



Fannie Mae®

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# Multifamily Selling and Servicing Guide

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## 1602.01 Description

### 1602.01A Definitions

#### Requirements

Preferred Equity is an equity investment in an entity where the holder is entitled to preferred dividends, distributions, payments, or returns relative to the other equity owners.

Fannie Mae defines 2 types of Preferred Equity.

Type	Definition
Soft Preferred Equity	Preferred Equity that: <ul style="list-style-type: none"><li>• only requires preferred payments or returns to the holder if cash flow from the Property is sufficient to make the payments or returns after satisfying the payment, reserve, escrow, and funding obligations of the Mortgage Loan and all Property operating expenses;</li><li>• has organizational documents that explicitly state that the preferred return may accrue if cash flow from operations is insufficient to pay the return; and</li><li>• does not have a maturity date, redemption date, trigger date, or require repayment during the term of the Mortgage Loan.</li></ul>
Hard Preferred Equity	Preferred Equity that requires preferred payments or returns to the holder, regardless of whether cash flow from the Property is sufficient to make the payments or returns.

### 1602.01B Exclusions

#### Guidance

This Section does not apply to:

- Soft Preferred Equity that does not benefit from any remedial rights related to the failure to make or pay any preferred payment of return; or
- any Borrower organizational or capital structures relating solely to the



allocation of LIHTCs.

For example, [Part III, Chapter 16: Mezzanine Financing and Preferred Equity, Section 1602: Preferred Equity](#) does not apply to:

- Soft Preferred Equity that is Preferred Equity only because of “promoted interest” or priority “waterfall” distributions in the organizational structure of the Borrower, but does not otherwise benefit from remedial rights when distributions are not paid or made.
- Instances where a provision in the Borrower’s organizational documents allows or requires a forced sale of the Property to a third party in an arm’s length transaction
  - if preferred payments or returns are not made, or
  - for standard non-recourse guaranties.

### **1602.01C** Eligible Mortgage Loans

#### Requirements

Mortgage Loans with Preferred Equity structures must:

- be newly originated;
- be fixed rate; and
- for Hard Preferred Equity,
  - have an original principal balance of at least \$10 million, and
  - be flagged for MBS additional disclosure per [Form 4098](#).

### **1602.01D** Structures

#### Guidance

Preferred Equity may be structured in a variety of ways, and appear similar to a traditional equity investment, while having rights or remedies similar to debt, such as Mezzanine Financing.

To determine if the Preferred Equity is Soft or Hard, you should analyze the:

- Borrower’s organizational and capital structure;
- Borrower’s applicable joint venture or operating agreement with the Preferred Equity provider; and
- rights and remedies of the direct and indirect equity owners against the



Borrower.

## 1602.01E Limitations

### Requirements

Preferred Equity must:

- not have a maturity date, redemption date, trigger date, or require repayment during the term of the Mortgage Loan;
- have a fixed rate of return without escalations during the term of the Mortgage Loan;
- not include cash flow sweeps above the stated return;
- not be cross-collateralized with multiple assets;
- for a deal that has both a Hard Preferred Equity return and Soft Preferred Equity return, be underwritten using the total combined preferred return to calculate the DSCR per Form 4660;
- not have intercreditor or recognition agreements between you and the Preferred Equity holder; all rights of the Preferred Equity holder that you recognize must be contained in the Loan Documents;
- not have side letters; all information, terms, and conditions relating to the Preferred Equity must be contained in the organizational documents; and
- for Hard Preferred Equity, not be less than \$1 million.

You must underwrite the Preferred Equity as Hard Preferred Equity, if any of the following apply:

- the organizational documents do not explicitly state that the preferred return may accrue if cash flow from operations is insufficient to pay the preferred return;
- there are remedies associated with operating benchmarks such as NCF, NOI, or other operating thresholds;
- there are reserves to ensure the payment of the preferred return; or
- the holder of Preferred Equity benefits from a
  - pledge of the general partner's or managing member's interest in the Borrower, or any direct or indirect owner of the Borrower, or
  - guaranty or indemnity from the general partner, managing member, or manager of the Borrower (or any parent or other Person Controlling any of them) with respect to the preferred payment or returns. If a guaranty or indemnity is executed by the Key Principal executing a Guaranty for the Mortgage Loan, the guaranty or indemnity of the



preferred payment or returns must be expressly subordinate to the Guaranty for the Mortgage Loan.

## **1602.01F** Lender's Loan Application

### Requirements

Your loan application form must:

- require the Borrower to indicate whether it has or intends to obtain Preferred Equity as part of its organizational or capital structure; and
- inform the Borrower that you may delay approval or revoke any prior approval if the Borrower changes its intention to obtain Mezzanine Financing.



# Glossary

## B

**Borrower** Person who is the obligor per the Note.

### **Synonyms**

- Borrowers
- Borrower's

## F

**Form 4660** Multifamily Underwriting Standards identifying Pre-Review Mortgage Loans and containing the underwriting requirements (e.g., debt service coverage ratio, loan to value ratio, interest only, underwriting floors, etc.) for all Mortgage Loans.

### **Synonyms**

- Multifamily Underwriting Standards

## G

**Guaranty** Payment Guaranty, Non-Recourse Guaranty, or other guaranty by a Guarantor for the Mortgage Loan.

## K

**Key Principal** Person who

- controls and/or manages the Borrower or the Property,
- is critical to the successful operation and management of the Borrower and the Property, and/or
- may be required to provide a Guaranty.

### **Synonyms**

- Key Principals
- Key Principal's

## L



## Loan Documents

All Fannie Mae-approved documents evidencing, securing, or guaranteeing the Mortgage Loan.

### **Synonyms**

- Loan Document
- Mortgage Loan Document
- Mortgage Loan Documents

## **M**

### MBS

Mortgage-Backed Security

### Mezzanine Financing

Subordinate debt financing provided to a direct or indirect owner of a Borrower that is secured by a pledge of the direct or indirect equity interest in the Borrower held by the owner, and not by a Lien on the Property.

### Mortgage Loan

Mortgage debt obligation evidenced, or when made will be evidenced, by

- the Loan Documents, or
- a mortgage debt obligation with a Fannie Mae credit enhancement.

### **Synonyms**

- Mortgage Loans
- Mortgage Loan's

## **P**





## Person

Legal person, including an

- individual,
- estate,
- trust,
- corporation,
- partnership,
- limited liability company,
- financial institution,
- joint venture,
- association, or
- other organization or entity (whether governmental or private).

### **Synonyms**

- Persons
- Person's

## Property

Multifamily residential real estate securing the Mortgage Loan, including the

- fee simple or Leasehold interest,
- Improvements, and
- personal property (per the Uniform Commercial Code).

### **Synonyms**

- Properties
- Property's