive documents and, if the interests are represented by a certificate, the certificate must contain a legend stating that the interest represented by the certificate is governed by Article 8.⁹⁶ In a case where the issuer opts for Article 8 governance, the interests are governed by Article 8 as "securities", and Article 9 as "investment property."⁹⁷

For consistency, the authors will continue to generally assume that the Owning SPE and the Borrowing SPE are limited liability companies, al-

93. 11 U.S.C. § 524(e) (2006) (providing that, as a general matter, the effect of discharge of a debtor does not affect the liability of another any other entity with respect to the discharged debt).

94. *See, e.g., Vornado PS, L.L.C. v. Primestone Inv. Partners, L.P.*, 821 A.2d 296, 315 (Del. Ch. 2002), *aff'd sub nom.* 822 A.2d 397 (Del. 2003) (holding that lender showed commercial reasonableness and therefore deficiency judgment challenge by borrower failed).

95. Berman, *supra* note 64, at 998. Andrew Berman has expertly described the process for perfecting a security interest under Article 9 and much of this section will follow his outline. Citations will be made to the U.C.C. where universally true and to Berman where the authors of this study draw upon insights unique to his work.

96. U.C.C. § 8-102(15) (1994).

97. Berman, *supra* note 64, at 1003.

though these SPEs can be limited partnerships or, theoretically (though rare in practice), corporations.⁹⁸ In general, the concepts discussed in this article apply the same to limited partnerships as to limited liability companies, notwithstanding that the terms of the discussion refer to limited liability companies. However, limited partnerships and limited liability companies are creatures of state statutes, and the laws with respect to them, including, potentially the laws of fiduciary duty, vary not only between jurisdictions but between limited partnerships and limited liability companies. As such, when considering any particular situation in a given jurisdiction, it is imperative to consider the laws applicable to the subject entity in the relevant jurisdiction.

Where the operating agreement of a limited liability company does not explicitly opt for Article 8 governance, Article 9 will apply to the membership interests of a limited liability company. Article 9 covers security interests in personal property.⁹⁹ Under state law, the membership interests of a limited liability company are considered personal property.¹⁰⁰ Similarly, most take the position that membership interests are a species of “general intangibles,” which are personal property governed by Article 9.

Where a party pledges personal property as security for a loan, such security interest becomes attached to the property when it becomes enforceable.¹⁰¹ Enforceability arises when the lender disburses funds (i.e., transmits “value”),¹⁰² the debtor holds the right to the collateral and the power to transfer that right to the secured party, and the debtor grants the security interest to the secured party. This grant may be evidenced in any of a number of ways, including the borrower signing (“authenticating”)¹⁰³ a document pledging the security interest or the delivery of certificated collateral to the secured party.¹⁰⁴ An important issue to flag for the potential mezzanine lender with security interests governed by Article 9 is that its security interests must be perfected according the process outlined

98. *Id.* at 999. Most often the Owning SPE will be incorporated as a limited liability company (LLC), in which case its equity would not be a security under Article 8 unless it is traded on a securities exchange, it is issued by an investment company or the limited liability company’s operating agreement explicitly states that its equity takes the form of securities governed by Article 8. *See id.* at 998; *see also* U.C.C. § 8-103(c) (1994).

99. U.C.C. § 9-109(a)(1) (2000).

100. *See* Berman, *supra* note 64, at 1000. *See e.g.*, DEL. CODE ANN. tit. 6, § 18-702 (2012) (providing that the membership interests in a limited liability company are assignable, a right commonly signaling a property interest).

101. U.C.C. § 9-203(a) (2000).

102. *See id.* § 1-201(44) (defining value):

[A] person gives ‘value’ for rights if he acquires them (a) in return for a binding commitment to extend credit or for the extension of immediately available credit whether or not drawn upon and whether or not a chargeback is provided for in the event of difficulties in collection; or (b) as security for or in total or partial satisfaction of a pre-existing claim; or (c) by accepting delivery pursuant to a pre-existing contract for purchase; or (d) generally, in return for any consideration sufficient to support a simple contract.

103. *See id.* § 9-102(a)(7)(A).

104. *See id.* § 9-203(b)(3).

above before any other lenders with security interests in the same property if it wants to have the highest priority amongst the Owing SPE's creditors.¹⁰⁵

Berman notes that many mezzanine lenders, rating agencies, and title companies, circa 2007, began to require borrowers to certificate in registered form the pledge membership interests and expressly opt for Article 8 to govern as added protection for security interests, because the perfection by delivery of a registered certificate under Article 8 is given higher priority in liquidation than a perfection by filing, even if the filing is done first.¹⁰⁶

We now turn to the relationship of the mezzanine lender and the preferred member to the Senior Lender via the inter-creditor agreement.

E. *Rights vis-a-vis Other Creditors*

Defaults upon the senior mortgage agreement are almost always events of default upon the mezzanine loan or preferred equity investment.¹⁰⁷ Conversely, defaults upon the mezzanine loan or the preferred investment are almost never events of default under the senior mortgage agreement.¹⁰⁸ When the preferred member takes over management of the Owing SPE or the mezzanine lender takes ownership of the Borrower SPE, typically the inter-creditor agreement will require that an updated non-consolidation opinion to be delivered.¹⁰⁹ Non-consolidation opinions are issued by the Owing SPE counsel and represent that in the opinion of counsel the organizational structure of the Owing SPE (of the mezzanine lender standing in the same position as the Owing SPE after realizing upon its collateral) will not be consolidated with any other entity or persons.¹¹⁰ The Senior Lender would want this opinion to ensure that financial problems of the members or affiliates of upper-level entity will not result in the mortgaged property being subject to a bankruptcy filing.

The inter-creditor agreement may also call for the new controlling party to grant a carve out guaranty for the senior loan.¹¹¹ It may require a

105. *See id.* § 9-322.

106. Berman, *supra* note 64, at 1004. *See also*, U.C.C. § 8-106 (1994) (providing definition of "control" as delivery).

107. *Cf.* CRE FINANCE COUNCIL, INTERCREDITOR AGREEMENT 19 (1999), available at <http://www.crefc.org/WorkArea/linkit.aspx?LinkIdentifier=ID&ItemID=10064> (giving right to cure default on senior loan to mezzanine lender, the curing of which would likely not occur without some calling of default on the mezzanine borrower, the Owing SPE) (last visited June 29, 2012).

108. *See, e.g., id.* at 14-16 (Modifications, Amendments, etc. and Subordination of Mezzanine Loan and Mezzanine Loan Documents).

109. *See generally, id.* at 12-13 (Foreclosure of Separate Collateral).

110. *See* Gordon L. Gerson, *Special-Purpose Bankruptcy Remote Entities*, GERSON LAW FIRM, 3, available at www.gersonlaw.com/images/content/specialpurpose_bankruptcyremote_entities.pdf (last visited Mar. 29, 2012).

111. *See* CRE FINANCE COUNCIL, INTERCREDITOR AGREEMENT 13 (1999) (Foreclosure of Collateral Subsection (A)).

new environmental indemnity agreement and the placement of a qualified property manager as the managing member of the Owning SPE to manage the underlying property.¹¹² Lastly, the inter-creditor agreement may impose cash management requirements at the Borrower SPE level to ensure that cash is not improperly diverted from the Borrower SPE to the Owning SPE.¹¹³

It is important to note that while Senior Lenders have occasionally granted inter-creditor agreements similar to mezzanine inter-creditor agreements to preferred equity investors, the preferred equity investor often receives much less from the Senior Lender. At a minimum, it is important that the preferred equity investor obtain an agreement from the Senior Lender that a replacement of the Sponsor as the managing member by preferred equity member upon a default under the operating agreement will not result in a violation of the transfer restrictions under the senior loan documents or otherwise constitute a default. In exchange for such an agreement, the Senior Lender may require the preferred equity investor to provide a suitable carve-out guaranty at the time of its take-over of management of the Owning SPE. In addition, it is important that the preferred equity investor receive notice from the Senior Lender of any defaults or events of default.

Each of these items is provided to the mezzanine lender in the standard inter-creditor agreement (and the mezzanine lender is not always required to post a new carve-out guaranty, at least if the existing carve-out guarantor is not removed). In addition, the inter-creditor agreement typically provides the mezzanine lender, among other things, specified cure rights in addition to any cure rights that Borrower SPE may have. The inter-creditor agreement may also provide the mezzanine lender with a right to purchase the senior loan at par, and potentially without the payment of default interest, certain late fees and, sometimes, yield maintenance premiums, after a senior loan event of default and before the completion of foreclosure.¹¹⁴

As a matter of structural priority, any creditor of the Borrowing SPE will take priority over the rights of either the preferred member or mezzanine lender. The reason for this is plain: after a takeover, the new owner of the Borrower SPE membership interests or the new controller of the Owning SPE will necessarily be subject to the absolute priority rule¹¹⁵ and any statutory requirement to make distributions flow to creditors first

112. *Id.*

113. *Id.*

114. *See id.* at 13-14.

115. *See* Mark G. Douglas, *Application of the Absolute Priority Rule to Pre-Chapter 11 Plan Settlements: In Search of the Meaning of "Fair and Equitable,"* JONES DAY (May/June 2007), available at <http://www.jonesday.com/newsknowledge/publicationdetail.aspx?publication=4313> (explaining that the absolute priority rule is a creature of bankruptcy jurisprudence and Chapter 11, but the principle exists beyond the Chapter 11 context).

before any equity holders.¹¹⁶ Before any distributions can flow up to the equity owners of the Borrower SPE, the debt at the Borrower SPE level must be serviced.

Where preferred investments and mezzanine loans differ is at the Owning SPE level. In terms of the ability to realize upon collateral, the mezzanine lender will not be subject to any other creditor of the Owning SPE assuming its security interest is perfected and its perfected interest has priority over any other pledged membership interests.¹¹⁷ To the extent that the proceeds from the UCC sale of the collateral does not cover the total outstanding obligations under the mezzanine loan document, the sale has the effect of eliminating all junior liens filed against the collateral,¹¹⁸ provided that proper notice is given to junior lienholders.¹¹⁹ The mezzanine lender's sale of collateral at auction does nothing to alter the debts of the Owning SPE, but those debts are irrelevant to the mezzanine lender unless it seeks a deficiency judgment against the Owning SPE. The Owning SPE is no longer part of the capital structure of the project when the mezzanine lender takes control of the membership interests in the Borrower SPE. As the new owner of the Borrower SPE, however, the mezzanine lender will be subject to all of the debts of the Borrower SPE and to all liens upon the property owned by the Borrower SPE.

The preferred member, on the other hand, will remain subject to the creditors of the Owning SPE, if any exist, because the Owning SPE remains the owner of the Borrower SPE (i.e., the property owner) after the preferred member takes over the managing member position. In addition, the preferred member will remain subject to and debts of the Borrower SPE and to any liens upon the Property owned by the Borrower SPE. There may be instances where the preferred member could challenge as unauthorized those debts of Owning SPE or Borrower SPE that the Sponsor caused the Owning SPE or the Borrower SPE to incur prior to preferred equity member's taking control of the Owning SPE without preferred equity member's consent, if and to the extent that such consent was required under the Owning SPE's operating agreement before the change of management control.¹²⁰

One issue for preferred members in attacking debts incurred or liens or other transfers granted by an SPE under a Sponsor's direction, where Sponsor lacked the actual authority to cause the SPE to incur such debt or grant such lien or other transfer, is the issue of apparent authority.¹²¹ Even though the Sponsor did not have the actual authority to cause the

116. *See, e.g.*, DEL. CODE ANN. tit. 6, § 18-804 (2012).

117. U.C.C. § 9-322 (2000).

118. *See id.* § 9-615(a) (2000) (providing that the application of proceeds goes first to the administrative costs of the U.C.C. sale, then to satisfying the obligations secured by the senior security interest, then to subordinated security interest holders).

119. *See id.* §9-614 (providing the information necessary for a sufficient notice).

120. *See* RESTATEMENT (THIRD) OF AGENCY § 2.01 (2006).

121. *See id.* §2.02.

SPE to take such action (because such action required the consent of the preferred equity member under the terms of the applicable operating agreement and such consent was not given), the Sponsor may have had the apparent authority to take such action and it may have been reasonable for third parties to rely upon the Sponsor's representations that it did have such authority.

The rules of thumb for the preferred member are to negotiate for greater control of the debts that can be taken on under the limited liability company agreement, to prevent the incurrence of unwanted debts prior to preferred member's taking control of Owing SPE, and to give notice to all who may reasonably rely on the Sponsor holding himself out as an agent of the venture after Sponsor has been replaced by preferred member as the managing member.

One way for the preferred member to obtain some protection from creditors who extend credit based on the apparent authority of the Sponsor is to have the Owing SPE's and Borrower SPE's articles of organization, certificate of formation or certificate of limited partnership (that are required to be filed with the secretary of state for the state where such SPE is organized) expressly refer to the consent rights of the preferred member with respect to specified major decisions. For many types of transactions, such as making mortgage loans, it is standard practice for the lender or its title company to review the organizational documents of the borrower or grantor that are on file with the secretary of state of the state of the entity's formation. If such organizational documents clearly show that the consent of the preferred member is necessary to authorized the contemplated transaction, then it becomes more difficult for the creditor to claim that its loan or lien is binding upon the SPE on the basis of apparent authority, because it has been put on notice that Sponsor did not have the actual authority to authorize such matter. Any such filings with the secretary of state should be promptly updated to show the preferred equity member as the managing member upon any change in control of the SPE, so as to put the world on notice that the preferred member and not Sponsor is now the managing member.

While battles over whether or not a particular debt, lien or other transfer was authorized by either actual or apparent authority can be difficult, the existence of the consent right over such matters typically included within a preferred member's major decision rights provides a potential advantage to the preferred equity investor over the mezzanine lender. While the mezzanine lender takes free of any liens or debts of the Owing SPE (provided that mezzanine lender was properly perfected with first priority in the pledged equity), it is subject to any debts or liens of Borrower SPE, even if those were incurred or granted in violation of the terms of the mezzanine loan documents. Although there are potentially some additional considerations (such as whether or not the preferred equity investor benefited from the unauthorized transaction), the preferred equity investor, however, may not be subject to such burdens to the extent that it can

show that the Sponsor had neither the actual nor the apparent authority to authorize the loan, encumbrance, or transfer. In addition, the mere fact of the existence of preferred equity member's rights, may effectively prevent the Sponsor from incurring such burdens, particularly where third parties have notice of preferred member's rights either as a result of the terms of the filed organizational documents of the SPE.

Mezzanine lenders and preferred members will want to protect themselves from acts of the Sponsor contrary to the relationship outlined in the operating agreement. These are generally referred to as Sponsor "bad boy" acts.

F. *Sponsor Bad Acts*

Non-recourse carve-out guarantees, or "bad boy" guarantees, are a standard requirement of CMBS mortgage loans, of mezzanine loans and of those preferred equity investments that are the functional equivalent of mezzanine loans (the type of preferred equity investment generally discussed in this article).¹²² Such guarantees are much less common and, where they exist at all, are much more limited, in the context of those preferred equity investments structured closer to a typical joint venture equity investment rather than to a mezzanine loan equivalent.¹²³ The bad boy guarantees across the three asset classes (CMBS loans, mezzanine loans and preferred equity) are generally, at their core, very similar. There are some differences that are typically found, but the similarities outweigh the differences, and we begin with them.

The guarantor's liability under a typical non-recourse carve-out guaranty is bifurcated into two broad categories: (i) liability for losses suffered by the mortgage lender, mezzanine lender or preferred equity investor (each an "*Obligee*") as a result of certain acts of borrower or its affiliates, and (ii) liability for the entire amount of the debt (including all principal, interests and costs) upon the occurrence of certain acts or circumstances, regardless as to whether or not the Obligee suffers a loss as a result of such acts or occurrences.

The first category, liability for losses, typically includes many things that one would generally consider to be "bad acts," including for example: waste of the mortgaged property; fraud or material misrepresentation of the Sponsor, borrower or guarantor; or misappropriation of rents or insurance or condemnation proceeds.¹²⁴ Also, often included in the "losses" section, is a guaranty by the guarantor of all of Borrower SPE's obliga-

122. See John C. Murray, *Carveouts to Nonrecourse Loans: They Mean What They Say! Clauses in Commercial Loan Agreements That Provide for Personal Borrower Liability Really Are Enforceable*, 19 PRAC. REAL EST. L. 19 (2003) (noting that non-recourse carve-outs have been required for mortgages since the mid-1980s).

123. The authors speculate that this may be due to lower agency costs with the more equity-like preferred investment because the preferred member has more control and access to information under the operating agreement.

124. See Murray, *supra* note 122, at 23 for a list of "bad boy" acts.

tions under any environmental provisions of the transaction documents, including any environmental indemnity.¹²⁵ In many transactions, the guarantor is actually made a jointly and severally liable party to an environmental indemnity¹²⁶ and, in those cases, environmental liability may not also be covered in the carve-out guaranty.

