REAL ESTATE · INVESTOR DILIGENCE PRACTICE NOTE

Inside the Capital Stack

A Plain-English Diligence Guide for Accredited Investors — What You Are Actually Buying, and What Protects You

A sponsor sends you a pitch deck for a real estate offering. The first page promises a clean return — twelve percent, fourteen, sometimes more. The third page mentions the capital stack. Later, you are told you will be a "senior-secured" investor, a "preferred" investor, or simply "in the deal."

The most important question an accredited investor can ask is one the marketing rarely answers directly: *what, exactly, am I buying?* Common equity? Preferred equity? Mezzanine or subordinate debt? A first-lien senior loan? Each of these is a distinct legal position with its own rights, remedies, and risk profile. The expected return should reflect the position — and very often, it doesn't.

This note is a plain-English diligence guide for accredited investors evaluating private real estate investments. It explains what each layer of the capital stack actually is, how risk and return are supposed to align with position, and the credit enhancements that thoughtful counsel use to protect investor capital. It closes with a twelve-question checklist that every investor should be able to answer — in writing — before signing a subscription agreement.

Position Is the Investment

The "capital stack" is the layered structure of capital that funds a real estate project. Each layer represents a separate source of capital with its own legal documents, payment priority, voting and consent rights, default remedies, and expected return. The layers are not interchangeable. A 12% return on senior debt is not the same investment as a 12% return on common equity — even if the cash flow on day one looks identical.

Where you sit in the stack determines **three** things that the marketing materials rarely lead with:

- **What you own.** A recorded mortgage on the property is a fundamentally different instrument than a membership interest in a Delaware LLC. One is a real-property security interest; the other is a contract right governed by the operating agreement.[i]
- **How you get paid.** Payment priority — sometimes called the waterfall — controls the order in which proceeds from rent, refinance, or sale flow to each layer. Senior debt is paid first; common equity is paid last.

- **What you can do if it goes wrong.** A first-lien lender can foreclose on the property. A mezzanine lender can foreclose on the LLC interests under UCC Article 9. A preferred equity holder may have forced-sale or sponsor-removal rights. A common equity investor typically has none of those things.

> *A 12% return on senior debt is not the same investment as a 12% return on common equity — even if the cash flow on day one looks identical. The proper return is a function of the position.*

The Five Layers — In Practice

Senior / First-Lien Debt

A senior real estate loan is a recorded mortgage or deed of trust against the property, secured by a first-priority lien. The lender holds the loan agreement, the promissory note, the security instrument, an assignment of leases and rents, and a title insurance policy showing first-position priority. On default, the senior lender can pursue foreclosure under state law — judicial or non-judicial depending on jurisdiction — and recover principal from sale proceeds before any junior creditor or equity holder.

Expected returns are the lowest in the stack because the position is the most protected. Florida, Michigan, and New York each treat foreclosure mechanics differently, and recovery is never instantaneous: legal fees, broker commissions, carrying costs, and forced-sale discounts can erode net recoveries materially. A 70% LTV on the marketing deck is not a 30% loss cushion in a true workout scenario; the realistic cushion, after foreclosure costs and a distressed-sale discount, is meaningfully thinner.

Mezzanine / Subordinate Debt

Mezzanine debt sits between the senior loan and the equity. It is typically secured not by the property itself, but by a pledge of the equity interests in the property-owning LLC, perfected by a UCC-1 filing. On default, the mezzanine lender forecloses on the LLC interests under UCC Article 9 — taking control of the entity, not directly of the real estate. The relationship between the senior and mezzanine lenders is governed by an **intercreditor agreement** that defines standstill periods, cure rights, purchase options, and what each party can do on default.[ii]

Expected returns are higher than senior debt — coupon, PIK, and exit fees — because the position is subordinate and the security is one step removed from the real estate. The intercreditor agreement is the single most important document for any mezzanine investor; without it, the "second lien" can be paralyzed by senior lender consent rights or pre-empted by a senior foreclosure.

