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**Real Estate Preferred Equity Investments:
*Issues Concerning the Sponsor Principal***

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TABLE OF CONTENTS

| | Page |
|--|------|
| Introduction..... | 1 |
| I. Nomenclature and a Dichotomy | 3 |
| A. What do we mean by a “Real Estate Capital Investment Agreement”? | 3 |
| 1. The Preferred Equity Agreement | 4 |
| 2. The Joint Venture Agreement..... | 5 |
| B. What do we mean by the “Sponsor Principal”? | 6 |
| 1. Who she is..... | 6 |
| 2. The scope of her obligations and related matters..... | 6 |
| a. Scope: A question of control..... | 6 |
| b. How she is designated and the type of instrument she signs | 8 |
| II. Consequences: Sponsor Principal Liability and Re-characterization of the Capital Partner’s Equity Investment as Debt..... | 9 |
| A. As a matter of fairness, should the type of Real Estate Capital Investment Agreement inform the scope of the Sponsor Principal’s liability? As a matter of market reality, does it? | 9 |
| 1. The normative question: How should things be?..... | 9 |
| 2. The positive question: How are things?..... | 11 |
| B. Designation of the Sponsor Principal and the type of instrument she signs | 12 |
| 1. “Debts,” “performance,” and “obligations” | 12 |
| 2. Re-characterization | 14 |
| a. General principles and the Castle Harbour litigation..... | 14 |
| b. Conclusions..... | 21 |
| III. Issues Attending the Removal or Departure of the Sponsor Principal | 29 |
| A. Limiting liability for the Sponsor Partner and the Sponsor Principal..... | 32 |
| B. Limiting liability for the Capital Partner | 35 |
| Conclusion | 36 |

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INTRODUCTION

In its most basic form, a real estate preferred equity investment transaction involves two partners: one who provides the expertise to locate, acquire, operate, and sell a piece of real estate,¹ and another who provides the capital to support these endeavors.² In practice, real estate preferred equity investment transactions are almost never as simple as this basic form. Beyond it lies a multitude of variations, even a few of which can quickly transform a transaction structure from “basic” to “complex.” This paper does not undertake to survey these variations. Instead, it considers issues created by one of the most common variations on the basic form – a requirement by the Capital Partner that the Sponsor Partner provide a person or entity³ who will backstop either or both (i) the Sponsor Partner’s obligations to the Capital Partner⁴ and (ii) the Company’s obligations to a third-party lender extending credit to the Company.⁵

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¹ This partner is referred to herein as the “**Sponsor Partner**.”

² This partner is referred to herein as the “**Capital Partner**.”

³ This person or entity is referred to herein as the “**Sponsor Principal**.” Most Capital Partners insist that a person serve as the Sponsor Principal rather than an entity. However, if the Sponsor Partner is a subsidiary of a large institutional investor, most Capital Partners are relatively more willing to accept an entity as the Sponsor Principal.

⁴ The Sponsor Partner and the Capital Partner will be the co-owners of an entity – most commonly members of a limited liability company. For purposes of this paper, this entity is referred to as the “**Company**.” Further, consistent with current market practice, this paper assumes that the Company is a limited liability company formed under and governed by the laws of the State of Delaware and, thus, is subject to the Delaware Limited Liability Company Act, Del. Code tit. 6, § 18-101 et seq. (the “**Act**”).

⁵ Referred to herein as a “**Lender**.”

Part I addresses nomenclature encountered in real estate preferred equity investment transactions and establishes a dichotomy that structures the analysis set forth in this paper.

Part II considers whether the type of limited liability company agreement used in a particular transaction⁶ does (or perhaps should) affect the scope of the Sponsor Principal's liability.⁷ In addition, this portion of the paper examines whether there are practical consequences based on how the Sponsor Principal is identified in the transaction and the type of instrument she is asked to sign to backstop the Sponsor Partner's or the Company's obligations. Part II considers these issues both from the standpoint of the Capital Partner's efforts to enforce liability against the Sponsor Principal and from the standpoint of risk that the Capital Partner's equity investment could be re-characterized as debt for Federal income tax purposes. Although commercial real estate lawyers representing Capital Partners, Sponsor Partners, and Sponsor Principals usually do (and always should) involve their tax colleagues in the writing and negotiation of the governing documents, real estate lawyers would be well served to have at least some familiarity with debt re-characterization principles. Real estate preferred equity investments that, at the outset of negotiations, look very much like equity structures sometimes morph during negotiations into more debt-like structures. Of likely greater concern, equity investments that initially contain some debt-like features can take on additional earmarks of debt as negotiations progress, often to the point that the professed equity investor appears to be a thinly-disguised mezzanine lender. As borne out by the analysis of the Castle Harbour opinion in Part II, re-characterization of an equity investment as debt can be a multi-million dollar problem for a Capital Partner. Given this magnitude of risk, any lawyer involved in the writing and negotiation of the documents that govern these types of transactions – especially counsel for the Capital Partner – should have some familiarity with re-characterization principles.