The second category, full recourse, is often referred to as “springing” recourse.¹²⁷ Events that typically spring the loan or preferred equity investment to full recourse include the voluntary bankruptcy of Borrower SPE, or in the case of a mezzanine loan or preferred equity investment, Owing SPE; the Borrower SPE, Owing SPE, Sponsor or, often guarantor, consenting to or colluding in the filing of an involuntary bankruptcy; a transfer of the property or of the direct or indirect equity in the Borrower SPE in violation of the transaction documents; or a violation of the single purpose, bankruptcy remote entity covenants (i.e., the SPE provisions) of the Borrower SPE, or in case of a mezzanine loan or preferred equity investment, Owing SPE.¹²⁸

When negotiating a carve-out guaranty at loan closing, guarantor’s counsel needs to pay particular attention to any provisions imposing liability in connection with any violation of any of the SPE provisions. This special attention is necessary because the SPE covenants are often quite broad and may include covenants that are outside of the control of the Sponsor, including, for example, a covenant that the SPE remain solvent. Recently, many state courts have construed these springing recourse provisions strictly, much to the chagrin of the guarantors.¹²⁹ Therefore, it is

125. *Id.*

126. See Mark S. Dennison, *Validity and Applicability of Contractual Allocations of Environmental Risk*, 34 AM. JUR. PROOF OF FACTS 465 (3d ed. 1995) (discussing of indemnity agreements in the context of CERCLA litigation and the nature of environmental indemnities, or “risk-shifting” contractual language).

127. See TALCOTT J. FRANKLIN, ET AL., MORTGAGE AND ASSET BACKED SECURITIES LITIGATION HANDBOOK § 7:23 (2008) (citing to *Blue Hills Office Park LLC v. J.P. Morgan Chase Bank*, 477 F. Supp. 2d 366 (D. Mass. 2007) (noting that this springing, full, recourse carve-out was enforced). *But see* MICHAEL T. MADISON, ET AL., 2 LAW OF REAL ESTATE FINANCING § 15:6 (2011) (indicating that springing guarantees are not always full recourse).

128. See 2 Law of Real Estate Financing *supra* note 127; *see also*, *Wells Fargo Bank NA v. Cherryland Mall Limited P’ship, et al.*, 2011 Mich. App. LEXIS 2360 (Mich. App. 2011) (outlining SPE provisions and possible liability for their breach); CRE FINANCE COUNCIL, MORTGAGE AND SECURITY AGREEMENT, Art. 1.1, *available at* <https://www.crefc.org/WorkArea/linkit.aspx?LinkIdentifier=ID&ItemID=13150>.

129. See *In re Wells Fargo Bank NA*, 2011 Mich. App. LEXIS 2360 (holding a full recourse carve-out enforceable against guarantor). *See also*, *Bank of America, N.A., v. Lightstone Holdings, LLC*, 938 N.Y.S.2d 225 (N.Y. 2011) (holding \$100MM carve out enforceable); *CSFB 2001- CP-4 Princeton Park Corporate Center, LLC v. SB Rental I, LLC*, 410 N.J. Super. 114, 980 A.2d 1 (App. Div. 2009) (holding that carve out was not a liquidated damages clause not an unenforceable penalty and that carve out was enforceable even after borrower cured breach); Susan C. Tarnower, et al., *Enforcement of Guarantees Securing Commercial Real Estate Loans*, PROB. & PROP. 40 (March/April 2011) (arguing that there has been a surge recently in lenders pursuing of guarantors and that this may be due not only to increased defaults but may also represent a new strategy for recovering on defaulted loans).

important that a guarantor review the proposed guaranty closely with counsel before agreeing to execute and deliver it.

Generally where there are differences between carve-out guaranties for mezzanine loans or preferred equity transactions and those for mortgage loan transactions, the differences relate to the fact that the mezzanine lender or preferred equity provider does not have a lien upon the real estate and is in a structurally subordinate position to creditors of the Borrower SPE. So, for example, it is more typical to find in a mezzanine loan or preferred equity carve-out guaranty than in a mortgage loan carve-out guaranty, recourse for:

- (i) any liens filed upon the property without the Obligee's consent;
- (ii) title exceptions not approved by the Obligee;
- (iii) actions taken by the Sponsor, guarantor, Owing SPE or Borrower SPE to impair or impede Obligee's enforcement of its rights and remedies under the transaction documents, and this liability sometimes is full springing recourse;
- (iv) liability for violations of cash management provisions of the loan documents; and
- (v) liability for the occurrence of mortgage loan events of default that cannot be cured by the Obligee.¹³⁰

For the Obligee, the identity of the guarantor is very important. Typically the lender or investor wants the individual (a "warm body") or individuals who have ultimate control over the Sponsor to serve as the guarantor. In circumstances where a Sponsor is successful in negotiating for the Obligee to accept an entity rather than an individual guaranty, the Obligee will require that the guarantor entity have substantial net worth and liquidity and control over the management and policies of the Sponsor, the Owing SPE and the Borrower SPE, as applicable.

An example of a situation where entity guarantors are fairly common is where a substantial private equity fund is the Sponsor and its wholly owned and controlled subsidiary is either the Sponsor member in the preferred equity joint venture, the Owing SPE or the Borrower SPE. Often, whether the guarantor is an individual or an entity, the lender or preferred equity investor will require net worth and liquidity covenants. While the wherewithal to make good upon the guaranty is, of course, important, it is essential to know that these carve-out guarantees are not credit guarantees.

A debt service or full or partial payment guaranty is generally obtained for credit support, and serves to protect the Obligee when the property and its cash flow are not sufficient on a stand alone basis to satisfy the underwriting requirements for the loan or preferred equity investment. The carve-out guaranty, on the other hand, is primarily an *in terrorem* guaranty. Its primary purpose is to ensure that the Sponsor does not permit the Borrower SPE or, in the case of a mezzanine loan or preferred

130. Sample Agreements on file with Authors.

equity investment, the Owing SPE or Sponsor member of the Owing SPE to engage in or permit the occurrence of any “bad acts.”¹³¹

In light of these characteristics of guarantees, the lender or preferred equity investor will want to ensure that the guarantor has control of the Borrower SPE, the Owing SPE, in the case of a mezzanine loan, or the Sponsor, in the case of a preferred equity investment. If more than one individual or entity has ultimate control of the applicable entities, then each person or entity having such control should be a guarantor. A good rule of thumb is that (ignoring the consent required of any independent directors) any person or entity that could cause the Borrower SPE, the Owing SPE, in the case of a mezzanine loan, or the Sponsor, in the case of a preferred equity investment, to file for bankruptcy should be a guarantor.

A final key point for lenders and preferred equity investors about carve-out guarantees is to not underestimate the importance to the transaction of having a strong guaranty from a credit-worthy control party. In many instances, the only thing that prevents a Sponsor from filing the applicable of the Borrower SPE or the Owing Entity into bankruptcy to forestall a lender’s or preferred equity investor’s exercise of its remedies is the existence of the carve-out guaranty. While the guaranty is ultimately of little utility if the guarantor is itself in bankruptcy or otherwise judgment-proof, when the guarantor is solvent, the recourse carve-out guaranty is a very powerful tool for ensuring sponsor’s cooperation when a loan or preferred equity investment goes bad.

We now turn our sights to the U.S. bankruptcy regime as it applies to these deals, starting with a consideration of who has the ability to file for bankruptcy in these organizational structures, followed by an analysis of the effect of filing.

G. *Bankruptcy*

1. Ability to File

i. *Owing SPE Filing*

In a preferred equity transaction, the Sponsor member of the Owing SPE will be the managing member or the operating partner. As such, save for consent and approval rights negotiated for by the preferred equity investor in the operating agreement, and absent any required consent of any independent director or manager contained in the organizational structure due to the requirements of the Senior Lender, the Sponsor member would have the authority to cause the Owing SPE to file for voluntary bankruptcy.¹³² With this power, the Sponsor could also cause the Owing SPE,

131. See BLACK’S LAW DICTIONARY 3316 (8th ed. 2004) (defining a “no-contest” clause, which is synonymous with “*in terrorem*” clause, as “[a] provision designed to threaten one into action or inaction”) (alteration in original).

132. Per business organizations law, the equity holders with consent rights to bankruptcy filing and the management of the filing entity control the acts of that entity. See 11

as the sole member of Borrower SPE, to in turn cause the Borrower SPE to file for voluntary bankruptcy.

Generally, however, in a preferred equity transaction, the operating or limited partnership agreement will provide that the managing member or the general partner cannot make a major decision without the prior consent of the preferred equity investor, and will define any decision to file either the Owing SPE itself or its subsidiary, the Borrower SPE into bankruptcy as a major decision. Provided that such consent or approval right is contained in the governing organizational document, the preferred equity member or limited partner should be able to prevent the filing of a voluntary bankruptcy of either SPE. If the Sponsor member goes ahead and files one of the SPE's into voluntary bankruptcy without such consent or approval, then the preferred equity investor would be in a very good position to have the filing dismissed for lack of authority or, potentially, as a bad faith filing. Contrast this with the mezzanine lender: as a creditor to the Owing SPE, the mezzanine lender does not have authority to initiate a voluntary filing by the Owing SPE.¹³³ Moreover, the mezzanine lender is also often barred by the inter-creditor agreement from even trying to influence the members of the Owing SPE to file voluntarily.¹³⁴

In theory, the mezzanine lender could commence an involuntary bankruptcy proceeding against the Owing SPE. Under Section 303 of the Bankruptcy Code creditors may commence an involuntary bankruptcy proceeding under Chapters 7 or 11 with respect to the entity against which it has a claim.¹³⁵ Section 330(i) permits the Bankruptcy Court to award costs and attorney's fees against the petitioning creditors if the involuntary petition is dismissed. If the Bankruptcy Court finds the petition was filed in bad faith, the Court may award compensatory or punitive damages against the petitioning creditors.¹³⁶

Where the debtor entity has fewer than twelve creditors in total, a creditor with a claim of at least \$14,425¹³⁷ has standing to commence an involuntary proceeding.¹³⁸ Any mezzanine lender relevant to the current study will satisfy this low threshold. Assuming the Owing SPE has fewer

U.S.C. § 301 (providing that any entity that qualifies as a debtor under the chapter under which it intends to file may file), *id.* § 109(b) (providing that any person who is not a railroad, insurance company, bank, among others may be a debtor under Chapter 7), *id.* § 109(d) (providing that only railroads, any person that may be a debtor under Chapter 7 who is not a stockbroker or commodities broker, and uninsured banks may be debtors under Chapter 11).

133. *Cf. id.*

134. See CRE FINANCE COUNCIL, INTERCREDITOR AGREEMENT 18 (1999) (providing that the mezzanine lender shall not try to influence the Owing SPE to enter bankruptcy voluntarily while it is still a creditor).

135. 11 U.S.C. § 330(a) (2010).

136. *Id.* § 330(i) (2010) (noting that where a creditor files in bad faith, they are liable not only for costs and reasonable fees, but also damages).

137. Aggregate amount. If the creditor filed alongside others, all claims in the aggregate would have to exceed this amount.

138. 11 U.S.C. § 330(b)(2) (2010).

than twelve creditors, which is likely the case in most of these deals, the mezzanine lender would have standing to commence an involuntary proceeding against the Owing SPE. If the Owing SPE has twelve or more creditors, then the statute requires at least three creditors to execute the involuntary petition.¹³⁹ Only valid claims may be counted toward the involuntary filing. If the claims of a petitioning creditor are subject to a *bona fide* dispute, the claims cannot be counted.¹⁴⁰

In practice, however, an inter-creditor agreement usually bars the mezzanine lender from forcing an involuntary bankruptcy of the Owing SPE.¹⁴¹ As discussed below in the Bankruptcy Effect section, the mezzanine lender would not have any incentive to file an involuntary petition under Chapter 7 or 11 at the Owing SPE level in any case because filing would be unlikely to offer the mezzanine lender any benefit that it does not already enjoy under the mezzanine loan agreement. The only scenario in which the mezzanine lender might want to file is where another lender is threatening to accelerate a loan to the Owing SPE.

ii. *Borrower SPE Level*

As in the Owing SPE scenario, under most operating agreements the managing member has to gain unanimous consent of all members of the Owing SPE to file at the Borrower SPE level. Therefore, through the same consent rights discussed above, the preferred member can block filing. Filing would allow for the Borrower SPE to forestall the Senior Lender's collection efforts on the senior mortgage, although, as we will see in the next section, the Bankruptcy Code places limitations on this protection with respect to single-asset real estate projects.

A mezzanine lender retains no control over the Borrower SPE beyond the rights triggered by events of default. A preferred equity member is generally similarly situated, as it is often a finance provider, and the operational and management decisions for the Owing SPE and the Borrower SPE are generally being made by the Sponsor member, subject to the consent and approval rights of the preferred member as set forth in the Owing SPE's operating agreement. Generally, each of the preferred member and the mezzanine lender must take over control of the Borrower SPE (the preferred member by exercising its rights to replace the Sponsor member as the managing member of the Owing SPE with itself, and the mezzanine lender by foreclosing upon the pledged equity in the Borrower SPE by a UCC foreclosure sale) to gain managerial control of the Borrower SPE.

One significant difference between the mezzanine lender and the preferred equity investor in this regard is that the preferred equity investor

139. *Id.* § 330 (b)(1).

140. *Id.* § 303(b)(1).

141. See CRE FINANCE COUNCIL, INTERCREDITOR AGREEMENT 18 (1999) (Rights of Subrogation; Bankruptcy).

will be able to seize control much more quickly because it does not need to go through the UCC sales process. A potential snag for the preferred member is the possibility that the Sponsor either runs into court to prevent the takeover or becomes so uncooperative that the preferred member requires judicial action to give meaning to its takeover, potentially bogging down the takeover process in litigation. Of course, mezzanine borrowers (the Owning SPE) can similarly attempt to use judicial intervention to prevent a UCC sale as well and, as discussed below, have the trump card of staying the sale with a voluntary bankruptcy filing.

Because neither the mezzanine lender nor the preferred member is a creditor of the Borrower SPE, it has no ability to force an involuntary proceeding.¹⁴²

2. Bankruptcy Process and Effect; Principles of Law and Process

Upon the filing of a petition for bankruptcy and the issuance of an order for relief at either the Owning or the Borrower SPE level, the automatic stay takes effect, preventing the commencement of collection efforts, or continuing collection efforts, on any indebtedness against the filed entity.¹⁴³ After filing, the SPE will be allowed to continue operating “in ordinary course.”¹⁴⁴ The property of the bankrupt entity existing prior to the filing of the petition becomes property of the bankruptcy estate,¹⁴⁵ as well as any proceeds, rents or profits from such property.¹⁴⁶ Under Chapter 11, the SPE would then submit a reorganization plan, which, as an adequate means for the execution of that plan, can include the retention by the entity of any or all of the property of the estate.¹⁴⁷ Thus, the SPE under a reorganization would then become a Debtor-in-Possession (“DIP”), which transforms the SPE into an operating entity that manages the estate property (with managing member in control per company form), much like the trustee-in-bankruptcy in the Chapter 7 liquidation context.¹⁴⁸

Through the DIP financing power, the SPE could seek out additional funding. Acting as a trustee, the DIP may access credit to finance the short term operations of the project while it devises a reorganization plan.¹⁴⁹ Understanding that creditors may reasonably withhold extension of credit to bankrupted entities, the Code provides carrots to induce creditors to provide financing. For instance, the DIP lender may be given priority over

142. 11 U.S.C. § 303(b) (2010) (providing that to have standing to file, an entity must be a “holder of a claim” against the person it seeks to force to file).

143. *Id.* § 362(a)(1).

144. *Id.* § 362(c).

145. *Id.* § 541.

146. *Id.* § 541(a)(6).

147. *Id.* § 1123(a)(5)(A).

148. ELIZABETH WARREN & JAY LAWRENCE WESTBROOK, *THE LAW OF DEBTORS AND CREDITORS* 396 (6th ed. 2011).

149. *See* 11 U.S.C. § 364 (2010).

all administrative and unsecured claims because the court can order that the DIP financing be given priority over the administrative expenses of the estate.¹⁵⁰ Under narrow circumstances, the Bankruptcy Court has authority to order that the DIP financing be senior to or *pari passu* with the pre-petition secured creditor liens.¹⁵¹

Only impaired creditors vote on the plan proposed by the DIP.¹⁵² All creditor claims against the bankruptcy estate are deemed “impaired” unless the DIP leaves the legal and equitable rights of the claimant unaltered (or unaccounted for in its reorganization plan) or the debtor cures the default, reinstates the maturity of the claim, compensates the claimant for any damages derived from reasonable reliance on the contract terms without otherwise altering the legal or equitable rights of such creditor.¹⁵³

Every class of impaired claimants in a class must accept the reorganization plan so long as at least one half of the total number of creditors in the class approve the plan and their claims total at least two thirds in amount of indebtedness of the class.¹⁵⁴ The Bankruptcy Court will confirm the plan as long as the claimants of any class will receive at least as much as they would under a Chapter 7 liquidation,¹⁵⁵ at least one class of impaired creditors vote to accept the plan,¹⁵⁶ and the court determines that the plan is feasible.¹⁵⁷ Upon confirmation of the plan, all debts not accounted for in the plan are discharged.¹⁵⁸

Congress has enacted a number of provisions related to single asset real estate (“SARE”)— debtors who receive substantially all of their gross income comes from a single property or project.¹⁵⁹ Over the last sixty years, most SARE Chapter 11 filings were the result of over-leveraged real estate projects that experienced a decline in rents, which the debtor depended on to service its debt.¹⁶⁰

150. *Id.* § 364(c)(1).

