

Construction Mezzanine Financing

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Construction mezzanine lending is on the rise and more development deals are getting done with a capital stack that includes mezzanine debt in addition to the traditional components of sponsor equity and senior mortgage debt. Below are important issues and concepts to bear in mind when structuring the financing of a construction project that includes a mezzanine debt component.

Funding Sequence

When will the proceeds of the mezzanine loan be advanced? In some instances, the mezzanine loan proceeds will be advanced only after all of the borrower's equity has been contributed to the construction of the project. In other instances, the borrower's equity and the mezzanine loan proceeds go in either *pari passu* or simultaneously at another ratio. If the equity is not entirely contributed in advance, the mezzanine lender may require that the uncontributed equity be held by the mezzanine lender or held in a pledged account. The mezzanine lender may also further mitigate the risk of non-funding of the equity by requiring an equity funding guaranty (as discussed below).

Additionally, when will the mezzanine loan proceeds be advanced in relation to the senior mortgage loan proceeds? Will the entire mezzanine loan be advanced prior to any senior mortgage loan advance or will they be advanced *pari passu*? Depending on the business deal, the mezzanine loan agreement will need to reflect how and when the equity, the mezzanine debt, and the mortgage debt will be advanced.

Security

The "borrower" under construction mezzanine financing will be the "parent" of the mortgage borrower/owner of the project. The mezzanine borrower will borrow the mezzanine loan proceeds from the mezzanine lender and contribute the funds to its subsidiary (the mortgage borrower/owner of the project) for use in constructing the project. As is the case in "typical" (non-construction) mezzanine financing, the mezzanine borrower will secure its payment and performance obligations by granting a pledge of and security interest in one-hundred percent of the equity interests (typically, limited liability company interests) it holds in the mortgage borrower/property owner pursuant to a pledge and security agreement.

A mezzanine loan will not be secured by a second lien mortgage on the underlying project. As a result of the mezzanine loan not being secured by a recorded lien on the "bricks and sticks," care must be taken when negotiating the provisions of the mezzanine loan documents relating to the conditions precedent for loan advances, the impact of mechanic's liens, and the various representations, warranties and covenants made by the mezzanine borrower as respects the mortgage borrower/property owner.

Guarantees

A typical mezzanine loan structure will generally include a non-recourse carve-out guaranty and an environmental indemnification agreement from a "deep pocket" individual or sponsor-controlled entity. These guarantees will also be part of the collateral package for a construction mezzanine loan. In addition, the mezzanine lender will also require a completion guaranty substantially similar to the completion guaranty that will be required by the mortgage lender (completion guarantees are discussed further in the section below

titled "Intercreditor Considerations").

In the event the borrower's equity is contributed in a *pari passu* fashion along with mezzanine loan advances and/or will continue to be contributed to the project after the mezzanine loan is fully advanced, the mezzanine lender may also require an equity funding guaranty to address the mezzanine borrower's ongoing obligation to commit the required amount of equity. This additional guaranty is, of course, subject to deal-specific negotiations and discussions at the business level. In the event all of the equity being contributed is a condition precedent to any mezzanine loan advances being made, the need for such an additional equity funding guaranty is greatly reduced.

Intercreditor Considerations

The senior lender and the mezzanine lender will want to start their intercreditor discussions relatively early in the life of the deal because of the complexity of the many of the issues to be discussed. Some of these points are quite similar to those points which would be addressed in non-construction senior-mezzanine capital stack. Topics to be addressed include:

1. the mezzanine lender's right(s) to cure monetary and non-monetary defaults under the senior loan,
2. the mezzanine lender's right to purchase the senior loan upon the occurrence of certain trigger events, such as an event of default under the senior loan and/or the enforcement of rights and remedies by the senior lender,
3. recognition by the senior lender of the mezzanine lender's right to foreclose upon the pledged equity collateral and "take over" the mortgage borrower/property owner,
4. the agreement by the mezzanine lender (or its designee) to issue "replacement guarantees" in favor of the senior lender in the event the mezzanine lender (or its designee) acquires the pledged equity interests and takes over control of the mortgage borrower/property owner, and
5. the agreement of the senior lender not to accept a deed-in-lieu of foreclosure from the mortgage borrower while, for example, the mezzanine lender is curing defaults under the senior loan.

With regard to the delivery of "replacement guarantees" in favor of the senior lender in the event of a foreclosure sale of the pledged equity interests under the Uniform Commercial Code or an assignment of such interests in lieu of foreclosure, the senior lender and the mezzanine lender will want to focus on who exactly can qualify as an acceptable replacement completion guarantor under the senior loan and when those replacement guarantees need to be provided. The senior lender will want to ensure that the proposed replacement guarantor has the financial wherewithal to honor its lien-free completion obligations and the mezzanine lender will want to secure the senior lender's pre-approval of a specific entity(ies) as an acceptable completion guarantor by expressly identifying such entity in the Intercreditor Agreement. Both are reasonable requests. Even if the senior lender agrees to "hardwire" such pre-approved entity in the Intercreditor Agreement, the senior lender will likely require other general conditions related to the approval of the replacement guarantor, such as, for example, the absence of litigation between the senior lender and the proposed replacement guarantor.

The mezzanine lender should also seek recognition from the senior lender that in the event the mezzanine lender (or its designee) "takes over the project" through the acquisition of the pledged equity interests it will have an additional reasonable period of time after the acquisition of the pledged equity to get its "arms around the project" (including, perhaps, getting a new general contractor in place if circumstances warrant) in order to properly honor its construction-related obligations. Mezzanine lenders should give careful consideration to the scope of the completion guarantees that are entered into in connection with the senior loan as the very nature of the construction mezzanine lender's position increases the likelihood that the mezzanine lender (or its designee) will need to complete or cause the completion of the project.

Other Considerations

The mezzanine loan agreement and certain other ancillary documents are often drafted based off of the mortgage loan documents. There are, however, many important differences and nuances to be included in the mezzanine loan documents. Consideration must be given to the differing rights and interests of the mortgage lender and the mezzanine lender as a result of their different positions in the capital stack and the general complexities associated with construction financing.

For example:

- Will the mortgage lender control reserves (*i.e.*, taxes, insurance, ground lease payments, operating expenses, and mezzanine debt service) and, post-completion, cash flow?
- Will the mezzanine lender have rights to approve changes to the construction budget and the operating budget?
- Will the mezzanine lender be able to control or have approval rights with respect to the release of retention to contractors, loan balancing, and, after completion, leasing activity?
- For condominium developments, will the mortgage lender permit a portion of sales proceeds to pay down the mezzanine loan prior to full repayment of the mortgage loan?

These are just a few examples of the types of issues that will need to be analyzed and discussed by the parties.

Construction mezzanine financing is growing in popularity and developers are increasingly turning to mezzanine lenders to complete their capital stacks and senior lenders are increasingly accepting the participation of mezzanine lenders and the rights and remedies attendant to their position.

This high level summary includes a few of the issues and concepts to keep in mind when thinking about a construction mezzanine transaction from a legal perspective, and is not intended to be a detailed analysis of all of the issues or concepts to consider or that may arise during the course of a deal. If you have questions or would like further information, please contact Tim Davis (davist@whiteandwilliams.com; 215.864.6829) or Steven Coury (courys@whiteandwilliams.com; 212.631.4412).

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