Part III analyzes issues attending the removal or departure of a Sponsor Principal from a real estate preferred equity investment. From the perspective of the Sponsor Principal, this portion of the paper examines the Sponsor Principal's obligations to the Capital Partner and to a Lender in the wake of a removal or departure event. From the standpoint of the Capital Partner, this portion of the paper notes the possibility of post-removal liability for the Capital Partner and highlights an easy way to mitigate this potential liability.

⁶ Referred to herein as a “**Real Estate Capital Investment Agreement**.”

⁷ References herein to “the Sponsor Principal's liability” generally assume that the Sponsor Partner is liable as well: because, again, in real estate preferred equity investment transactions the Sponsor Principal is typically called upon to backstop the Sponsor Partner's obligations. However, Sponsor Principals certainly can undertake liability in addition to that assumed by the Sponsor Principal. *See, e.g., Int'l Plaza Assocs., L.P. v. Lacher*, 104 A.D.3d 578, 579 (N.Y. App. Div. 2013) (stating that a guarantor's liability may exceed the scope of the principal's liability) (citations omitted); *Gard Entm't, Inc. v. Country in New York, LLC*, 96 A.D.3d 683 (N.Y. App. Div. 2012) (stating that ordinarily the liability of a guarantor will not exceed that of the principal, but that a guaranty is a separate undertaking and may impose lesser or even greater collateral responsibility on the guarantor) (citations omitted). For the relevance of New York law to guaranty and guarantor issues discussed herein, *see infra* note 35 and the accompanying text.

I.
NOMENCLATURE AND A DICHOTOMY

A.
WHAT DO WE MEAN BY A “REAL ESTATE CAPITAL INVESTMENT AGREEMENT”?

Even when limited to the realm of commercial real estate, the term “preferred equity” denotes multiple types of investments. These investment types exist on a continuum, some with more equity-like features and others with more debt-like features. A Capital Partner seeking high returns and willing to wait until a sale or refinancing of the real property⁸ to receive those returns – if and when such sale or refinancing may occur – is at the “equity” pole of this continuum. A Capital Partner requiring regular – and even fixed – payments during the time the Company owns the asset or requiring an outside date by which the investor must receive its return on, and return of, capital is at the “debt” pole of this continuum.⁹

⁸ Referred to herein as a “**Project**.”

⁹ One might ask: If a proposed real estate preferred equity investment transaction is near the debt pole of the continuum, why not just structure it as a debt transaction (i.e., a mezzanine loan)? A full answer to this question exceeds the scope of this paper, given its implication of state transfer tax concerns (in some jurisdictions), Federal income tax law (although a single aspect of Federal income tax law is considered in detail in Part II), and accounting regulations (governing accounting treatment of investments) – among other considerations. Nonetheless, the examples set forth below illustrate why there can be compelling reasons to structure a debt-like transaction as an equity investment. For an excellent analysis of reasons why investors might opt for one form of investment (i.e., mezzanine debt versus equity investment) over another, see J. Dean Heller, *What’s in a Name: Mezzanine Debt Versus Preferred Equity*, 18 STAN. J. L. BUS. & FIN. 40 (2012).

First, various jurisdictions impose significant transfer taxes on real estate transactions. In some of these jurisdictions, “real estate transactions,” for transfer tax purposes, include transfers of equity in entities that own real estate, even if the transfer is from a defaulted borrower to a mezzanine lender that is realizing on its equity collateral. As a result, a foreclosing mezzanine lender will pay the transfer tax once upon its acquisition of the pledged equity collateral and then pay it a second time when it causes the owner of the real property to sell its assets. Structuring the transaction as an equity investment eliminates this concern.

Second, whether an investment is structured as debt or equity can have significant consequences under Federal income tax law. As one example, interest income from debt investments is taxed as ordinary income, whereas gain upon exit from equity investments typically will be taxed as long-term capital gain. As another example, mezzanine loans create tax complications for REITs. Based on a 2003 Revenue Procedure issued by the Internal Revenue Service, a REIT can make mezzanine loans secured by an equity interest in an entity that owns real property without risking adverse tax treatment of the REIT, but only if the REIT can satisfy an eight-point safe harbor test. See Rev. Proc. 2003-65, 2003-32. The prevailing form of mezzanine loan in the real estate capital markets space would generally fail to satisfy at least one prong of this test: the requirement that the loan be non-recourse. See *id.* (“The loan is nonrecourse, secured only by the partner’s interest in the partnership, or the member’s interest in the disregarded entity; thus, in the event of default, the sole recourse is against the pledged ownership interest”). Given the ubiquity and necessity of guaranties in real estate mezzanine loan transactions, many mezzanine loans would not satisfy this prong of the safe harbor. Further, compliance with the safe harbor mandates that interest on the mezzanine loan meet the requirements of Treasury Regulation §§ 1.856-5(a) and (b), which eliminates a common form of “equity kicker” in favor of the REIT. See *id.* (“Interest on the loan meets the requirements of §§ 1.856-5(a) and (b); thus, the interest includes only an amount that constitutes compensation for the use or forbearance of money, and, subject to the exception contained in § 1.856-5(d), the determination of the amount does not depend in whole or in part on the income or profits of any person”).

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