151. *Id.* § 364(d)(1) (providing that the trustee or DIP may only do so if the primed lien holder is adequately protected).

152. David Gray Carlson, *Rake's Progress: Cure and Reinstatement of Secured Claims in Bankruptcy Reorganization*, 13 BANKR. DEV. J. 273, 283 (1997). See also S. REP. NO. 95-989, 120 (1978), reprinted in 1978 U.S.C.C.A.N. 5787, 5906 (“[T]he holder of a claim or interest who under the plan is restored to his original position, when others receive less or get nothing at all, is fortunate indeed and has no cause to complain.”) (alteration in original).

153. 11 U.S.C. § 1124(1), (2)(A)-(C), (E) (2010).

154. *Id.* § 1126(c)-(d).

155. *Id.* a§ 1129(a)(7).

156. *Id.* § 1129(a)(10).

157. *Id.* § 1129(a)(11).

158. WARREN & WESTBROOK, *supra* note 148, at 397.

159. 11 U.S.C. § 101(51B) (2010) (providing a definition of SARE).

160. Kenneth N. Klee, *One Size Fits Some: Single Asset Real Estate Cases*, 87 CORNELL L. REV. 1285, 1294 (2002).

Since 2001,¹⁶¹ the Bankruptcy Code has included special provisions for all SARE Chapter 11 filings that will allow for relief from the automatic stay in favor of a claimant on an expedited basis. Under Section 362(d)(3), a senior mortgagee will be granted relief from the automatic stay unless the debtor files a plan that is likely to be confirmed within 90 days of filing for bankruptcy relief, or has begun to make mortgage interest payments to the mortgagee according to contract terms.¹⁶² Scholars have put forth many arguments to justify these limitations,¹⁶³ but Congress' putative aim was to prevent equity holders from hiding the collateral they pledged behind the shield of the automatic stay in hopes that their property might regain value through an uptick in the market.¹⁶⁴

Warren and Westbrook note that filing for Chapter 11 is an invitation to a formalized negotiation.¹⁶⁵ They argue that Chapter 11 allows the debtor to have bargaining power that it would not otherwise have in a private negotiation where the lenders' rights under the loan documents would place the lenders in a superior position.¹⁶⁶ Bankruptcy, at least temporarily, gives the debtor greater bargaining power, which helps to explain the emphasis by mezzanine lenders and preferred equity investors on carve-out guarantees and single purpose, bankruptcy remote entity provisions in an attempt to minimize the risk that an SPE will be able to file for bankruptcy or, once in bankruptcy, to retain the property or collateral in the bankruptcy estate.¹⁶⁷

161. *See id.* at 1293 (noting that under the 1994 amendments to the Bankruptcy Code, SARE limitation applied only to cases with a value of less than \$4 million, but that in 2001, Congress repealed the cap.)

162. 11 U.S.C. § 362(d)(3) (2010).

163. *See, e.g.,* Douglas G. Baird & Edward R. Morrison, *Bankruptcy Decision Making*, 17 J.L. ECON. & ORG. 356, 371 (2001) (arguing for allowing state foreclosure law to govern SARE's because allowing SARE's to file Chapter 11 prevents the efficient allocation of the resources tied up in failing projects); Daniel C. Draper, *Stays of Mortgage Foreclosure—A Proposal for Reform*, 93 BANKING L.J. 133, 135-36 (1976) (arguing that the common pool problem, where one creditor forecloses on its security interest to the detriment of all other creditors, which is generally mitigated by reorganization, is usually absent from the SARE context because of the low number of creditors involved in the deals).

164. *See* Klee, *supra* note 160, at 1292 (citing “[t]he problem with single asset cases is that there is usually not reasonable prospect of reorganization. The bankruptcy filing is simply used as a legal method to delay foreclosure.”) (citing COMMERCIAL AND CREDIT ISSUES IN BANKRUPTCY: HEARING BEFORE THE SUBCOMM. ON COURTS & ADMIN. PRACTICE OF THE SENATE COMM. ON THE JUDICIARY, 102D CONG. 89 (1991) (statement of Mary Jane Flaherty) (alteration in original)). *See also* In re JER/ Jameson Mezz Borrower II, LLC, 461 B.R. 293 (Bankr. D. Del. 2011) (dismissing a bankruptcy petition by SARE company for bad faith when filed on the eve of foreclosure).

165. WARREN & WESTBROOK, *supra* note 148, at 398.

166. *See id.* (noting that it affords the debtor: (1) the possibility of adopting a plan that legally binds all creditors, even if a minority rejects it; (2) six months or more with the exclusive right to propose a plan; (3) the turnover or avoidance powers that increase the assets available to turnaround the business and provides powerful leverage over otherwise potentially over powering creditors whose rights under contract are considerably in their favor).

167. *Id.* at 399.

3. Owning SPE Filing

The members of the Owning SPE will only file to protect against the acceleration of any debt held at the Owning SPE level. Where the threatened acceleration exists at the Borrower SPE level, filing at the Owning SPE level will do nothing to protect the revenue-producing asset property. While the Owning SPE would benefit from the automatic stay upon its creditors, the lifeblood of the project, the cash flows from the underlying property, would not be protected from foreclosure on the mortgage at the Borrower SPE level.

If the senior loan cannot be cured within the cure period defined by the contract, the Senior Lender will be entitled to foreclose on the property and the Borrower SPE will, in most states, have to fulfill all of its obligations under the senior mortgage document prior to the foreclosure sale in order to redeem its interest in the property.¹⁶⁸ The automatic stay at the Owning SPE level in the scenario where the Borrower SPE defaults would not protect the profit-producing source, the underlying asset property, because the property is not an asset of the debtor, the Owning SPE, but of its subsidiary, the Borrower SPE. In order to forestall the Senior Lender from exercising its remedies against the property, the members of the Owning SPE would need to cause the SPE Owning Entity, as the sole member of the Borrower SPE, to in turn cause the Borrower SPE to file for voluntary bankruptcy, which would stay any collection efforts of the senior lender on the Borrower SPE.¹⁶⁹

Keep in mind that filing at the Owning SPE level will not protect any carve-out guarantor against any guarantor liability that the lender or preferred equity member may have against the guarantor. In order to gain such protection, the guarantor would have to file for bankruptcy itself.

The remainder of this section will contemplate a scenario where the members of the Owning SPE, file as a protective measure against acceleration under a mezzanine loan at the Owning SPE level.

After filing, through the automatic stay and the increased bargaining power and the protections under the Bankruptcy Code, the Owning SPE gains breathing room to attempt to reorganize its operations. Assuming there is sufficient equity in the project to provide the necessary incentives to compel their activities, the equity holders of the Owning SPE may well undertake the endeavor notwithstanding any carve-out guaranty exposure to its principals.

Where the mezzanine lender has perfected its security interest in the shares of the Owning SPE,¹⁷⁰ the mezzanine lender would be secured to the extent of the value of its interest in the pledged equity in Borrower

168. See *supra* Section II.A for a general survey of the requirements to redeem a foreclosed property.

169. 11 U.S.C. § 362(a) (2010).

170. See *supra* Section II.D for a discussion of perfecting security interests in the Borrower SPE membership interests.

SPE.¹⁷¹ If the source of the inability to service the mezzanine debt derives from problems with the cash flows from the underlying property, it is unlikely that the membership interests in the Borrower SPE would fully secure the mezzanine lender's claim. While any increase in value during the pendency of the bankruptcy proceeding would accrue to the benefit of the mezzanine lender,¹⁷² if the underlying asset property is not performing well, the membership interests may be of a lesser value than the mezzanine lender's allowed secured claim. The amount of its total claim (the amount of debt outstanding) less the value of its security interest would be unsecured.¹⁷³

The valuation of collateral is to be determined "in light of the purpose of the valuation and of the proposed disposition or use of the property".¹⁷⁴ While in the consumer bankruptcy context, this valuation is determined by the replacement value (the cost of replacement on the retail market),¹⁷⁵ in the business context there is no statutory guidance. However the valuation of collateral is ultimately determined, there is a reasonable likelihood that the value of the pledged equity in the Borrower SPE will be less than the amount outstanding under the mezzanine loan, and, in such a case, the mezzanine lender would be undersecured.

The mezzanine lender will often seek relief from the automatic stay from the bankruptcy court. If such relief were granted, the mezzanine lender would be free to proceed with a UCC foreclosure sale upon the pledged equity in Borrower SPE. If the interests of the secured creditor are adequately protected, and provided that no other basis for stay relief exists under Section 362, relief from the automatic stay will not be ordered.¹⁷⁶ Although Section 361 of the Bankruptcy Code does not define the phrase adequate protection, Section 362 offers three ways to effectuate adequate protection: (1) through periodic payments to the secured creditor, (2) through an additional or replacement lien, or (3) through other means "as will result in the realization by such entity of the indubitable

171. 11 U.S.C. § 506 (a)(1) (2010).

172. *But see* *Dewsnup v. Timm*, 502 U.S. 410, 417 (1992) (holding that "§ 506(d) does not allow petitioner to "strip down" respondents' lien, because respondents' claim is secured by a lien and has been fully allowed pursuant to § 502."). This case stands for the principle that a mortgagor may not strip the value of a junior mortgagee's security interest in the subject property to the judicially determined value of the collateral and that, therefore, the lien "passes through bankruptcy unaffected." *Id.* at 417. *See also* *In re Machinery, Inc.*, 287 B.R. 755 (applying the policy principle of *Dewsnup* to security interests in the cash proceeds from aerial lifts, which are governed by Article 9 of the UCC, stating that the *Dewsnup* holding was "premised . . . in part on a policy principle that any increase in the value of collateral during the pendency of the bankruptcy accrues to the secured creditor . . . [and] should not be judicially frozen at some particular point in time . . .") (alteration in original).

173. 11 U.S.C. § 506(a)(1) (2010).

174. *Id.*

175. *Id.* § 506(a)(2).

176. *Id.* § 362(d).

equivalent of such entity's interest in such property."¹⁷⁷ Therefore, as a secured creditor, the mezzanine lender would be entitled to adequate protection through one of these methods for the amount of its allowed secured claim.

In a Chapter 7 liquidation scenario, the mezzanine lender would be entitled to recoup the total amount obtained through the sale of the collateral by the trustee up to the value of its interest in the property.¹⁷⁸ To the extent that the value obtained through such sale was less than the value of the mezzanine lender's claim, the remaining difference of the mezzanine loan would be considered an unsecured claim,¹⁷⁹ and would be subject to the pro rata distribution of remaining cash obtained through liquidation of the Owing SPE's other assets after secured claims and unsecured claims of greater priority are satisfied.¹⁸⁰ Because the only assets of the Owing SPE are the Borrower SPE membership interests, this distribution would likely be zero. Following the distribution of the liquidated assets, the remaining amount of the mezzanine lender's interest would not be discharged under Chapter 7.¹⁸¹ This will likely spell the end for the bankrupted entity, thus foreclosing any opportunity to recoup on any of the remaining interest because the Owing SPE would likely not have money to pay the non-discharged debt.

Theoretically, the net effect of a Chapter 7 filing at the Owing SPE level for the mezzanine lender would not produce an outcome differing from what is already available through the recourse provided for under the loan document. As noted before, the mezzanine lender can seize the collateral shares in the event of default and put them up for UCC sale. If the trustee of the bankruptcy estate seized the property, the proceeds of the sale of the collateral would go to the mezzanine lender up to the value of the mezzanine lender's allowed secured claim. In fact, under such circumstances, the trustee may abandon the property or consent to the relief of stay to allow the secured lender to liquidate the collateral outside of the bankruptcy.¹⁸² Such action would leave the mezzanine lender's security interest in the collateral untouched and have no impact on the mezzanine lender's lien, leaving the mezzanine lender in the position it was in before the filing. Whether or not the process would work out as favorably for the

177. *Id.* § 361(1)-(3). For a discussion of adequate protection, see *In re Rogers Development Corp.*, 2 B.R. 679, 680 (Bankr. E.D. Va. 1980).

178. 11 U.S.C. § 506(a)(1) (2010).

179. *Id.*

180. 11 U.S.C. § 726(b) (2010).

181. See 11 U.S.C. § 727(a)(1) (2010) (providing that the debtor in Chapter 7 after liquidation and distribution will be discharged of debt unless it is not an individual); *Cf.* 11 U.S.C. § 101(9) (2010) (providing that a corporation is an association having power or privilege that a private corporation, *but not an individual . . . possesses . . .*) (emphasis added); see also Warren, *supra* note 148, at 397.

182. See 11 U.S.C. § 554(a) (2010) (giving the trustee the power, after notice and hearing, to abandon property of the estate that is of "inconsequential value and benefit to the estate.").

mezzanine lender, the mezzanine lender would prefer to avoid the costs and delays of a bankruptcy of its borrower (the Owing SPE).

In the context of a UCC sale conducted by the mezzanine lender, no third party trustee would impose any hindrances on a sale conducted in compliance with the requirements of the UCC, but otherwise according to the mezzanine lender's desires. In a scenario where the mezzanine loan is in default and the mezzanine lender is not being paid the amounts due to it under the mezzanine loan documents, at least with a UCC sale, control of the process is in the mezzanine lender's hands. In light of a mezzanine lender's preference to control the process, the mezzanine lender will generally move to accomplish a sale as quickly as possible while still being commercially reasonable, with the goal of completing the sale before the Sponsor files the Owing SPE into bankruptcy.

Note that once the Sponsor makes up its mind to file, filing can be done almost immediately. This deserves more attention because it speaks to the mezzanine lender's motivations in general. The mezzanine lender does not want the Owing SPE to file for bankruptcy, because the bankruptcy process can be unpredictable, other than with respect to the fact that it will lead to additional costs and delay for the mezzanine lender. Once the situation has deteriorated to the point where the mezzanine lender is exercising remedies, what the mezzanine lender wants is to gain control of the Borrower SPE (and therefore the mortgaged property) so that it can try to rectify whatever operating problems exist at the property, gain control of any property cash flow excess after senior loan payments and, either promptly or after some period of repair and releasing, market the property for sale.

If the mezzanine lender believes that the Sponsor is not a source of the property's problems and if the Sponsor is cooperating with the mezzanine lender, then the mezzanine lender and the Sponsor would enter into a work-out and the mezzanine lender would not need to exercise its remedies and the Owing SPE would not need to file for bankruptcy. While there are certainly disagreements between mezzanine lenders and Sponsors as to whether or not the best course of action is a restructuring, in the mezzanine lender's view, if restructuring were the best option, it would have taken it consensually and through private action. A mezzanine lender does not want to have a restructuring forced upon it by the bankruptcy process.

Under the DIP financing power, the Owing SPE could seek additional funding from creditors.¹⁸³ This power is reason for concern for the mezzanine lender. The only assets owned by the Owing SPE are the Borrower SPE membership interests, all of which have already been pledged to the mezzanine lender as a security interest for the loan it gave to the Owing SPE. Unless the DIP can convince a new creditor to give a loan in exchange for priority as an administrative expense of the estate under

183. 11 U.S.C. § 364 (2010).

§ 364(a) or (b), or with a junior lien on the Borrower SPE membership interests under § 364(c), then the only other option would be to prime the lien the mezzanine lender has on the Borrower SPE membership interests.¹⁸⁴ While the mezzanine lender would be protected by the court approval required and the requirement of adequate protection, being subject to a prior or *pari passu* lien on the pledged collateral is not what the mezzanine lender bargained for. The good news for the mezzanine lender is that such a priming or *pari passu* lien is only allowable under very narrow circumstances.

While such a situation is theoretically possible, under the standard single purpose, bankruptcy remote entity structure of mezzanine loans, it is very unlikely. There simply would not be any way for the DIP to provide the mezzanine lender with adequate protection for the repayment of its debt, because the Owing SPE has no assets other than the pledged collateral. If the pledged collateral had sufficient value above the mezzanine loan amount to allow for senior DIP financing, it is difficult to see many circumstances where the bankruptcy would be necessary.

If the members of the Owing SPE file for bankruptcy before the mezzanine lender completes the UCC sale, the mezzanine lender would have the right to object to any proposed Chapter 11 reorganization plan.¹⁸⁵ In a simpler capital structure where there are no other creditors to the Owing SPE, the mezzanine lender would be the necessary vote to get to either the two thirds total claim amount or one half total number of creditors needed for the plan to be considered for certification by a court.¹⁸⁶ Even in a scenario where there are many creditors at the Owing SPE level, giving the mezzanine lender insufficient voting power to block the plan, the Bankruptcy Code gives the mezzanine lender the baseline protection that the plan must provide for the mezzanine lender to at least recoup what it would under Chapter 7.¹⁸⁷

The mezzanine lender is given another tool to protect itself under § 1111(b). The lender's interest, under the § 1111(b) election, could be protected to the full extent of the face value of the loan.¹⁸⁸ According to Warren and Westbrook, this provision is used most often in the SARE

184. *Id.* § 364(a)-(d).

