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Understanding Future Advance Conditions

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While some commercial real estate loans are fully funded at loan closing, others are funded in whole or in part through future advances. Some loans provide for future advances to fund tenant improvement work and leasing commissions and/or capital improvements. Loans on transitional properties that do not have a rent stream sufficient to fully fund the property's operating expenses may also include future funding for shortfalls in debt service payments and other carry costs such as real estate taxes, insurance premiums, management fees, etc. Construction loan advances will typically cover all construction costs, including both hard and soft costs, and all debt service and other carry costs, in excess of the borrower's required equity contribution. From the lender's perspective, each future advance increases its exposure, and for that reason, loan documents typically include "future advance conditions," which consist of requirements that must be satisfied to trigger the lender's obligation to fund a requested advance. The borrower needs to be able to draw down post-closing advances in order to operate, and in some cases develop, its property and to make payments required under the loan documents and third-party contracts as they become due; and from its perspective the future advance conditions need to be limited to those that it can satisfy, preferably without creating an excessive administrative burden.

We can think of most future advance conditions as falling into at least one of four categories: (i) requirements intended to prevent the lender from having to throw good money after bad by funding into a default or distress situation or a situation that is likely to become a default or distress situation; (ii) requirements intended to assure the lender that the costs being funded have actually been incurred and are in accordance with the requirements and standards imposed by the loan documents; (iii) requirements intended to preserve the priority of the lender's security; and (iv) requirements intended to meet the lender's operational constraints. While not all future funding conditions fall neatly into these categories, and while some could be said to fall into more than one category, these categories are useful as a framework for understanding the various requirements. This article discusses examples of typical future advance conditions that fall into each category. It does not attempt to cover all typical future advance conditions.

Avoiding Funding into Distress Situations

(a) <u>No Default</u>. The most basic future advance condition is that the loan not be in default. It is difficult for a borrower to argue that its lender should be obligated to fund a loan where there exists an event of default, *e.g.*, a default where any required notice calling the default has been given and any period during which the borrower has the right to cure has expired. But what about a situation where the borrower still has a period in which it has the right to cure the default? The lender does not want to increase its exposure in a situation where it knows there is a problem and it may be just be a matter of time before the default ripens into an event of default. The borrower, however, may need the advance to fund debt service or other costs that need to be paid in order to avoid additional defaults, or to keep a construction project on track, and wants to have sufficient time to cure the default without coming out-of-pocket to fund costs that need to be paid during that period. Typically, the lender will insist on the condition that no monetary default exists, which is difficult for the borrower to object to because monetary defaults can be cured simply by making a payment. Non-monetary defaults, however, might take time to cure. Lenders will sometimes agree to limit the funding condition to the absence of material non-monetary defaults and will sometimes eliminate the condition entirely as it relates to non-monetary defaults. Another potential lender concession is to agree to fund advances for debt service and certain other carry costs such as insurance premiums and taxes notwithstanding a material non-monetary default, but to refuse to fund other costs until the default has been cured. This gives the borrower some breathing room in that it provides the funds necessary to make payments that if not paid when due will trigger an event of default, while not funding costs that the borrower may be under less pressure to pay timely and that it might be able to stretch out. Because the lender is the recipient of the debt service payments and would likely have to make protective advances for taxes and insurance if the loan were to go into default, it might view making these advances in the face of an unmatured non-monetary default as more acceptable than funding other costs.

(b) Balancing. Balancing requires the borrower to post cash collateral with the lender in the event that the lender determines that the aggregate of unadvanced loan proceeds, amounts held in lender-controlled reserves and any projected rents and other property revenues are not sufficient to pay all carry and construction costs required to be paid under the loan documents through loan maturity (or some other negotiated period) or that such available amounts, taking into account restrictions on the use of loan advances, reserve funds and property revenues, are insufficient to pay any category of such expenses. Balancing requirements are intended to provide the lender with assurances that the property will not run out of money before construction is completed and/or the loan matures. Although balancing calls are an anathema to borrowers because they force them to contribute additional unanticipated capital, they are common in construction loans and in loans where carry costs are being funded from loan proceeds.

(c) Bringdown of Representations and Warranties. The representations and warranties made by the borrower in the loan documents provide the lender with the borrower's certification that the facts relating to the loan that the lender understands to be true at the time of the loan closing are in fact true. The lender wants a similar certification with respect to the relevant facts as they exist at the time that each advance is made. This is accomplished by conditioning the borrower's right to obtain post-closing advances on its representations and warranties remaining true as of the date of each future advance and its certifying the same to the lender. But what if underlying facts have changed? For example, the loan documents will likely include a representation with respect to the accuracy of the property's rent roll provided to the lender at closing. Rent rolls, however, are not static, and changes over time will typically not violate the loan documents. Other representations, such as compliance with single-purpose entity requirements, are intended to remain true throughout the term of the loan, and non-compliance with these requirements will trigger a default. So, the future advance condition relating to a bringdown of representations and warranties should be crafted to provide that those representations required to remain true throughout the loan term do in fact remain true and to permit changes in the underlying facts with respect to the balance of the representations. Prudence dictates a careful review of each representation to determine which category each representation falls into.