Preferred Equity

Preferred equity is equity in form but often debt in economics. The preferred holder typically receives a fixed preferred return paid before common equity distributions, with redemption rights at a specified date and consent rights over major decisions. On a default in the preferred return, the preferred holder may gain forced-sale rights, capital-call rights against the sponsor, or the ability to remove and replace the sponsor as manager.

There is no recorded lien. The preferred position is created entirely by the LLC or LP agreement — which is why reading the operating agreement carefully matters far more for preferred equity than the marketing summary suggests. Expected returns are higher than mezzanine debt to compensate for the absence of a recorded security interest and the structural subordination to all debt.

Common Equity

Common equity is the sponsor and the LPs who participate in the residual upside of the deal. Common equity is paid last in the waterfall, absorbs the first dollar of any loss, and carries the highest expected return — typically through a promote or carried interest structure that pays the sponsor a disproportionate share of profits above defined hurdles.

Voting rights are full; default remedies are essentially limited to derivative or direct litigation. The common equity investor's real protections are pre-investment — diligence on the sponsor, the asset, and the waterfall — because the post-default tools are weak. The return targets quoted in real estate syndications are almost always common equity returns, and investors should read them as such.

Credit Enhancements

Credit enhancements are not themselves a position in the stack. They are tools layered across positions to reduce loss-given-default — sinking funds, escrows, guaranties, letters of credit, completion guaranties, master leases, recourse carve-outs. They can sit at every level of the stack and can transform the risk profile of an investment without changing its formal position. They are the subject of the next section.

Position-by-Position Rights, Returns & Remedies

Where each layer of the capital stack sits — and what an investor in that position actually owns

POSITION	Payment Priority	Voting & Control	Default Remedies	Typical Return	Key Documents to Diligence
Senior / First-Lien Debt *Recorded mortgage or deed of trust; first to be paid; lowest expected return; strongest remedies.*	1st — paid in full before any other class	Limited; consent rights via loan covenants	Foreclosure on the property; UCC remedies on collateral; receivership.	Lowest — fixed or floating coupon; current pay	Loan agreement, note, mortgage/deed of trust, title policy, intercreditor
Mezzanine / Subordinate Debt *Pledge of equity interests (UCC Article 9); paid after senior debt; intercreditor agreement governs.*	2nd — after senior, before all equity	Negotiated consent rights; springing control on default	UCC Article 9 foreclosure of LLC interests; intercreditor standstill applies.	Higher — coupon + PIK + exit fees	Mezzanine loan agreement, pledge agreement, UCC-1, intercreditor agreement
Preferred Equity *Equity in form, debt in economics; redemption rights and preferred returns; no recorded lien.*	3rd — after all debt, before common equity	Negotiated consent rights; forced-sale or removal rights on triggers	Forced sale, capital-call rights, replacement of sponsor; arbitration or litigation.	Higher still — preferred return + redemption	LLC/LP agreement, preferred equity term sheet, redemption mechanics, side letter
Common Equity (Sponsor & LP) *Last to be paid; absorbs first losses; highest expected return; full upside participation.*	4th — residual; last to be paid	Full member/partner voting; sponsor controls day-to-day	Derivative or direct suit; very limited self-help; loss often absorbed first.	Highest — promote / waterfall economics	LLC/LP agreement, subscription agreement, waterfall provisions, sponsor PPM
Credit Enhancements *Layered across positions; sinking funds, escrows, guaranties, letters of credit, completion guaranties.*	Position-specific — supplements the underlying claim	None directly; rights run to the beneficiary of the enhancement	Draw on letter of credit, demand on guarantor, release of escrowed funds.	Reduces risk; modest yield drag on the position it protects	Guaranty, letter of credit, escrow/reserve agreement, completion guaranty

Each layer carries distinct rights, remedies, and risk premia. The proper return is a function of the position — not the marketing.

FIGURE 1 — WHAT EACH LAYER OF THE CAPITAL STACK ACTUALLY OWNS

Credit Enhancements — The Real Margin of Safety

A sophisticated investor evaluates not only where they sit in the stack, but what enhancements have been negotiated to reduce loss-given-default. Each enhancement adds protection — but only as far as the document creating it actually goes. A guaranty from an insolvent guarantor is worse than no guaranty at all because it creates a false sense of security.