185. 11 U.S.C. § 1128(b) (2010) (providing that any party in interest may object to the proposed plan at the confirmation hearing). *See also* 11 U.S.C. 1126(a) (2010) (providing that a holder of a claim may accept or reject a plan). The combination of these provisions gives the holder of a claim a stronger negotiating position with respect to the contents of the plan. With respect to the subject deals of this study, a mezzanine lender, or a preferred member with accrued dividends putting it in the position of a creditor, the small number of creditors to the Owing SPE would give them more bargaining power than a creditor in the context of a large corporate reorganization with many creditors would have. *See* DEL. CODE ANN. tit. 6, § 18-606(1)(b) (2012) (providing that a member of a limited liability company that becomes entitled to receive a distribution has the status of a creditor).

186. 11 U.S.C. § 1126 (c)-(d) (2010).

187. *Id.* § 1129(a)(7).

188. *See* WARREN & WESTBROOK, *supra* note 148, at 677.

context and primarily benefits under-secured creditors under § 506(a).¹⁸⁹ Under § 1111(b), both recourse and non-recourse lenders may, prior to the conclusion of the disclosure statement hearing, elect to waive the unsecured portion of their allowed claim under § 506(a).¹⁹⁰ When the lender so elects, the debtor is required to pay the total dollar amount the creditor is owed under the promissory note. That is, the total nominal amount of the note is allowed as a secured claim.¹⁹¹ The debtor must pay the total present value of the claim up to the value of the collateral and any remainder must be paid at the nominal value.¹⁹²

Where the secured creditor makes the § 1111(b) election, the debtor must satisfy a two-part payment test under § 1129(b)(2)(A)(i)(II).¹⁹³ First, the debtor must pay cash payments “totaling at least the allowed amount of such claim”¹⁹⁴ Second, the payments must be “of a value, as of the effective date of the plan, of at least the value of such holder’s interest in the estate’s interest in such property.”¹⁹⁵ This test is structured not as two separate amounts that must be paid, but as two components of a test that must be satisfied by the debtor’s payment plan.¹⁹⁶ The first part refers to the total nominal claim.¹⁹⁷ The second part refers to the value of the security interest, which is allowed at a value adjusted by a present value calculation.¹⁹⁸

To illustrate the operation of these provisions, consider the following.¹⁹⁹ A mezzanine lender makes a \$1,000,000 loan to the Owing SPE. The Owing SPE pledges all the shares of the Borrower SPE as collateral for the loan. When the Owing SPE files for Chapter 11, the value of the pledged equity is only \$500,000. Therefore, under § 506(a), the total secured portion of the allowed claim would be \$500,000, and the unsecured portion of the claim would be \$500,000. Assuming a plan that called for all payments to be made within one year with a rate of interest at 10% (to account for present value), then at the end of the year, the mezzanine lender would receive \$550,000. Assuming that the unsecured claims are receiving a *pro-rata* distribution at 20 cents on the dollar, the mezzanine lender would receive an additional \$100,000, bringing the total to \$650,000.

Where the mezzanine lender makes an § 1111(b) election, the total value of its allowed secured claim would be \$1,000,000. Assume the debtor

189. *Id.*

190. 11 U.S.C. § 1111(b)(1)(B) (2010).

191. WARREN & WESTBROOK, *supra* note 148, at 678.

192. *Id.*

193. *Id.*

194. 11 U.S.C. § 1129(b)(2)(A)(i)(II) (2010).

195. *Id.*

196. WARREN & WESTBROOK, *supra* note 148, at 678.

197. *Id.*

198. *Id.*

199. Modeled after the hypothetical provided in WARREN & WESTBROOK, *supra* note 148, at 678-79.

has submitted and the court has confirmed a plan that lasts one year. If the lender receives payment for that total by the end of the year, both elements of the two-part test would be satisfied. It would receive “at least the . . . amount of . . . [the allowed] claim” as well as an amount “at least the [present] value of [its] interest in the estate’s interest in such property,”²⁰⁰ which is the value of the collateral at the time of the effectiveness of the plan, i.e. \$500,000 plus \$50,000 interest.

In the case of a quick repayment schedule like this, the mezzanine lender makes out better than it would without making the § 1111(b) election.²⁰¹ Contrast this with a longer term plan: If the plan were ten years long, the creditor would lose out by not opting for the \$650,000 available without the § 1111(b) election.²⁰² Assuming a discount rate of 10% and \$100,000 payments per year for ten years, the present value of such an annuity would be just under \$615,000. Therefore, the mezzanine lender would be better off not making the § 1111(b) election in this scenario.

Only impaired creditors may be included in creditor classes with the power to vote for or against a reorganization plan.²⁰³ By making the § 1111(b) election, the mezzanine lender would no longer be impaired because its claim would be equal to the amount it was due under the original mezzanine loan agreement. Therefore, the mezzanine lender would not be able to vote for or against the plan because its claim has not been impaired. Creditors will often seek an indication of the terms of the plan the debtor intends to propose in order to maximize value through the choice of whether to make the 1111(b) election. The debtor may have something to gain out of withholding such information, as outlined in the ten year plan hypothetical above. Therefore, there is a potential for litigation costs preceding the election where the parties refuse to cooperate.²⁰⁴

With respect to the ultimate effect of bankruptcy, the Owning SPE members almost certainly have more to gain than the mezzanine lender. While the mezzanine lender would stand before the members in the event of liquidation, in the event of a confirmed reorganization plan all lenders are bound to honor the plan.²⁰⁵ Thus, even in the scenario where the property makes a phenomenal turnaround and the debtor could have repaid all of the debt, the debtor is only required to pay the amount outlined in the reorganization plan, which could produce a windfall for the equity members retained by the plan²⁰⁶ who benefit from the breathing room of the automatic stay and the discharge of any debt not included in the plan.²⁰⁷

200. 11 U.S.C. § 1129(b)(2)(A)(i)(II) (2010) (alteration in original).

201. WARREN & WESTBROOK, *supra* note 148, at 679.

202. *Id.*

203. 11 U.S.C. § 1126 (2010).

204. WARREN & WESTBROOK, *supra* note 148, at 681.

205. 11 U.S.C. § 1141(a) (2010).

206. *See id.* § 1141(d)(2) (providing that equity holders may be terminated by the plan in addition to the discharge of debts not included in the plan).

207. *Id.* § 1141(d)(1)(A).

4. Filing at Borrowing SPE Level

Where the cash flows of the underlying asset property are insufficient to service the senior debt, the members of the Owing SPE or the mezzanine lender (after having taken ownership of the Borrower SPE membership interests through the UCC sale) may seek to file at the Borrowing SPE level.

The applicable legal principles and process would generally be the same as outlined above. At filing, the automatic stay would attach, preventing the Senior Lender from pursuing any collection activities against the Borrower SPE. The automatic stay would give the controlling party of the Borrower SPE breathing room to step back and come up with a reorganization plan. The Senior Lender's allowed secured claim under 506(a) would be equal to the value of the underlying property and any remaining value of the outstanding loan balance exceeding the value of the property would be considered unsecured. The valuation of the property would turn on the "intended disposition or use" which could cut in favor of using liquidation value because if the debtor does not redeem, the inevitable disposition would be foreclosure. The SARE provisions will apply here and so the Borrower SPE will, within 90 days of filing, have to either commence making regular payments under the contract terms or submit a plan with a reasonable likelihood of being confirmed.

The DIP in this scenario would be controlled by the managing member of the Owing SPE, per company form. The Owing SPE owns all of the membership interests in the Borrower SPE, and the Owing SPE is the manager of the Borrower SPE. Therefore, the manager of the Owing SPE would, via the organizational structure, manage the Borrower SPE and therefore the estate. Of course, if the mezzanine lender has foreclosed upon the equity in the Borrower SPE before the filing, then the DIP would be controlled by the mezzanine lender. The DIP financing power is a function that could prove efficacious. With it the members of the Owing SPE could, if no other creditors could be convinced to provide financing at a lower level priority, prime any existing creditor's lien on the Borrower SPE assets. Therefore, the Borrower SPE could, in theory, obtain a new senior loan with more favorable terms and prime the lien on the old senior loan. Given the general suspicion Congress has expressed through the SARE provisions, however, it is unlikely that a bankruptcy court would allow such action.

Of course, if the mezzanine lender has foreclosed upon the equity in the Borrower SPE before the filing, then the DIP would be controlled by the mezzanine lender²⁰⁸ and, similarly, if the preferred equity member had replaced or thereafter replaces the Sponsor with itself as the managing member or general partner of the Owing SPE, then the preferred member will control the DIP.

208. Note that the mezzanine lender is stepping into the place where the Owing SPE previously stood by foreclosing on the membership interests of the Borrower SPE.

The Senior Lender will have the option of making the § 1111(b) election, but the cost-benefit analysis to motivate that choice would again turn on the length of the reorganization plan. If the Senior Lender opts for § 1111(b), then it will not be able to vote on the plan. So long as the payment test under § 1129(b)(2)(A)(i)(II) is met, along with the other elements of § 1129, the plan will be confirmed. If the Senior Lender does not opt for the § 1111(b) election, it may still wield its vote against the confirmation of the plan, which would likely be a fatal blow against confirmation because the Borrower SPE is unlikely to have any other significant creditors.

As noted in the Sponsor Bad Acts section, there may be guarantees that are triggered by the voluntary filing of the Borrower SPE providing for liability of the Sponsor for the total outstanding senior debt upon the filing. One important practice point, if mezzanine lender has foreclosed, then the carve-out guarantor affiliated with the Sponsor may find itself in a situation where it no longer has any control over the actions of the Borrower SPE (including, whether or not it will file for bankruptcy) but is nevertheless liable for its “bad acts” under the carve-out guaranty that it gave to the Senior Lender. While this situation provides the maximum flexibility for the mezzanine lender, as the entity controlling the Borrower SPE, in its negotiations with the Senior Lender, it is a bad result for both the carve-out guarantor, who becomes exposed to liability not of its making. Similarly, the Senior Lender will be worse off because it no longer has the benefit of the *in terrorem* effect of the guaranty. Counsel for the guarantor and the Senior Lender should address this issue in the negotiation of the loan documents and inter-creditor agreement prior to loan closing.

5. Sponsor Filing

The Sponsor may file for bankruptcy in an attempt to hide behind the automatic stay to prevent its replacement as managing member of the Owing SPE to the preferred member or to pay on any guaranty under the senior mortgage or the mezzanine loan. In this case, the mezzanine lender, or any other creditor of the Owing or Borrower SPE would not be stayed from collection actions against the Owing or Borrower SPE because neither the Owing nor the Borrower SPE has filed. They would, however, be stayed from any collection efforts upon the Sponsor under any guarantees.

The story is different with respect to the preferred member seeking to obtain control of the Owing SPE. While the Sponsor would argue otherwise, the preferred member may not necessarily be stayed from wresting control of the Owing SPE from the Sponsor. The preferred member could argue that the Sponsor as managing member acts as a fiduciary for the Owing SPE and therefore his role is a “power that the debtor may exercise solely for the benefit of another entity other than the debtor . . .” which is explicitly excluded from the Sponsor’s estate and thus not able to

benefit from the protection of the automatic stay.²⁰⁹ Moreover, if the filing was solely a litigation tactic to avoid the transfer of control, the preferred member would have an argument that the filing was made in bad faith.²¹⁰

Finally, the argument against the Sponsor's position could be further bolstered by state law. Under the Delaware Limited Liability Company Act (hereinafter DE LLC Act), where a member of a limited liability company files for voluntary bankruptcy, unless otherwise provided for in the operating agreement, its membership in the limited liability company is terminated by operation of law.²¹¹ Most other jurisdictions take the same position.²¹² Therefore, the Sponsor would no longer be a member of the Owing SPE limited liability company after filing for bankruptcy and so as a matter of law the Sponsor's position is no longer protected because its rights to participate in management cease with the termination of its membership. As such, the Sponsor's assertion of intrusion upon the automatic stay would fail on these grounds as well.

The authors find the preferred member's arguments persuasive, but note that the Bankruptcy Code's provisions for voiding *ipso facto* provisions in contracts may present an issue for the preferred member's case. An *ipso facto* provision is a contractual provision that terminates an executory contract as a result of a bankruptcy filing or financial condition.²¹³ Such provisions are generally unenforceable.²¹⁴ These provisions most often effectuate a termination of rights and obligations automatically upon a bankruptcy filing and,²¹⁵ in the scenario governed by provisions like the one we are discussing, the effect is a change in management control of the Owing SPE triggered by a bankruptcy filing. Courts that have considered the enforceability of a provision in an operating agreement or limited partnership agreement that upon bankruptcy the manager or general party ceases to have the power to manage the limited liability company or the limited partnership are split.²¹⁶

209. 11 U.S.C. § 541(b)(1) (2010). This argument assumes that fiduciary duties have not been contracted away. *See supra*, Section II.H, for a discussion of fiduciary duties under Delaware Limited Liability Company Law.

210. *See* 11 U.S.C. § 1129(a)(3) (2010).

211. DEL. CODE ANN. tit. 6, § 18-304(1)(b) (2012).

212. *See, e.g.*, FLA. STAT. § 608.4237(1)(b) (2000).

213. *See* 9C AM. JUR. 2D *Bankruptcy* § 2345 (2012).

214. *Id.*

215. *See id.* at n. 1, for cases where the provision in question provided for termination (citing *In re Margulis*, 323 B.R. 130 (Bankr. S.D.N.Y. 2005); *In re Maxon Engineering Services, Inc.*, 324 B.R. 429 (Bankr. D. P.R. 2005); *In re Woskob*, 305 F.3d 177 (3d Cir. 2002); *In re Compass Van & Storage Corp.*, 65 B.R. 1007 (Bankr. E.D.N.Y. 1986)).

216. *See, e.g.*, *In re Deluca*, 194 B.R. 65 (Bankr. E.D. Va.1996) (holding that a Virginia limited liability company's operating agreement, which provided for the dissolution of the company upon a member's bankruptcy filing, with the remaining members having the right to elect to continue the business and to elect a new manager, fell with the exception of 11 U.S.C. § 365(e)(2) and accordingly are not invalid *ipso facto* provisions under § 365(e)(1)). *See also*, *Milford Power Co., LLC v. PDC Milford Power, LLC*, 866 A.2d 738, 761 (Del. Ch. 2004) (noting that "[i]n the case of an LP or LLC agreement that makes the debtor-partner or

6. Filing at the Owing SPE Level, Change of Control, and the Automatic Stay

We now turn to the issue of the preferred member taking control of the Owing SPE by wresting the position of managing member from the Sponsor where the Sponsor has not filed but the Owing SPE has. If the operating agreement requires the removal of the Sponsor from the managing member position upon filing, replaced by the preferred member, would the preferred member's act of taking control violate the automatic stay? While there is some language under 11 U.S.C. § 362(a)(3) forbidding "any act to obtain possession of property of the estate or of property from the estate or *to exercise control over property of the estate,*"²¹⁷ the authors view it as unlikely that change of control would violate the stay. The management rights are the rights of the Sponsor and not of the Owing SPE. The situation is analogous to a situation where an entity files bankruptcy and a pledgee of the equity in the entity exercises its rights to realize upon the pledged equity. In both situations the property of the debtor is not subject to the enforcement action and the stay should not be considered violated.

In any event, this issue generally does not arise in the preferred equity context, because the preferred equity agreement between the Sponsor member and the preferred equity member almost always requires that the Owing SPE may not file for bankruptcy without the prior consent of the preferred equity member. If the preferred equity document so provides, then the Sponsor member would not have authority to itself cause the filing and any filing effected by the Sponsor member without the preferred member's consent, would be subject to dismissal both on grounds of being an unauthorized filing and as bad faith.

Members of the Owing SPE may seek to stay the mezzanine lender from collection efforts through filing for bankruptcy. Filing would stay any collection action, including foreclosure on the collateral and the UCC sale. Contemplating this danger, the mezzanine lender will often seek provisions that make the guarantor of the mezzanine loan, often the Sponsor,

member a key part of the entity's management on a going-forward basis, there is . . . a strong argument that [11 U.S.C. §§ 365(e)(2) and 365(c)(1), which make personal service contracts unassumable,] preclude a Bankruptcy Trustee from assuming at least those aspects of the contract granting the debtor managerial rights. . . ." (alteration in original); *cf.* In Re Garrison-Ashburn, LLC, 235 B.R. 700, 708 (E.D. Va. 2000) (holding that where a limited liability company's operating agreement "merely provides the structure for the management of the company", it is not an executory contract and therefore unassumable); *but cf.*, Summit Inv. & Development Corp. v. Leroux, 69 F.3d 608, 609 (1st Cir. 1995) (holding that 11 U.S.C. § 365(e) preempts certain provisions in a limited partnership agreement and the Massachusetts Limited Partnership Act which each purport to convert the general partnership interests held by general partners into limited partnership interests immediately upon its filing of a Chapter 11 petition); In re Clinton Court, 160 B.R. 57, 60 (Bankr. E.D. Pa. 1993) (holding partnership agreements are executory contracts which cannot be affected by *ipso facto* clauses found in state statutes).