Substantiation of Costs

Before making advances to fund the payment of particular costs, the lender will want to see evidence that the costs have in fact been incurred. The related loan document requirements will vary depending on the type of costs being funded. For some types of costs, this might be as simple as a borrower certification backed by an invoice. Construction loan draw requirements are much more extensive and include the submission of documentation intended to substantiate not only that the costs have been incurred but that the work being paid for satisfies the requirements of the loan documents with respect to quality, compliance with legal requirements, conformance with approved plans and specifications, etc. While a detailed discussion of construction loan draw requirements is beyond the scope of this article, it may include, for example, an Application and Certificate of Payment (usually in the form of AIA Document G702) signed by the general contractor and architect as to the work completed, retainage held and conformity of the work to the approved plans and specifications, payment requisitions from trade contractors, an anticipated cost report that sets forth the anticipated costs of various construction line items, copies of contracts and subcontracts for which payment is being made and approval by the lender's construction consultant based on its review of the documentation submitted and on-site inspection of the work. Draw requirements for advances to fund tenant improvements and other capital improvements are usually abbreviated versions of construction loan draw requirements.

Preservation of Priority

The lender's concern here is to assure that its mortgage lien insofar as it secures post-closing advances will have the same priority that it has with respect to amounts that it advanced at loan closing, at the time that its mortgage was recorded and its loan title insurance policy was issued, and that such priority will be insured under its title insurance policy. In other words, the lender wants to make sure that there are no liens or other encumbrances that arose post-closing that will have priority over its mortgage insofar as it secures post-closing advances. In a construction loan context, mechanics liens are of particular concern. Note that in many jurisdictions a mechanics lien may be filed within a specified period after work was performed and the filing will "relate back" to the date on which the work was commenced, meaning that in some jurisdictions it will have priority over mortgage loan advances made after the work was commenced. The rules relating to mortgage lien priority vary substantially from jurisdiction to jurisdiction. In some jurisdictions, post-closing advances secured by a mortgage recorded at the time of closing that states that it secures future advances up to a stated amount will have priority over encumbrances arising after the recording of the mortgage notwithstanding that they may have arisen prior to the making of the post-closing advance in question. In other jurisdictions, encumbrances arising after the recording of the mortgage but prior to the making of the post-closing advance in question will have priority over the mortgage insofar as it secures the post-closing advance. In those jurisdictions, it is necessary to include a future advance condition that requires the borrower to deliver a title continuation or endorsement issued by the title insurer that, based on an updated title search, increases the amount of the policy to include the amount of the post-closing advance and amends the effective date of the policy to the date of the advance without taking any additional exceptions to coverage. Future advance conditions will also typically require delivery of lien waivers from all contractors, subcontractors, material suppliers and any other potential mechanics lien claimants that performed work to be paid for out of the requisitioned disbursement, pursuant to which such party waives lien rights to the extent of the payment made.

Lender Administration

In order to properly administer a loan, the lender needs to make sure that it receives sufficient information to determine whether the conditions to the advance have been satisfied and has sufficient time to review that information. It also needs sufficient time to obtain the funds with which the loan advance will be funded, which in the case of a syndicated loan, will entail the administrative agent’s collecting from each syndicate member its proportionate share of the advance, and in the case of other loans, may involve obtaining the funds from an investor or a party providing financing to the lender. In addition, since reviewing draw requests can be time-consuming, particularly in construction lending, the lender will want to put limitations on the frequency of draw requests. This is typically accomplished by limiting draw requests to one per month and sometimes imposing a floor on the amount that can be requisitioned, and by giving the lender a specified period to fund the draw, which does not commence until the lender receives the draw request and all required supporting materials.

From both the lender’s and the borrower’s perspectives, future advance conditions are among the most important loan document provisions. Unlike many provisions that come into play only upon the happening of certain contingencies, the borrower and the lender will have to deal with the draw conditions on a regular basis. The lender needs the ability to make sure that it understands what it is funding and that it is not unnecessarily increasing its exposure on what may become a problem loan. The borrower is entering into the loan transaction for the purpose of drawing down loan proceeds, and constraints on its ability to do so are usually at or near the top of its concerns. Accordingly, the draw requirements warrant the close attention of both parties at the negotiation stage.