Six categories of enhancement appear repeatedly in well-structured private real estate deals. The figure below summarizes what each does and what an investor should diligence to confirm it is real.

FIGURE 2 — SIX TOOLS THAT CHANGE THE RISK PROFILE OF ANY POSITION IN THE STACK

When the Offering Comes Through a Broker-Dealer or RIA

The diligence framework is essentially the same whether the offering is made directly by the sponsor or through a registered broker-dealer or investment adviser channel — but the documentation expectations shift. A broker-dealer distributing the offering will have conducted its own **reasonable-basis suitability** analysis under FINRA Rule 2111[iii], and Regulation Best Interest applies when the BD is recommending the security to a retail investor[iv]. The investor should ask the BD for its written reasonable-basis file and, if relevant, its Form CRS[v].

An offering distributed through a registered investment adviser carries an independent fiduciary obligation under the Investment Advisers Act of 1940[vi]. Performance presentations, testimonials, hypotheticals, and case studies are governed by **Marketing Rule 206(4)-1**[vii]. An investor with an RIA in the chain should ask whether the RIA receives compensation from the sponsor, how it is disclosed, and how the offering fits within the RIA's fiduciary recommendation. None of these layers replaces the investor's own diligence on the underlying position in the capital stack — they supplement it.

Bottom Line

Capital stack diligence is, at bottom, a discipline of reading what you actually own. The marketing tells you the return; the documents tell you what protects it. Senior debt, mezzanine debt, preferred equity, and common equity are not different flavors of the same instrument — they are different instruments with different rights, different remedies, and different risk premia. Credit enhancements can meaningfully change the risk of any position, but only when they are documented, funded, and enforceable.

An accredited investor is presumed by the federal securities laws to be able to evaluate the merits and risks of a private investment[viii]. The presumption is a serious one. The checklist that follows is the working document we recommend any investor — sophisticated or otherwise — complete in writing before subscribing.

> *Position is the investment. The proper return is a function of the position — not the marketing.*

The Accredited Investor's Capital Stack Checklist

Twelve questions every investor should answer — in writing — before subscribing

1. **Confirm the position**
   Get it in writing: Am I buying senior debt, mezzanine debt, preferred equity, or common equity? Read the actual instrument — not the marketing.

2. **Match the return to the position**
   A 12% preferred return on common equity is not the same as 12% on senior debt. Risk and return should be calibrated to seniority, not to a headline number.

3. **Read the recorded documents**
   For real estate debt, pull the recorded mortgage or deed of trust and the title policy. For mezzanine, request the pledge agreement and UCC-1 filing. Both should exist.

4. **Demand the intercreditor agreement**
   If there is senior debt above you, read the intercreditor agreement. Standstill periods, purchase options, and cure rights determine what you can actually do on default.

5. **Test the appraisal, not just the LTV**
   A 65% LTV is only as reliable as the appraisal beneath it. Ask: as-is or stabilized value? Who appraised it? What are the comparable sales?

6. **Quantify the cushion after foreclosure costs**
   Headline LTV ignores legal fees, broker commissions, carrying costs, and forced-sale discounts. The realistic recovery cushion is materially thinner than the LTV suggests.

7. **Identify every credit enhancement — and its limits**
   Letters of credit, guaranties, escrows, completion guaranties: each has a cap, a trigger, and an expiration. Confirm them in writing; do not rely on a summary deck.

8. **Diligence the guarantor, not the guaranty**
   A guaranty is only as strong as the guarantor. Demand current personal financial statements, prior litigation history, and a list of other outstanding guaranties.

9. **Map the waterfall in dollars**
   Build a one-page distribution waterfall in dollars at base, downside, and stress cases. If the sponsor cannot or will not produce one, that is a diligence answer in itself.

10. **Confirm bad actor and Reg D compliance**
    Verify the offering is properly exempt — Rule 506(b) or 506(c) — and that Bad Actor screening (Rule 506(d)) has been completed for all covered persons.