217. 11 U.S.C. § 362(a)(3) (2010) (emphasis added).

liable for the total outstanding principal and interest upon voluntary bankruptcy filing of the Owing SPE. This recourse will generally provide sufficient incentive to dissuade the Sponsor from a voluntary filing.

The guarantor/Sponsor may be willing to risk being sued in this scenario and litigate out the conflict, in which case the mezzanine lender will have to determine if such litigation is a positive net present value endeavor. The guarantor may try to argue that it did not have ultimate decisional authority over the filing, although unless the action of the guarantor itself was required under the terms of the guaranty to trigger recourse, this is unlikely to be a good defense. Of course, if the guarantor is judgment-proof, the mezzanine lender's recourse to the guarantor would be largely meaningless.

When the preferred member successfully takes over the management of the Owing SPE, it must consider what duties attach with the assumption of control. In the next section, we consider the law on default fiduciary duties managers of limited liability companies owe to other members.

H. Preferred Member Fiduciary Duties

While the preferred member will not be burdened by the same procedural and substantive limitations to its remedies that the mezzanine lender²¹⁸ will be, the preferred member could owe fiduciary duties to the Sponsor and any other members of the Owing SPE when the preferred member takes over as managing member.²¹⁹ The Delaware LLC Act provides that the company "may" provide penalties for breaching loyalty to the members in the entity's limited liability company agreement. When a company does so, however, it provides that the penalties "shall be" specified for a manager that does not act in accordance with the limited liability company agreement.²²⁰ The passive Sponsor would have standing to challenge acts of the preferred member with respect to its management choices. It is first the duty of managers to bring challenges, but where managers fail to bring an action for breach, a member or assignee of a membership interest may bring a derivative suit.²²¹

Section 18-1101(c) of the Delaware LLC Act provides that the limited liability company agreement may expand, contract or eliminate rights and penalties against a member or manager for violation of duties outlined in the operating agreement.²²² Parenthetically, the provision includes fiduciary duties in addition to those provided in the limited liability company agreement.²²³ Allen, et al., note that this parenthetical addition was added

218. For example, the requirements that the sale of pledged collateral be commercial reasonable is discussed above in *supra* Section II.D.

219. *See, e.g.*, DEL. CODE ANN. tit. 6, § 18-405 (2012).

220. *Id.* (i) – (ii).

221. *Id.* § 18-1001.

222. DEL. CODE ANN. tit. 6, § 18-1101(c) (2012).

223. *Id.*

in response to uncertain case law implying the courts would enforce broader fiduciary duties upon limited liability company managers than those provided for in the operating agreement.²²⁴

In the newly-minted *Auriga Capital Corporation v. Gatz Properties, LLC* case,²²⁵ the Chancery did away with this uncertainty. So long as the operating agreement does not contract away the implied covenant of good faith and fair dealing,²²⁶ the Chancery found that the General Assembly made clear with this parenthetical addition that it intended to “give maximum effect to the principle of freedom of contract and the enforceability of limited liability company agreements.”²²⁷

In order to know what fiduciary duties to expand, contract or eliminate while negotiating the preferred member agreement, parties must be informed to what extent default fiduciary duties apply to limited liability company managers. Until *Auriga*, the Chancery had left open the question of the extent to which default fiduciary duties of loyalty and care applied to limited liability company managers. The Chancery explained that traditional default fiduciary duties of loyalty and care apply to management of limited liability companies noting that “LLC managers are clearly fiduciaries . . .”²²⁸ because “the manager is vested with discretionary power to manage the business of the LLC”²²⁹ and other members without management authority repose “special trust in and reliance on [their] judgment . . .”²³⁰ Looking to legislative history and the case law presupposed in that legislative history, the Chancery noted that the legislature was assuming that default duties applied when it enacted Section 18-1101(c). Given that the statute expressly “incorporates equitable principles”²³¹ and such principles are the basis for fiduciary duties,²³² fiduciary duties attach by default to limited liability company managers.

The Chancery next considered whether Section 18-1101(c) allows for parties to contract for a complete waiver of fiduciary duties. Vice-Chancellor Strine explained that according to the language of the statute, the parties may completely eliminate fiduciary duties, or modify them in part.²³³ Accordingly, where parties eliminate or modify them the Chancery gives

224. WILLIAM T. ALLEN ET AL., COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATION 80-81 (3d. ed. 2009).

225. *Auriga Capital Corp. v. Gatz Prop., LLC*, C.A. 4390-CS, 2012 WL 361677 (Del. Ch. 2012).

226. See generally ALLEN ET AL., *supra* note 226, at 80-81.

227. DEL. CODE ANN. tit. 6, § 18-1101 (2012).

228. *Auriga Capital Corp.*, 2012 WL 361677, at 8.

229. *Id.*

230. *Id.* (alteration in original).

231. *Id.* at 9. See DEL. CODE ANN. tit. 6, § 18-1104 (2012) (“In any case not provided for in this chapter, the rules of law and equity, including the law merchant, shall govern.”).

232. See *id.* at n. 65.

233. *Id.* at 9.

“effect to the parties’ contract choice.”²³⁴ If they have not been modified or eliminated, however, the default fiduciary duties apply.²³⁵ Where these duties are waived, all that remains is the implied covenant of good faith and fair dealing derived from contract law.²³⁶ While the Chancery noted some potential policy problems with this approach, it deferred to the Delaware General Assembly’s intent, which allows for contracting away default fiduciary duties.²³⁷

Therefore, the preferred member should be sure to amend the agreement upon its investment to waive default fiduciary duties to any other members of the Owning SPE, or contract them to the extent necessary for the preferred member to be comfortable. One might expect pushback on this from the Sponsor, especially if the preferred member seeks to enjoy the protections provided by such duties when the Sponsor is in control of the managing member.

But what does it mean to retain the implied covenant of good faith and fair dealing when the fiduciary duties are wholly waived? For instance, if the operating agreement waives away the duty of loyalty, would the covenant of good faith and fair dealing limit the managing member of a limited liability company from obviously self-dealing acts? Chief Justice Steele of the Delaware Supreme Court has written that he sees the limited liability company as a creature of contract and that therefore the duty of good faith and fair dealing binds the manager to a duty to not frustrate the fruits of the bargain memorialized in the operating agreement.²³⁸ Thus, only material breaches would appear to give rise to a cause of action. The definition of a self-dealing transaction is one where a fiduciary makes a decision on how to dispose of corporate assets in a way that benefits the fiduciary to the detriment of the company. Therefore, would a self-dealing transaction necessarily frustrate the fruits of the bargain? Or is the possibility of a self-dealing transaction a risk that is assumed when you contract away the duty of loyalty?

Both Chief Justice Steele and Vice Chancellor Strine make clear that the statute allows for contracting away fiduciary duties. The DE LLC Act, moreover, allows for maximum flexibility.²³⁹ It allows members to eliminate or modify fiduciary duties, but it also allows for them to specify specific duties and penalties for their violation.²⁴⁰ Therefore, parties may

234. *Id.*

235. *Id.*

236. *Id.* at 9-10.

237. *Id.* at 25-26.

238. Myron T. Steele, *Freedom of Contract and Default Contractual Duties in Delaware Limited Partnerships and Limited Liability Companies*, 46 AM. BUS. L.J. 221, 223 (2009).

239. *Id.* at 240. *See also, e.g., Elf Atochem North America, Inc. v. Jaffari*, 727 A.2d 286, 291 (Del. 1999) (noting the policy of the General Assembly being to give such flexibility by showing that the LLC Act is replete with default rule provisions that may be modified by the operating agreement).

240. DEL. CODE ANN. tit. 6, § 18-405 (2012).

waive duties but then carve out specific scenarios they want to protect against, should they want to do so. From *Auriga Capital Corporation*, we know that default fiduciary duties apply and, therefore, where parties wish to waive fiduciary duties, courts will likely assume parties have contemplated the implication of such waivers.²⁴¹ Being a creature of contract, not corporate law,²⁴² the limited liability company members therefore assume any risk associated with the adoption of a provision waiving such duties and therefore should be bound by the terms of the bargain.²⁴³ As such, there are likely no implied or latent fiduciary duties that will be contravened by a self-dealing transaction if such obligations are waived, so long as acts do not rise to the level of material breaches of the contract.

Another option for the preferred member would be to seek indemnification for any liability arising from breaches of fiduciary duties.²⁴⁴ Either strategy will place the preferred member in the same economic position, but there may be unique variables in the negotiating context that would lead the preferred member to pursue this strategy. For instance, perhaps the preferred member does not want to waive all the default fiduciary duties in the Sponsor because the specter of fiduciary duty violations imposes a higher reputational risk on the Sponsor. But to protect himself economically in the scenario that the preferred member takes over the management of the project, the preferred member may be willing to allow for partial or total indemnification for breaches of such duties that would lessen the economic impact of a Sponsor breach, so that the preferred member can enjoy the same protection if it is ever in control.

Preferred membership interests present two other issues distinct to preferred equity instruments: the risk of equity re-characterization, and constraints on distributions at state law.

I. Equity Re-characterization and Constraints on Distributions

Preferred equity can take many forms in these deals. The preferred member agreement often includes fixed distributions, payable regardless of cash flow, and with mandatory distribution dates as well as a mandatory redemption date. In such a scenario, the preferred member will often not share in the residual, opting instead for limited downside exposure in lieu of upside potential. The members of a deal can structure it with any variation of the above three variables. Parties might opt for non-guaranteed distributions and a greater share of the residual. They might allow for flex-

241. Cf. Steele, *supra* note 240, at 236 (noting that the application of default duties in the limited liability company context would incent actors to use fiduciary duties *ex post* because they believe a jury will be sympathetic to a fiduciary duty theory when *ex ante* the parties bargained for the contracting away of such duties).

242. Steele, *supra* note 240.

243. See ROBERT COOTER & THOMAS ULEN, *LAW AND ECONOMICS 201* (Addison-Wesley 3d. ed. 2000) (“[E]conomic efficiency requires enforcing a promise if the promisor and promisee both wanted enforceability when the promise was made.”) (alteration in original).

244. DEL. CODE ANN. tit. 6, § 18-108 (2012).

ibility in the distribution dates and allow for the accrual of distributions instead of guaranteed distributions. They might not have a hard and fast redemption date, and so on.

This section will explore two issues: (1) Is there a substantial likelihood that a court would re-characterize a preferred investment as debt, thereby rendering the preferred member an unsecured creditor? (2) What are the effects of statutory distribution constraints on the ability of the preferred member to receive its distributions, what rights does the preferred member have where as a matter of law the company is unable to distribute and what, if any, is the effect of equity re-characterization on the balance sheet or by a court on distribution constraints?

1. Equity Re-characterization

Businesses which have preferred members in their capital structure may treat preferred equity as debt for accounting purposes under GAAP rules.²⁴⁵ Similarly, at times some courts hold that preferred equity can be re-characterized as debt.²⁴⁶ But examples abound where the Delaware Chancery has refrained from such re-characterization.²⁴⁷ The determinative factor has turned not on how preferred equity was treated from an accounting perspective, but the actual terms of the preferred position.²⁴⁸

In the Delaware Bankruptcy case, *In re Color Tile, Inc.*, cited by the Chancery in *Harbinger Capital Partners*, the determinative factor that led the court to refuse re-characterization of the preferred shares was that the holders' liquidation preference only allowed payment "out of the assets of the Company available to its stockholders . . . [which meant that] the preferred . . . interests as class were junior to corporation's secured creditors in the context of liquidation."²⁴⁹ The *Harbinger* court noted that the preferred shares in question in the case were equity as a matter of law because the equity instruments gave their holders no right to guaranteed distributions, not because they were referred to as equity in the instrument evidencing their interests.²⁵⁰ The Chancery also noted that the instruments gave their holders no right to redeem, cutting in favor of characterizing them as equity.²⁵¹

245. See ACCOUNTING FOR CERTAIN FINANCIAL INSTRUMENTS WITH CHARACTERISTICS OF BOTH LIABILITIES AND EQUITY, Statement of Fin. Accounting Standards No. 150 (Fin. Accounting Standards Bd. 2003); see, e.g., *Harbinger Capital Partners Master Fund I, Ltd. v. Granite Broad. Corp.*, 906 A.2d 218 (Del. Ch. 2006) (showing a defendant corporation applying FAS 150).

246. See, e.g., *Costa Brava P'ship, III, L.P. v. Telos Corp.*, 2006 WL 1313985 (Md. Cir. Ct. Mar. 30, 2006).

247. See, e.g., *Harbinger Capital Partners Master Fund I, Ltd. v. Granite Broad. Corp.*, 906 A.2d 218 (Del. Ch. 2006).

248. *Id.* at 230.

249. *In re Color Tile, Inc.*, Civ.A 98-358-SLR, 2000 WL 152129, at 5 (Bankr D. Del. Feb. 9, 2000) (alteration in original).

250. *Harbinger Capital Partners Master Fund I, Ltd.*, 906 A.2d at 231.

251. *Id.*

For those contemplating a preferred investment in a limited liability company formed in Delaware, *Harbinger* is a reason for pause. Under its holding, rights to guaranteed distributions and a mandatory redemption date,²⁵² because they give the equity holder a right to payment beyond a claim to the residual value of the company inconsistent with the rights normally accorded to equity investors,²⁵³ militate against a finding that the preferred member interest is equity. *Harbinger* may be distinguished in that it was a case where a preferred member sought re-characterization in order to have standing under the Delaware Fraudulent Transfer Act, but the rules enunciated could transfer easily to a context where the preferred holder sought an opposite end.

Two other factors may also lead to re-characterization of equity as debt: the adequacy of capitalization in the company and whether the rate of return on the investment is characteristic of debt or equity. The *Harbinger* court cited to cases involving tax disputes, where jurisprudence on re-characterization has been developed considerably. In tax disputes, however, it must be noted that it is usually the Internal Revenue Service who challenges the characterization of an investment as debt because the payments on debt are deductible by the payor.²⁵⁴ Such courts may find that thin or inadequate capitalization cuts in favor of re-characterization of a shareholder loan as equity.²⁵⁵ By negative implication, if the preferred equity investment sits atop a large common equity cushion, this may cut in favor of re-characterization as debt. Similarly, if the rate of return on a debt instrument is more akin to that which is more characteristic of equity, tax authorities may re-characterize it as equity.²⁵⁶ Again, by negative implication, where a preferred investment has a rate of return more like the market rates for debt instruments, this could cut in favor of re-characterization as debt.

The impact of re-characterizing preferred shares as debt would be to make the preferred member an unsecured creditor because it has no perfected security interest in the membership interests of the Owning SPE or the Borrower SPE. In the event of liquidation the preferred member turned creditor would do no worse than it would have as a preferred member because as a creditor of the Owning SPE it will be entitled to be paid in full before any equity holder in the Owning SPE receives payment.

252. Mandatory distributions are fixed returns, like commonly found in a debt security. With such mandatory distributions often comes a cap on, or total absence of participation in, returns from the residual funds of the company after all preferred members and creditors have been paid for their accrued distributions and capital investment and any rights to payments from capital events.

253. See *Harbinger Capital Partners Master Fund I, Ltd.*, 906 A.2d at 230.

254. See, e.g., *Estate of Mixon v. United States*, 464 F.2d 394, 401 (5th Cir. 1972).

255. Cf. *id.*

256. David P. Hariton, *Distinguishing Between Equity and Debt in the New Financial Environment*, 431 PRACTICING LAW INST. TAX LAW & EST. PLAN. COURSE HANDBOOK SERIES, 1253, 1310 (1998).

Were a court to re-characterize, a potential draw-back is that the preferred member may lose management or consent rights over the Owing SPE and, therefore, the Borrowing SPE, if the court decides to treat the preferred equity holder's major decision rights as belonging only to a member of the Owing SPE and not applicable as loan covenants upon a re-characterization of the preferred member's equity investment into debt. In effect, it could lose its ability to control its own destiny including, among other things, the ability to control the filing of bankruptcy. These control rights are precisely what the preferred member had bargained for in becoming a preferred member.

While this is theoretically a concern, in practical terms it would seem to be a perverse result. First, in general, in a re-characterization case, a third party creditor or taxing authority is often seeking to have debt re-characterized as equity and not the other way around.²⁵⁷ Perhaps for financial reporting or tax accounting the preferred equity may be treated as debt, but this should not affect the bargained-for legal rights between the Sponsor, who after all agreed to such rights, and the preferred equity investor. Where the authors could see this issue arising is in a case where the Sponsor filed the Owing SPE into bankruptcy and then defends against a motion to dismiss brought by the preferred equity investor on the grounds that the provisions granting a consent right to file to preferred equity investor were simply loan covenants and therefore not enforceable to prevent the filing.

While the authors are not aware of a reported decision so holding, another potential danger is that the preferred investment could be re-characterized as debt of the Sponsor or any other equity member pre-existing the preferred investment. A simple example will illustrate the concern. Suppose the Borrower SPE needs more capital to service its debt under the senior mortgage loan. The capital call will go to the members of the Borrower SPE. The membership interests are held by the Owing SPE and so the members of the Owing SPE bear the onus of the capital call. This is a scenario where the members of the Owing SPE might seek a preferred investment or mezzanine loan. Assuming they sought a preferred investment, and one member kicked in his share of the capital call and the Sponsor did not. The preferred investment flows in and covers the Sponsor's share. The Sponsor would be deemed to have fulfilled its obligation under the capital call, but the benefit of later distributions attributable to this capital infusion would flow to the preferred member. In this scenario the preferred investment could, in theory, be deemed by a court as debt extended to the Sponsor.

This would be a very unfortunate result for the preferred member because, not only would it lose its management and consent rights over the Owing SPE, but it would have no claim against the Owing SPE at all. In a scenario where the Sponsor has no other assets other than its interests in

257. *See, e.g.*, Estate of Mixon, 464 F.2d at 401.

the Owning SPE, the preferred member would thereby be limited to chasing any distributions made to the Sponsor by virtue of the Sponsor's equity interests in the Owning SPE. As with the re-characterization as debt of the Owning SPE, this is not what the preferred member bargained for.

2. Distribution Constraints²⁵⁸

In this subsection, the authors will look to the distribution constraints regime under the Delaware Limited Liability Company Act with an eye to the practical impact on the preferred member's receipt of its distributions.

Under Delaware law, a limited liability company may not make distributions to its members where, after the distribution, all the liabilities of the company exceed the fair market valuation of its assets.²⁵⁹ The distribution must be challenged within three years of the distribution.²⁶⁰ Where a creditor has recourse limited to a specified security interest in property of the company, the debt held by such creditor is not included in the calculation of liabilities.²⁶¹ Any property that is subject to a security interest of the limited liability company may be included in the assets calculation to the extent that its fair market value exceeds the liability for which it is attached as a security interest.²⁶² A member who receives a distribution knowing that the limited liability company making the distribution was statutorily insolvent at the time such member received the distribution is liable to the company for the amount of the distribution, upon challenge from another member.²⁶³ This liability can be waived under Section 18-502(b), but it must be done through an amendment to the operating agreement.²⁶⁴

Section 18-607 is thus a balance sheet test. The Delaware Chancery described the test as a prohibition against "the stripping of corporate *assets* so as to render an LLC insolvent"²⁶⁵ Therefore, the relevant

258. While this section focuses on distributions of dividends, the same principles apply to mandatory redemption rights. *Cf.* *ThoughtWorks, Inc v. SV Inv. Partners, LLC*, 902 A.2d 745 (Del. Ch. 2006) (holding, in the C-corp context, that companies are obligated to redeem shares with redemption rights to the extent they may legally do so under the distribution constraints of Delaware Law and emphasizing that redemption rights are a contract term bargained for by the parties and therefore enforceable to the extent legally possible).

259. DEL. CODE ANN. tit. 6, § 18-607 (2012).

260. *Id.* § 18-607(c).

261. *Id.* For example, under the language of the statute, a non-recourse junior mortgage at the Borrower SPE would not be included.

262. *Id.*

263. DEL. CODE ANN. tit. 6, § 18-607(b) (2012).

264. *Id.* § 18-502(b). For a discussion of the use of § 18-502(b) to waive liability for an unlawful distribution, see Joint Task Force of Committee on LLCs, Partnerships and Unincorporated & Entities and the Committee on Taxation, ABA Section of Business Law, *Model Real Estate Development Operating Agreement with Commentary*, 63 BUS. LAW. 385, 510 (2008).

265. *Pepsi-Cola Bottling Co. of Salisbury, Md. v. Handy*, No. 1973-S, 2000 WL 364199 (Del. Ch. Mar. 15, 2000) (emphasis added).

inquiry is not related to cash flow insolvency, the ability to pay debts as they become due.²⁶⁶ Jurisprudence on the balance sheet test of the limited liability company statute is nonexistent. Looking to corporate law jurisprudence on the subject, however, is instructive.²⁶⁷ While Chief Justice Steele cautioned that it may not be appropriate in a fiduciary duty analysis to import corporate law jurisprudence to the limited liability company context,²⁶⁸ in the context of distribution constraints, the policy animating the law is the protection of creditors from company misrepresentations as to the financial viability of the company and acts that shift company assets out of the company after the creditor extends credit (with the principals of the company hiding behind the limited liability shield)²⁶⁹ is arguably applicable across contexts.

The balance sheet test in Delaware is largely a product of common law, but the Chancery has applied it inconsistently. For instance, in one case the Chancery applied a strict balance sheet test, declaring that “an entity is insolvent when it has liabilities in excess of a reasonable market value of assets held.”²⁷⁰ Other cases include an additional element to the strict test that there be “no reasonable prospect that the business can be continued in the face thereof.”²⁷¹ The latter narrows the number of corporations that would be deemed insolvent because the corporation would have the opportunity to show that, even though their balance sheet shows strict insolvency, the corporation has a reasonable prospect to continue business, which includes fulfilling the obligations they have to creditors.²⁷² This study does not seek to resolve this dispute. Instead, it will analyze the implications of both approaches for the purposes of the preferred member’s receipt of its distributions.

These aforementioned cases deal with the standing of creditors to bring fiduciary duty claims against managers of corporations. While this case law is related to creditor standing for challenging corporate acts while the corporation is insolvent and thus is not directly related to distribution constraints, as outlined above this case law is instructive as to how Dela-

266. See *Patrocínio v. Yalanis*, 492 A.2d 215, 218 (Conn. App. 1985), for a discussion of the distinction between the balance sheet test and the insolvency tests.

267. Chief Justice Steele of the Delaware Supreme Court, in his analysis of fiduciary duties as applied to limited liability companies, noted that developing “an entirely new body of law . . . would be an unwise course for Delaware, given its rich common law of corporations readily adaptable, where appropriate to . . . limited liability companies.” Myron T. Steele, *Judicial Scrutiny of Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies*, 32 DEL. J. CORP. L. 1, 8-9 (2007).

268. *Id.*

269. See ALLEN ET AL., *supra* note 226, at 131.

270. *Geyer v. Ingersoll Publ’ns Co.*, 621 A.2d 784, 789 (Del. Ch. 1992).

271. *North American Catholic Educ. Programming Found. v. Gheewalla*, 930 A.2d 92, 98 (Del. 2007).

272. Robert J. Stearn, Jr. & Cory D. Kandestin, *Delaware’s Solvency Test: What is it and Does it Make Sense? A Comparison of Solvency Tests Under the Bankruptcy Code and Delaware Law*, 36 DEL. J. CORP. L. 165, 174 (2011).

ware courts think about balance sheet tests. Moreover, it is relevant because it shows that creditors may stand in the shoes of shareholders to file a fiduciary duty action against management.²⁷³ Section 18-607(b) of the DE LLC Act provides that the member who receives the distribution in violation of this Section will be liable to the limited liability company.²⁷⁴ With the power given through this case law, the creditor may therefore stand in the shoes of the limited liability company to bring a claim for a wrongful distribution where the limited liability company is insolvent.

An important thing to notice about Delaware's balance sheet test is the allowance of a fair market valuation on the assets side and the apparent limitation of the liabilities side to book value. The legislature makes clear that it knows how to add a fair market value standard by its including one on the asset side, which arguably evinces a legislative intent to limit the liabilities side to book value.²⁷⁵ While this is likely of little practical importance because limited liability companies in these deals are not likely to issue privately or publicly-placed bonds,²⁷⁶ were the Owing SPE to do so, the company would not be allowed to mark down its debt based on secondary market valuations.

It is unclear from the statute how to characterize preferred equity for purposes of the distribution constraints. Does the GAAP standard applicable to valuation of the asset side imply that a GAAP standard should be applied to the characterization of preferred equity as debt? If so, in a scenario where preferred equity is characterized as debt for accounting purposes, does that mean that preferred equity would be placed outside of distribution constraints at state law? If not, would jurisprudence in other contexts related to equity re-characterization be used to determine whether a preferred investment in the Owing SPE is to be treated as a liability for distribution constraints?

a. *Preferred Equity: Liability or Shareholder Equity?*

The Financial Accounting Standards Board (FASB), the institutional body that promulgates the U.S. accounting rules known as Generally Accepted Accounting Principles (GAAP), requires that some forms of preferred equity be characterized as debt.²⁷⁷ Where an equity instrument is

273. North American Catholic Educ. Programming Found., 930 A.2d at 101 (“[T]he creditors of an *insolvent* corporation have standing to maintain derivative claims against directors on behalf of the corporation for breaches of fiduciary duties.”) (alteration in original) (emphasis in original).

274. DEL. CODE ANN. tit. 6, § 18-607(b) (2012).

275. See *O’Neill v. Town of Middletown*, CIV.A. 1069-N, 2006 WL 205071 (Del. Ch. Jan. 18, 2006), for an example of this principle of statutory construction.

276. The Delaware Limited Liability Company Act (DEL. CODE ANN. tit. 6) is silent as to whether Delaware limited liability companies have the authority to issue bonds.

277. See ACCOUNTING FOR CERTAIN FINANCIAL INSTRUMENTS WITH CHARACTERISTICS OF BOTH LIABILITIES AND EQUITY, Statement of Fin. Accounting Standards No. 150 (Fin. Accounting Standards Bd. 2003).

“mandatorily redeemable . . . by transferring its assets at a specified or determinable date (or dates) or upon an event that is certain to occur” is to be treated as a liability for GAAP purposes.²⁷⁸ Thus, if the preferred member’s investment has a mandatory redemption date, it shall be treated as a liability on the balance sheet. But it is not readily assumable that a court will apply a GAAP standard to the characterization of equity as debt for purposes of distribution constraints.

A statute is a law, and, therefore, the relevant jurisprudence in Delaware would determine the categorization of the preferred member interests as equity or debt.²⁷⁹ As noted in the previous section, Delaware courts may re-characterize equity as debt where there are mandatory, guaranteed distributions with distribution dates and priority in liquidation not characteristic of equity.²⁸⁰ A second key factor cutting in favor of re-characterization would be whether the equity holder is entitled to guaranteed distributions. Lastly, whether there is a mandatory redemption date would also cut in favor of re-characterization.

For purposes of distribution constraints, the preferred member’s position may actually obtain greater protection for its distributions if its investment were re-characterized as debt. If the investment is legally debt, it would follow that the preferred member’s distributions would fall within the category of payments that the distribution constraints are intended to protect.

One reason distribution constraints arguably exist, though, is because of the informational asymmetry between creditors and debtors. The concerns of misrepresentation of financial condition and the siphoning of funds to insiders derived from credit extensions common to all creditor and debtor law, which apply *a fortiori* where the insiders enjoy the limited liability shield of the company form, speak to the situation of the creditor relative to the debtor.²⁸¹ A creditor is an outsider to the company and therefore not apprised to all the financial realities of the company. They thus deserve protection from insider bad acts.

A preferred member of an Owning SPE with all the inside information that it has access to as a member of the SPE is not similarly situated to a creditor with respect to the company. To treat a preferred member of the Owning SPE as a creditor for purposes of the distribution constraints would give it the protections of an outsider by guaranteeing its payments

278. ACCOUNTING FOR CERTAIN FINANCIAL INSTRUMENTS WITH CHARACTERISTICS OF BOTH LIABILITIES AND EQUITY, Summary of Statement of Fin. Accounting Standards No. 150 (Fin. Accounting Standards Bd. 2003), *available at* <http://www.fasb.org/summary/stsum150.shtml>.

279. *See Harbinger Capital Partners Master Fund I, Ltd. v. Granite Broad. Corp.*, 906 A.2d 218 (Del. Ch. 2006) (“[t]o believe that [FAS 150] decides the case would grant FASB, which is neither lawmaker nor judge, the power to fundamentally alter the law’s understanding of the role of preferred shares.”) (alteration in original).

280. *See supra* Section II.I.1 for a discussion of equity re-characterization.

281. *See ALLEN ET AL.*, *supra* note 226.

alongside any other creditors regardless of the solvency of the balance sheet while the preferred member does not suffer from the lack of access to inside information of the SPE. Where there are additional *actual* creditors of the SPE, the preferred member's circumvention of the distribution constraints could be to the detriment of creditors, which could arguably undermine the purpose of the limitations on distributions.

Moreover, an additional rationale for the distribution constraints is that they are simply an expression of the general priority regime in corporate law. Equity holders are to be paid after debt holders. But where there are creditors of the Owing SPE, were the preferred member to step into a position *pari passu* to the position of such creditors for purposes of receiving its distributions, this would subvert the legal assumption that equity holders are paid after debt holders. This assumption undoubtedly forms part of the legal backdrop against which preferred members and creditors of the Owing SPE bargain for their terms. The assumption of a higher priority by the creditor will lead to a lower premium paid for its capital investment than a preferred member. Similarly, the return on investment the preferred member bargains for would likely be higher than the creditor because the preferred member expects a lower priority. This would subvert market participants' assumptions, thus undermining the risk profiles used to determine market rates.

The jurisprudential standard emphasizes mandatory distributions and liquidation priority not characteristic of equity as the key factors in determining whether equity should be re-characterized as debt while the GAAP standard emphasizes mandatory redemption dates. The *Harbinger* court also noted that the absence of a redemption right also cut in favor of finding that the equity instruments in question were equity as a matter of law.²⁸² Therefore, the GAAP standard would capture more equity instruments than the jurisprudential standard because the Chancery has made clear, at least in the C-corp context, that mandatory redemptions are subject to distribution constraints.²⁸³ Because the statute is a law, and the GAAP standard only captures scenarios that will be subject to the distribution constraints, the jurisprudential standard should apply, qualified by the policy considerations behind the statute already mentioned.

b. *Fair Market Valuation of Assets*

While it is unclear whether a legal or accounting standard for equity would apply to the categorization of preferred equity with respect to the liabilities side of the balance sheet test, the statute clearly indicates that a fair market valuation must be applied to the assets side. Thus, in the context of an under-productive underlying asset property, the Owing SPE would be required to mark-to-market the value of the asset shares of the Borrowing SPE, its only assets. The value of these shares, in turn, is de-

282. *Harbinger*, 906 A.2d at 230-31.

283. *See ThoughtWorks, Inc v. SV Inv. Partners, LLC*, 902 A.2d 745 (Del. Ch. 2006).

pendent on the fair market value of the underlying asset property. FASB prescribes the types of pricing information relevant to the calculation of fair market value, to which we now turn.

FASB notes that the fair market value is “a market-based measurement, not an entity-specific measurement” “focus[ing] on the price that would be received to sell the asset . . . not the price that would be paid to acquire the asset . . .”²⁸⁴ Therefore, whatever assumptions market participants would use to value the asset in contemplation of purchase should be used to determine the fair market value of the asset.²⁸⁵ FASB prescribes a hierarchy for sources of evidence for these assumptions. First, market participant assumptions arising from the analysis of data by entities other than the entity that owns the asset or arising from sources outside of the owning entity (observable inputs) and, second, the entity’s own valuation according to its reading of “market participant assumptions based on the best information available in the circumstances (unobservable inputs).”²⁸⁶

Observable inputs that are “reasonably available without undue cost and effort” must be incorporated in the valuation process by the entity performing the valuation of its own assets.²⁸⁷ The market for equity interests in the Borrower SPE will likely be very small, if there is one at all, and equity interests are not traded on any exchanges. Therefore, the traditional sources of observable inputs are limited. While small, however, there is a market of funds and investors who are buy these assets. As such, it may be incumbent upon the accountants for the Owning SPE to look to databases and listings of comparative asset properties to update the value of the Borrowing SPE shares appropriately.²⁸⁸

The weight given to assumptions about the market for commercial real estate and the risk factors considered in determining the present value of the Borrower SPE membership interests should probably be disclosed in footnotes to the balance sheet. Likewise, observable inputs used to derive such assumptions and the weight given to them should also be disclosed in the footnotes.

c. Implications of Balance Sheet Test for Preferred Members

Under the strict balance sheet test, if the preferred member interests were considered liabilities and there were no other liabilities, the Owning SPE would not be allowed to pay any guaranteed distributions where its

284. See FAIR VALUE MEASUREMENTS, Summary of Statement of Fin. Accounting Standards No. 157 (Fin. Accounting Standards Bd. 2007), available at <http://www.fasb.org/summary/stsum157.shtml> (alteration in original).