11. **Understand liquidity and exit**
    Private positions are illiquid. Read transfer restrictions, redemption rights (if any), lock-up periods, and any rights of first refusal. Plan for no secondary market.

12. **Have your own counsel read the documents**
    Sponsor counsel represents the sponsor. An accredited investor in a substantial position should engage their own counsel to read the loan, equity, and subscription documents.

FIGURE 3 — THE TWELVE QUESTIONS TO ANSWER IN WRITING BEFORE SUBSCRIBING

FOR FURTHER INFORMATION

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E N D N O T E S

[i] A limited liability company membership interest is personal property, and a member has no interest in specific LLC property; the economic and governance rights attaching to the interest are defined by the operating agreement and the governing statute. See Del. Code Ann. tit. 6, §§ 18-701, 18-702 (membership interest is personal property; assignment governed by the operating agreement); id. § 18-101(9) (defining the limited liability company agreement). New York and Florida have analogous provisions. See N.Y. Ltd. Liab. Co. Law §§ 601–603; Fla. Stat. § 605.0501 et seq.

[ii] Mezzanine collateral typically consists of a pledge of the equity interests in the property-owning entity, perfected under U.C.C. Article 9. On default the mezzanine lender may dispose of the pledged collateral by a commercially reasonable sale. See U.C.C. §§ 9-601, 9-610, 9-611 (default remedies and notification of disposition); id. § 9-627 (commercial reasonableness). The relative rights of the senior mortgage lender and the mezzanine lender are governed by an intercreditor agreement; a widely used form is the CRE Finance Council (CREFC) model intercreditor agreement.

[iii] FINRA Rule 2111 (Suitability) requires that a member or associated person have a reasonable basis to believe a recommended transaction or investment strategy is suitable, based on reasonable diligence as to the customer's investment profile. For recommendations to retail customers, compliance with Regulation Best Interest is deemed to satisfy the suitability rule. See FINRA Rule 2111; FINRA Regulatory Notice 20-18 (June 2020).

[iv] Regulation Best Interest establishes a best-interest standard of conduct for broker-dealers and their associated persons when recommending a securities transaction or investment strategy to a retail customer. See 17 C.F.R. § 240.15l-1; Regulation Best Interest: The Broker-Dealer Standard of Conduct, Exchange Act Release No. 86031 (June 5, 2019).

[v] Broker-dealers and investment advisers must deliver a brief relationship summary (Form CRS) to retail investors. See 17 C.F.R. § 240.17a-14 (broker-dealers); 17 C.F.R. § 275.204-5 (investment advisers); Form CRS Relationship Summary, Exchange Act Release No. 86032 / Advisers Act Release No. 5247 (June 5, 2019).

[vi] An investment adviser owes its clients a fiduciary duty comprising duties of care and loyalty, enforced under Section 206 of the Investment Advisers Act of 1940. See 15 U.S.C. § 80b-6; SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963); Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Advisers Act Release No. 5248 (June 5, 2019).

[vii] Investment adviser advertisements—including testimonials, endorsements, hypothetical performance, and the presentation of performance results—are governed by the Investment Advisers Act Marketing Rule. See 17 C.F.R. § 275.206(4)-1; Investment Adviser Marketing, Advisers Act Release No. 5653 (Dec. 22, 2020).

[viii] The "accredited investor" definition appears in Rule 501(a) of Regulation D and includes, among others, natural persons meeting specified income or net-worth thresholds and persons holding designated professional certifications (e.g., Series 7, 65, or 82). See 17 C.F.R. § 230.501(a); Accredited Investor Definition, Securities Act Release No. 10824 (Aug. 26, 2020). As of the date of this alert the dollar thresholds remain unindexed for inflation. The INVEST Act (H.R. 3383), which would direct the SEC to add qualification

pathways and periodically index the thresholds to inflation, passed the U.S. House of Representatives on December 11, 2025 and remains pending in the Senate; it is not law, and nothing in this alert assumes its enactment.