285. *Id.*

286. *Id.*

287. *Id.*

288. *But see* *In re Radiology Assoc., Inc.*, 611 A.2d 485, 490 (Del. Ch. 1991), for an example of how fraught the comparative companies analysis can be in the context of a valuation of a closed corporation. The same measurement difficulties could arise in the valuation of the assets in question in the current study.

assets, the membership interests in the Borrower SPE, were of lesser value than the preferred member's interests. If the Borrower SPE were highly leveraged, this would reduce the asset side of the Owing SPE because the service of such debt would diminish the residual cash flows to the Owing SPE through its membership interests in the Borrowing SPE. This would thus decrease the value of the Borrower SPE shares on the Owing SPE's balance sheet, which in turn would decrease any surplus out of which the preferred member's distributions could be paid.

If the "no reasonable prospect that the business can be continued in the face thereof"²⁸⁹ element were applied, the Owing SPE may be able to justify distributions to the preferred member where circumstances were such that, at the moment, the balance sheet was formally insolvent, but the underlying asset property was likely to produce sufficient cash flow that the Owing SPE would be able to continue its business.

Absent a guaranty from the Sponsor to make the guaranteed payments should the Owing SPE be prohibited from doing so by law, the preferred member would not be permitted to collect its distributions. Its only recourse would be for breach of contract of the operating agreement or to take over management of the Owing SPE.

It is probably unlikely that a court would allow for damages where the company is prohibited by law to make distributions.²⁹⁰ As a practical matter, as long as there is cash flow to pay the preferred equity, it is unlikely that the Sponsor member would cause the Owing SPE to not make the required distributions to the preferred member based upon a failure of balance sheet insolvency. This result follows from the fact that (i) generally, in these structures, there would not be any meaningful creditors of the Owing SPE, and there almost certainly would not be any creditors not being paid ahead of the preferred member; and (ii) typically if it is not timely receiving required distributions, the preferred equity member has the right to replace the Sponsor member as managing member and take over control of the project (and, therefore, declare distributions).

d. *Accrued Dividend Treatment*

Under Delaware law, the member of a limited liability company that has become entitled to a distribution has "the status of, and is entitled to all remedies available to, a creditor . . . with respect to the distribution."²⁹¹ Where an operating agreement provides for guaranteed dividends, upon the declaration of a dividend, the preferred member would therefore have the status of a creditor with respect to that amount. The preferred member

289. *North American Catholic Educ. Programming Found. v. Gheewalla*, 930 A.2d 92, 98 (Del. 2007).

290. *Cf. ThoughtWorks, Inc v. SV Inv. Partners, LLC*, 902 A.2d 745 (Del. Ch. 2006) (holding that redemption right in the C-corp context, which are subject to distribution constraints, are enforceable only to the extent of funds legally available, suggesting that the preferred member's access to funds would be circumscribed by the distribution constraints).

291. DEL. CODE ANN. tit. 6, § 18-606 (2012).

may, at this point, seek a security interest in the assets of the Owing SPE as security for the distribution and file a UCC-1 financing statement to put relevant parties on constructive notice of its interest.²⁹² Upon obtaining a security interest, the distributions to which the preferred member is entitled could arguably fall outside of the distribution restraint regime. But even in the absence of a security interest, the preferred member may have greater rights than it would as a member without accrued dividends.²⁹³ While it is unlikely that this would change the preferred member's position in terms of payment priority, the preferred member's status as creditor could make it a party that enjoys the protections of the distribution constraints with respect to the accrued dividends, rather than a victim of them.²⁹⁴

The last issue pertinent to the preferred investment is related to forfeiture provisions in the operating agreement, a questionable practice, both in terms of enforceability and in terms of its effect on the preferred member's reputation.

J. Forfeiture Provisions in the Preferred Membership Agreement

In an effort to secure its investment, a preferred member sometimes will seek a forfeiture provision that provides for the membership interests of the Owing SPE to vest in the preferred member where the Owing SPE breaches the membership agreement. Courts generally look at provisions that trigger forfeiture upon breaching an agreement with suspicion.²⁹⁵

While no Delaware case law is directly on point, in *Walker v. Resource Development Co., Ltd., L.L.C.*,²⁹⁶ a cousin of former president George W. Bush, Randolph Walker, was cut out of a limited liability company due to his failure to obtain financing for the venture as was required of him under the operating agreement. The other members with authority to remove members not only terminated his membership in the limited liability company but also declared Walker's economic interest as forfeit.²⁹⁷ The operating agreement provided for removal but not the forfeiture of economic

292. Cf. Richard W. Nenno & John E. Sullivan III, *Delaware Asset Protection Trusts: Avoiding Fraudulent Transfers and Attorney Liability*, 32 EST. PLAN. 22, 31 (2005).

293. Cf. Frank L. Watson, Jr. & Mary Ann Jackson, *The Tennessee Revised Limited Liability Company Act: A Practitioner's Guide to Avoiding the Pitfalls*, 37 U. MEM. L. REV. 311, 346 (2007) (noting, in reference to the Revised Limited Liability Company Act, which contains a provision similar to §18-606, the member may have more rights).

294. Cf. Law of Fraudulent Transactions § 5:30 (2011) (noting that the purpose of distribution constraints, like prohibitions against fraudulent transfers, are to protect creditors from transactions that benefit the equity holders of a corporation to the detriment of the creditors).

295. See, e.g., *Old Time Petroleum Co. v. Turcol*, 18 Del. Ch. 121 (Ch. 1931) ("Conditions in a deed which upon breach work a forfeiture of the estate are not favored in law.").

296. 791 A.2d 799 (Del. Ch. 2000).

297. *Id.*

interests.²⁹⁸ The Chancery considered two questions relevant to our purposes: (1) whether the operating agreement of the limited liability company provided for the forfeiture of economic interests in such a case and, if not, (2) whether the default rules under the Limited Liability Company Act gave the other members the right to forfeit Walker's economic interest.²⁹⁹

The Chancery explicitly states that the policy position taken by the Delaware General Assembly is to give effect to the parties' desires as embodied in the cornerstone document of the limited liability company, the operating agreement.³⁰⁰ In dicta, Vice-Chancellor Lamb wrote that, had the other members simply made Walker's economic interest contingent upon the closing of the financing deal, they would have been "easily . . . protected"³⁰¹ The court held that the Delaware LLC Act does not give members any inherent power to cause the forfeiture of other members' economic interests in the venture.³⁰² It looked to other statutes (e.g., merger statutes), which provide for an inherent power to eliminate memberships, and noted that even in such statutes a member must be fairly compensated for its economic interest in the venture upon termination of its membership.³⁰³

On the one hand, the *Walker* case arguably stands for the principle that, where an operating agreement provides for the forfeiture of an economic interest upon some sort of failure to abide by the operating agreement, the Chancery will enforce the terms of the agreement. Absent clear provisions for such forfeiture, the default rules of the Delaware LLC Act will not grant any power to do so. If the limited liability company is a creature of contract, then the operating agreement could phrase unsatisfactory performance by the Sponsor as a material breach,³⁰⁴ which would relieve the other members from honoring its economic interest, acting as a liquidated damages clause. Where the operating agreement specifies that the failure of the Sponsor to perform satisfactorily is a material breach, the

298. *Id.* at 803-09.

299. *See id.* at 800.

300. *Id.* at 813 (" . . . LCC members' rights begin with and typically end with the Operating Agreement. ").

301. *Id.* Section 18-502(c) of the Delaware Limited Liability Company Act under Title 6 gives the authority for members' interests in the limited liability company to be reduced or eliminated for failure to make a contribution the member is obligated to make. DEL. CODE ANN. tit. 6, § 18-502(c) (2012). Section 18-101 (3) defines contribution as "any cash, property, services rendered or a promissory note or other obligation to contribute cash or property or to perform services, which a person contributes to a limited liability company in the person's capacity as a member." *Id.* § 18-101.

302. 791 A.2d at 815.

303. *Id.*

304. *See* 23 WILLISTON ON CONTRACTS § 63:3 (4th ed. 2011) (noting that a material breach "is a failure to do something that is so fundamental to a contract that the failure to perform that obligation defeats the essential purpose of the contract. ").

court will ordinarily have to honor it provided that questions of fact are resolved in favor of finding unsatisfactory performance.³⁰⁵

On the other hand, the *Walker* case is distinguishable from our context in that the economic interests of the plaintiff in the case was a product of his connections to a financing source. Walker was admitted to the limited liability company because he promised to provide access to capital, not because he contributed capital. In the context of real estate deals, the economic interest of the preferred member comes from its investment of capital. The Chancery never referenced the distinction between equity resulting from something other than capital investment and equity resulting from capital investment. However, the Chancery enunciated broad rules not tied to the particular facts of the *Walker* case. Therefore, the holding might arguably apply no matter the source of the economic interest. It follows that where a preferred member negotiates for a provision in the operating agreement to provide for a forfeiture of the Sponsor's interests should the Sponsor fail to meet the obligations set out in the operating agreement, the Chancery would likely enforce such a provision.

Another consideration is that attempting to obtain a forfeiture provision would likely be seen as harsh and unseemly. Private equity funds that specialize in preferred investments will naturally be concerned with preserving and facilitating future deal flow. Therefore, the reputational risks to the fund and fund manager associated with seeking harsh terms like forfeiture provisions may outweigh the protective benefits they provide. If the preferred member is unable to negotiate for a forfeiture provision or is concerned about its appearance, the preferred member may easily contract for a transfer of control rights in the event of default, as discussed above in multiple places.

Finally, while the authors are not aware of any cases on point, a forfeiture provision could increase the risk that the preferred equity might be re-characterized as debt. The rationale behind this thought is that the foreclosure of a lien upon collateral for debt, or upon a judgment lien securing a judgment upon unsecured debt, results in the elimination (leaving aside any post-foreclosure redemption rights provided in the mortgage context under the laws of a handful of states) of the debtor's interest in the collateral. A forfeiture would result in a similar elimination of interests in the entity as opposed to simply rendering the Sponsor member passive with subordinated cash flow rights, which is the more traditional remedy for a breach of obligations in an equity transaction.

We now turn to the issue of whether the traditional equitable mortgage doctrine should apply to mezzanine loans and preferred member investments. This issue has not yet come before a court, but one author has argued in favor of characterizing these funding mechanisms as mortgages. The risk of such re-characterization of the instruments as mortgages is an issue about which counsel for the mezzanine lender or preferred investor

305. *Id.*

should be aware, as it could form grounds for a challenge to their attempts to exercise their rights upon default or breach.

IV. SHOULD MEZZANINE LOANS AND PREFERRED EQUITY INVESTMENTS BE TREATED AS EQUITABLE MORTGAGES?

In “*Once A Mortgage, Always A Mortgage*”—*The Use (and Misuse of) Mezzanine Loans and Preferred Equity Investments*, Andrew R. Berman argues that the equity gap mechanisms discussed here are mortgage equivalents and, as such, should be treated by courts as equitable mortgages.³⁰⁶ However, treating these mechanisms as equitable mortgages would stifle real estate investment and provide undue protections to sophisticated borrowers.

Berman gives the following reasoning to show that courts should treat these funding mechanisms as mortgages. He begins by noting that courts circumvented the “freedom of contract” theory by looking beyond the document to discern the “true substance of the debt transaction.”³⁰⁷ He continues that the parcel of real property that serves as the security interest for the senior loan, in substance, forms the security interest for mezzanine loans or the membership interests of the preferred member in the Owning SPE.³⁰⁸ The Owning SPE typically has only one corporate purpose: the owning of membership interests of the Borrower SPE and, therefore, has no other assets.³⁰⁹ The value of the membership interests of the Borrower SPE is derived solely from the cash flows and underlying equity in the mortgaged property, held by the Borrower SPE.³¹⁰ Thus, albeit indirectly, the shares of the Owning SPE used as collateral for the mezzanine loan or purchased by the preferred equity member derive their value from the underlying property that forms the security interest of the senior mortgage.³¹¹ Therefore, the mezzanine lender and the preferred member (because preferred equity is economically similar to a mezzanine loan), in substance, are giving loans secured by an interest in the subject property, which is substantively equivalent to a mortgage. Ergo, courts should treat them as mortgages under the “once a mortgage, always a mortgage” maxim.

As a matter of first impression, Berman’s argument appears reasonable given the common law tradition of treating agreements that are substantively equivalent to mortgages as mortgages. Upon closer look, however, accepting Berman’s argument would require adherence to a policy stance taken for the protection of unsuspecting, unsophisticated mortgagors in equity courts of common law England, to sophisticated borrowers, who

306. 11 Stan. J.L. Bus. & Fin. 76 (2005).

307. *Id.* at 116.

308. *Id.* at 113-15.

309. *Id.* at 114.

310. *See id.* at 114-15.

311. *Id.*

consciously seek additional funding to fill the gap created by the prohibition against junior mortgages and limits senior lenders maintain on their loan-to-value ratios or to fund the gap between the value of the a first senior mortgage and the value of the mortgage obtained for refinancing.³¹²

While it is more likely than not that an agreement that looks and acts like a mortgage will be treated as mortgages by courts,³¹³ courts have not been unresponsive to changing economic realities in real estate finance and have found ostensibly mortgage-like agreements not to be equitable mortgages.³¹⁴ Were a court to be presented with the issue of whether mezzanine loans to a SPE or a preferred member's investment in an SPE are mortgages, it should not only look to whether in substance the transaction's debt is secured by real property, but should also look to the facts of the transaction to see if the spirit of the equitable doctrines of mortgage law are also applicable.

Berman never addresses the substantive inquiry of why mezzanine debt and preferred equity should be treated as mortgages, instead applying an equitable maxim in a legalistic manner. But the "once a mortgage, always a mortgage" maxim has been attached with less vigor in commercial deals on the basis that the central thrust of the maxim was to prevent "clogging" the equity of redemption,³¹⁵ and that such prohibitions are less likely to be necessary in the commercial real estate context.³¹⁶ Therefore, because the central goal of the maxim applied by Berman is to confirm the attachment of the equity of redemption doctrine, one must ask if it makes sense to attach the equity of redemption doctrine to commercial mezzanine loans and preferred equity investments.

The central goal of equitable redemption in mortgage law is to promote fairness.³¹⁷ Where an unsuspecting, unsophisticated mortgagor is in an unfair bargaining position, equity therefore requires extra protections, because actors in exigent or needful circumstances are "not . . . free men,

312. See Preble & Cartwright, *supra* note 26, at 829 (commenting that the application of the "once a mortgage, always a mortgage" maxim was in response to "surprise, [and] the unexpected detriment to the mortgagor, and the unconscionable advantage taken by the mortgagee of the hapless, unknowing and ill advised mortgagor" which is hardly the description of a sophisticated real estate investor).

313. See Marshall E. Tracht, *Renegotiation and Secured Credit: Explaining the Equity of Redemption*, 52 Vand. L. Rev. 599 (1999) (commenting that the attachment of equitable redemption rights to mortgages is largely unquestioned at this point).

314. *Id.* (noting that equity of redemption doctrine has not been intractably applied in modern real estate finance law).

315. Preble & Cartwright, *supra* note 26, at 825.

316. *Id.* at 829 (noting that a commercial deal is less likely to be an "oppressive bargain where the borrower is at the mercy of an unscrupulous lender" and is therefore less likely to receive equitable protection) (citing *Knightsbridge Estates Trust, Ltd. v. Byrne*, [1939] 1 Ch. 441, 445).

317. *Id.* at 828.

but . . . will submit to any terms that the crafty may impose upon them”³¹⁸ to keep their estates.³¹⁹ Such terms may result in usury and forfeiture, anathemas to fairness.

Scholars have attacked the economic rationality of the equity of redemption doctrine in general, but have done so with particular vigor in the commercial context. Marshall E. Tracht notes that the courts’ continual insistence, even in commercial deals, on the attachment of equity of redemption protection based on a fair bargaining rationale is insufficient for two reasons. First, in a competitive market for funding, a lender will not attempt to extract usurious terms from a sophisticated borrower because the borrower will choose another lender who does not seek such terms.³²⁰ Second, even where market failures lead to limited funding options, the lender who has an unfair bargaining position will simply shift its extortionate effort from a forfeiture clause to some other usurious term, such as higher interest, to circumvent forfeiture prohibitions, rendering such prohibitions impotent.³²¹

Some argue the equitable redemption doctrine leads to market inefficiencies such as higher interest rates across the board for all borrowers.³²² Schill sees no problem with this, equating equitable redemption doctrine to mandatory insurance imposed on the borrower to cover the risk of irrational optimism, insuring against unforeseen inability to meet the terms of the mortgage agreement.³²³ Lenders simply spread the cost of such irrationality amongst all mortgagors. However, Schill argues that this rationale is most applicable in the consumer context, not the commercial, because commercial players are less susceptible to irrational optimism.³²⁴

Notwithstanding the irrationality of applying the equity of redemption doctrine to commercial deals, Tracht argues that the equity of redemption doctrine in the commercial context may be explained as a facilitator of reasonable renegotiation. Specifically, he argues that it could be understood as a partial response to two distinct problems in the mortgage rela-

318. *Vernon v. Bethell*, (1762) 28 Eng. Rep. 838, 839.

319. *But see* William M. McGovern, Jr., *Forfeiture, Inequality of Bargaining Power, and the Availability of Credit: An Historical Perspective*, 74 Nw. U. L. REV. 141, 146-47 (1979) (showing that the primary mortgagors in the period wherein the equity of redemption had its genesis were wealthy merchants, perhaps undermining the traditional rationale for the doctrine).

320. Tracht, *supra* note 315, at 613.

321. *Id.* at 613-14.

322. *Id.* at 615. *See also* Terrence M. Clauretie, *The Impact of Interstate Foreclosure Cost Differences and the Value of Mortgages on Default Rates*, 15 REAL ESTATE ECON. 152 (1987); Mark Meador, *The Effects of Mortgage Laws on Home Mortgage Rates*, 34 J. ECON. & BUS. 143, 146-47 (1982).

323. Michael H. Schill, *An Economic Analysis of Mortgagor Protection Laws*, 77 VA. L. REV. 489, 495-500 (1991). *See also* E.N.D., Note, *The Basis of Relief from Penalties and Forfeitures*, 20 MICH. L. REV. 646, 647 (1922) (noting that the “overly-sanguine” borrower with “faith in a special providence” was often the basis for equitable protection).

324. Tracht, *supra* note 315, at 616-17 (citing Schill, *supra* note 323, at 535-36).

tionship—the bilateral monopoly (borrower and lender are the only parties that can meet each other’s respective needs related to the subject debt transaction)³²⁵ and problem of opportunistic renegotiation strategies (lender may attempt to threaten default to obtain more favorable terms)³²⁶—by defining the terms and sequence of events where the borrower defaults.³²⁷ But even Tracht recognizes that this is, at best, a partial explanation for the otherwise irrational application of equitable redemption doctrine to commercial mortgages.³²⁸

A second policy issue is with respect to economic and control rights. At common law, economic and control rights were intermingled in the same property such that it made no sense to address them separately. For instance, a farmer mortgagor would not only use its land for economic productivity, but also would live on the land. Thus, the sting of forfeiture would not only include lost future economic rights, but also the farmer’s home. In the modern commercial real estate deal, however, the mortgagor has only economic interests because the mortgagor’s sole interest is in the rents and profits from the real property. While the mortgagor maintains a right to control the premises of the property, such control is only relevant to the mortgagor because it facilitates the generation of rents and profits. Assuming the mortgagor does not occupy the premises, therefore, the equitable redemption doctrine may not apply with the same force because commercial deals are arguably more fungible than a person’s home.³²⁹

Where a borrower is sophisticated and fully capable of understanding the implications of the agreement it signs, equitable arguments are less persuasive. The above exposition shows that the attachment of the equity of redemption doctrine to actual commercial mortgages has been vigorously attacked. The operation of the “once a mortgage, always a mortgage” maxim extends the attachment of this doctrine to mortgage-like agreements. Given that the application of the doctrine to actual mortgages is challenged in the context of commercial deals, a thoughtful person will question whether the a court should extend the doctrine to agreements in the commercial context explicitly intended not to be mortgages by sophisticated parties via this equitable maxim.

The equitable limitations placed on mortgage-like agreements at common law were created to limit lender practices of forcing forfeiture,

325. *Id.* at 626-28.

326. *Id.* at 628-29.

327. *Id.* at 630-35.

328. *Id.* at 630 (“The equity of redemption *may* provide a *partial* cure for these twin problems.”) (emphasis added).

329. See Margaret Jane Radin, *Property and Personhood*, 34 *STAN. L. REV.* 957, 959-61 (1982) (commenting that, consistent with her personhood theory of property, there are assets that are fungible and assets that are non-fungible. A commercial deal is more fungible than a person’s home on the theory that the value of the latter is derived more from personal attachment and control, while the value of the former is derived from rents and profits, which may be obtained elsewhere).

whereas the equity gap mechanisms are efforts by borrowers to comport with lender covenants that prohibit borrowers from filling this gap through junior mortgages. This is not a case of a lender attempting to circumvent equitable protections to take advantages of unsuspecting, irrationally optimistic borrowers. This is a case of borrowers seeking additional funding in order to consummate their deals while following rating agencies' recommendations to structure their transactions in order to comply with CMBS requirements. That is, equity gap financing is a response by sophisticated borrowers attempting to meet their needs in the marketplace. Thus, the equitable ground upon which the attachment of the "once a mortgage, always a mortgage" maxim is normally based is inapplicable. Moreover, dating back to the early 20th Century, common law courts have shown respect for freedom of contract and under many circumstances have found that agreements with mortgage-like properties were not necessarily mortgages, especially in the commercial context.³³⁰

Preble and Cartwright identify the central consideration in determining whether a mortgage-like agreement should be an equitable mortgage and two categories of agreements where courts have not found mortgage-like agreements to be equitable mortgages. First, they emphasize that the intent of the parties is always paramount when deciding whether to apply the "once a mortgage, always a mortgage" maxim.³³¹ Absent independent equitable grounds for the attachment of the equitable protections, such as unfair dealing or undue pressure,³³² the courts would not deem mortgage-like agreements equitable mortgages.³³³ Where the intent of the parties was akin to a mortgage and the strict enforcement of the terms would lead to a surprising, unfair forfeiture of the property, it would be deemed a mortgage. But where it was not, it would be treated as a contract subject only to contract law procedural limitations and gap-fillers.

Mezzanine loans and preferred equity investments are expressly intended *not to be mortgages*. That is, the members of the Owning SPE expressly seek alternative financing mechanisms, with recourse limited to the foreclosure on the membership interests of the Borrower SPE and subsequent capture of the Borrower SPE, in the case of the mezzanine lender, or capturing of control through taking over as managing member of the Owning SPE in the case of preferred member. Once the preferred member takes control of the Owning SPE or mezzanine lender takes control of the Borrower SPE, it still has to cure the senior loan if it is in default,

330. See, e.g., *DeBeers Consol. Mines, Ltd. v. British South Africa Co.*, (1910) 2 Ch. 502, *rev'd*, [1912] A.C. 52 (H.L.) (appeal taken from Eng.) (finding separate commercial contract secured by real property was not a mortgage); *London & Globe Fin. Corp. v. Montgomery*, (1902) 18 T.L.R. 661 (explaining that purchase option not a mortgage); *Reeve v. Lisle*, [1902] A.C. 461 (appeal taken from Eng.) (finding passage of days made an option contract a separate agreement from the mortgage); *Davies v. Chamberlain*, (1909) 25 T.L.R. 766, *aff'd*, 26 T.L.R. 138 (finding purchase and sale agreement not a mortgage).

331. Preble & Cartwright, *supra* note 26, at 827.

332. See *Mainland v. Upjohn*, [1889] 41 Ch. 126 (Eng.).

333. Preble & Cartwright, *supra* note 26, at 827-28.

perform under the senior mortgage agreement, refinance, or surrender the property to the Senior Lender.

Preble and Cartwright show that where there are separate and independent transactions, an alleged clog in the right to redeem will be rejected.³³⁴ For instance, in *Reeve v. Lisle*, the passage of several days between transactions sufficed to separate the transactions.³³⁵ In *DeBeers Consolidated Mines, Ltd. v. British South Africa Company*, a commercially reasonable mining contract was sustained because the security phase of the contract was sufficiently separated.³³⁶

Relatedly, the second category Preble and Cartwright outline are those where the loan is part of a larger, complex transaction.³³⁷ In *MacArthur v. North Palm Beach Utilities, Inc.*, the lender lent money secured by real property, but the agreement also contained an option to buy the sewage and water system at the cost of the borrower paid to develop it.³³⁸ The option there was not supported by any independent consideration. The borrower received the loan from the lender but when the two parties were unable to agree on the option's exercise price, the borrower claimed a clogging defense against the option, requesting that the Florida court find the option to be an equitable mortgage. The court refused because to do so would have been to allow the borrower to benefit from the bargain but not bear its costs. Thus, the option was enforced according to its terms.

While, unlike in the *MacArthur* case, the preferred equity and mezzanine loan is typically provided by a separate entity than the senior lender, the legal principle should apply here as well. Why should a borrower who receives the benefit of a separate bargain from the mortgage and consciously enters into an agreement for funding its equity gap be able to renege on the costs of that agreement when it defaults?³³⁹ As noted in the previous section, a sophisticated borrower should be held to the agreement it signs. At the very least, again, courts should look to the facts of the transaction rather than turning the "once a mortgage, always a mortgage" equitable maxim into a rule of law.

Aside from these arguments, two last points are worth mentioning. First, mezzanine loans and preferred equity investments are already subject to legal regimes offering protections to the debtor or regular equity investor. In the case of mezzanine loans, the mezzanine lender is subject to the UCC foreclosure regime when it seeks to foreclose on the Borrower SPE membership interests. This UCC foreclosure process typically takes

334. *Id.* at 828.

335. [1902] A.C. 461 (appeal taken from Eng.).

336. (1910) 2 Ch. 502, *rev'd*, [1912] A.C. 52 (H.L.) (appeal taken from Eng.).

337. Preble & Cartwright, *supra* note 26, at 837.

338. 202 So. 2d 181 (Fla. 1967).

339. See *Kreglinger v. New Patagonia Meat & Cold Storage Co.*, [1913] UKHL 1, [1914] A.C. 25 (Lord Parker of Waddington) (noting that the borrower in question sought "relief from a contract which they admit to be fair and reasonable and of which they have already enjoyed the full advantage.").

between 30-45 days with a right to redeem the interests retained by the previous owners.³⁴⁰ In a right of sale state, the foreclosure process on a mortgaged property sometimes takes less than 30 days, with sales being final to any bona fide purchaser.³⁴¹ Thus, the time period for redemption does not necessarily contract the time available for redemption. While in the case of the preferred member the process might be more quickly consummated, absent a foreclosure provision, the other economic interests of the Sponsor or any other equity member of the Owning SPE are generally not extinguished, obviating any concern of unfair forfeiture. In the case of preferred equity, the preferred investor is subject to compliance with the laws applicable to the members or partners generally. For example, a preferred equity investor in a Delaware limited liability company is subject to the Delaware LLC Act and the body of case law interpreting that Act. So for example, as discussed earlier, a preferred equity investor who takes over management control of the Owning Entity is subject to the duty of good faith and fair dealing.

The second point is that, unlike in the prototypical equitable mortgage situation, neither the mezzanine lender nor the preferred equity investor has any direct interest in the underlying real estate. As a result, the mezzanine lender and the preferred equity investor have none of the protections which such an interest would afford. For example, if any lien, whether consensual or not, is filed upon the property, the mezzanine lender and the preferred equity investor (subject to a potential right of the preferred equity investor to challenge the granting of any such lien which it did not consent to where its consent was required under the applicable operating agreement) take subject to such lien. If the mezzanine lender or preferred equity investor had held a prior mortgage, they would have been able to take free of such lien by foreclosure. Unless one were to subordinate after arising interests to the equitable mortgage, a result of converting a mezzanine loan into an equitable mortgage would be to impose upon the mezzanine lender all of the foreclosure requirements appertaining to a mortgage and none of the benefits. Additionally, the mezzanine lender would certainly have to comply with the requirements of a UCC sale, otherwise other creditors of the mezzanine borrower that may be senior to the mezzanine lender would be effectively structurally subordinated.

To subvert the intention of the parties and to intervene judicially into a private market solution to a problem particular to structured finance, by forcing mezzanine lenders and preferred investors to contribute to the equity gap, would unnecessarily add uncertainty to the market. To introduce such uncertainty would chill direct investment, thereby undermining the

340. See U.C.C. § 9-623 (2011) (providing the right to redeem before the sale or acceptance of collateral as partial or full payment).

341. See David Gray Carlson, *Critique of Money Judgment Part One: Liens on New York Real Property*, 82 ST. JOHN'S L. REV. 1291, 1295 (2008) (noting that the bona fide purchaser receives the property free of unrecorded liens, etc.).

market for CMBS and stifling liquidity available to value adding commercial real estate projects.

V. CONCLUSION

This article has led the reader through the genesis, rise, and legal realities of two alternative funding mechanisms, preferred equity and mezzanine debt, which arose to fill the equity gap created by the loan to value ratio limits on commercial mortgages and the negative covenants against junior liens on the underlying real properties. This study does not intend to be an exhaustive treatment of the legal issues that must be considered when structuring these investments, but it has hopefully shed light on some of the most important ones. From the perfection of the mezzanine lender's collateral, to shadow of the federal bankruptcy regime that looms over all entrepreneurial endeavors, from the fiduciary duties the preferred members may owe when they take control of the Owing SPE, to the distribution constraints, the risks of equity re-characterization, and the enforceability of forfeiture provisions, this survey has attempted to provide an extensive outline of pertinent issues for counsel to consider.

One of the hoped-for takeaways from this article is an understanding of some of the primary similarities and differences between mezzanine loans and preferred equity investments. Mezzanine loans and preferred equity investments play similar roles in the capital structure of a transaction, each generally has similar economics, and each is subject to liens upon the underlying real estate and non-lien holding creditors of mortgage borrower.

Notwithstanding the broad similarities, a mezzanine loan is debt of the entity that holds the equity in the entity that owns the underlying real estate, the Owing SPE, and a preferred equity investment is equity generally in the Owing SPE. As outlined above, there are also a number of significant differences between these subordinate financing mechanisms. These differences include:

- (i) the mezzanine lender is generally able to obtain a comprehensive inter-creditor agreement from the Senior Lender, whereas the preferred equity investor often is not;
- (ii) a mezzanine lender's realization upon the pledged equity in the Borrower SPE eliminates all of the indirect interests of the Sponsor in the Borrower SPE, whereas, when a preferred equity investor exercises its remedies to take control of the Owing SPE, the Sponsor generally becomes passive but retains its indirect interest in the Borrower SPE;
- (iii) as a result of Sponsor maintaining such an interest, a preferred equity investor will owe the Sponsor member a duty of good faith and fair dealing (and any other fiduciary duties that are not waived) after it takes over control of the Owing SPE, whereas the mezzanine lender owes no such duty after the UCC sale;

(iv) generally, the mezzanine lender must hold a UCC sale to realize upon the pledged equity and gain control of the Borrower SPE, whereas the preferred equity investor does not need to hold such a sale and, depending upon the terms of the applicable operating or limited partnership agreement, can take over control of the Owing SPE and, therefore, of the Borrower SPE within a matter of days;

(v) the preferred equity investor typically has approval rights over a bankruptcy filing by the Owing SPE or the Borrower SPE and is much better able to prevent such a filing than a mezzanine lender. The preferred equity investor is also in a better position to prevent or challenge as unauthorized prohibited transfers of or liens upon the underlying real estate;

(vi) with respect to a mezzanine loan, provided it holds a perfected first priority lien, the mezzanine lender's interest in the pledged equity would not be subject to any debts of the Owing SPE, but would be subject to any debts of and liens and other transfers granted by the Borrower SPE. With respect to a preferred equity investment, the preferred equity investor will be structurally subordinate not only to all of the debts of and liens and other transfers granted by the Borrower SPE, but also to those of the Owing SPE. However, the case of a preferred equity investment, under a properly structured preferred equity operating agreement, the Owing SPE would not have any authority either in its own capacity or as the sole member of Borrower SPE to incur or to cause the Borrower SPE to incur any material indebtedness or to grant any liens or other transfers without the prior consent of the preferred equity investor. Any material indebtedness, liens or other transfers incurred or granted by the Owing SPE or the Borrower SPE upon Sponsor's authorization but without the requisite consent of preferred equity member would be subject to challenge by the preferred equity member; and

(vii) a preferred equity investment is subject to the potential re-characterization and distribution constraint risks discussed above, which are not risks borne by the mezzanine lender in a typical transaction.

While not generally addressed in this article outside of some mention in the section discussing potential re-characterization of preferred equity and distribution constraints, the tax and accounting treatment of mezzanine loans and preferred equity investments and tax planning opportunities, including, without limitation, potential methods to minimize differences in treatment between the different structures, should be reviewed by the transaction participants before finally settling upon a structure in any particular situation.

Like in many areas of law concerning various rights and remedies under organizational documents, there are often few court opinions from which to draw guidance. The authors have endeavored here to outline what they deem the most reasonable prediction of how courts would treat these issues. The equitable mortgage doctrine, sourced at common law for the protection of unsuspecting and unsophisticated borrowers, has no

place in a context of sophisticated market participants meeting their needs through alternative financing strategies and who bargain for and understand the terms of the agreements they undertake.

As the commercial real estate market continues to rebound after the trough of the financial crisis, the importance of preferred equity investments and mezzanine debt has expanded. Fewer senior lenders are willing to loan at such high loan-to-value ratios, the valuations pre-crisis that justified large loans no longer stand and therefore refinancing creditors are unwilling to provide the loans to cover the outstanding amounts due on loans based on such pre-crisis valuations. Thus a robust market has emerged for private equity funds specializing in filling the gap in exchange for lower priority positions that comport with the prohibitions against junior mortgages under the senior mortgages that are included in CMBS. This study hopes to be timely and relevant to the practitioners working in this fertile market.

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