



Securitizing Loans with Future Advance Obligations



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As the real estate industry continues to navigate the COVID-19 pandemic, lenders and borrowers have been forced to confront many new challenges. Simultaneously, the pandemic has heightened the importance of certain issues that are ever-present in the lending market – namely, the borrower’s desire to minimize costs and maximize repayment flexibility, and the lender’s desire for liquidity in the secondary markets. One loan feature which is emblematic of these somewhat conflicting considerations is a loan term for a lender to make future advances.

Putting aside construction loans, which are outside the scope of this discussion, the borrower may want a financing to include a commitment from the lender to make future advances for any number of reasons, such as future capital expenditures or leasing costs, additional acquisitions which will be added as new collateral to the loan facility, or to obtain additional loan proceeds upon the achievement of one or more financial tests typically called “earn-out” conditions. Irrespective of the purpose, a commitment from the lender to make future advances gives the borrower flexibility to increase the outstanding principal balance of the loan, and, unlike having a portion of the loan proceeds reserved at closing, structuring a loan with future advances allows the borrower to exercise its discretion as to the timing of the advances without paying interest on such un-advanced amount until the loan proceeds are actually required.

While frequently seen in the traditional syndicated loan markets, in a financing intended for a securitization, the commitment to make future advances may limit the liquidity of the loan since a securitization trust is not capable of funding such advances. If the loan is structured carefully, however, the lender can preserve its ability to securitize the portion of the loan that is fully funded, while maintaining the future advance portion outside of the securitization trust.

In order to securitize the fully funded portion of the loan, the fully funded portion of the loan and the un-advanced portion of the loan should be structured as separate components and must be evidenced by separate promissory notes. This

allows the role of “lender” to be bifurcated between the lender which has made the fully funded initial advance (the “Initial Advance Lender,” who will hold the note evidencing such fully funded component) and the lender responsible for funding future advances (the “Future Advance Lender,” who will hold the note evidencing such un-advanced component), notwithstanding that the two lenders will likely be the same entity at closing. This bifurcation also establishes the ability of the originating lender to transfer the fully funded component to the securitization trust while retaining the un-advanced component (and corresponding obligation to fund) outside of the trust structure.

The rating agencies will also require that the loan agreement contain an acknowledgement and agreement by the borrower that the borrower (i) will look only to the Future Advance Lender for such future advances, (ii) has exculpated all other noteholders (including the securitization trust) from any future advance obligations and (iii) waives any right of offset or other claim against the Initial Advance Lender with respect to any future advance obligations. Additionally, the Initial Advance Lender and the Future Advance Lender would enter into a co-lender agreement in which, among other things discussed in more detail below, the Future Advance Lender will be required to indemnify the other lenders for the failure to satisfy its obligation to fund.

While relatively straightforward in theory, the bifurcated structure creates numerous complexities that must be addressed in the loan documents. There are three issues in particular that warrant additional discussion in the context of a securitization:

1. Controlling Lender; Consents

First, as with any loan with multiple lenders, the bifurcation introduces the question of which lender will be the “controlling” lender and responsible for the administration of the loan. While the Initial Advance Lender (in this case, the servicer on behalf of the securitization trust) will be the controlling lender for all intents and purposes (including the right to call a default and to grant or withhold consent wherever required pursuant to the loan documents with respect to leasing, alterations, transfers, etc.), the Future Advance Lender should have the sole right to determine whether the applicable conditions to the borrower receiving an advance have been satisfied, and the Future Advance Lender should also retain a joint consent right with respect to any decisions only affecting the future advance component (e.g., approval of the budget related to a capital expenditure to be funded or reimbursed by future advances). Further, because the future advances will be unique to each deal, there may also be specific consent or approval rights that indirectly relate to the obligation to advance funds, or, that the Future Advance Lender otherwise has a vested interest in, which will need to be negotiated between the borrower, on one hand, and the lenders, on the other hand, in the loan agreement and/or separately negotiated between the Initial Advance Lender and the Future Advance Lender in the co-lender agreement.

Additionally, the rating agencies will likely require a right for the servicer to (i) make certain decisions on behalf of the Future Advance Lender if the Future Advance Lender fails to act in a timely manner or (ii) override certain decisions made by the Future Advance Lender if the Future Advance Lender acts in a manner that violates customary servicing standards. This right prevents the Future Advance Lender from wrongfully denying a future advance request, which could negatively

impact the collateral and the portion of the loan held by the securitization trust. Although this may seem onerous, the Future Advance Lender can rely on the fact that the servicer is independent and is required to adhere to industry-wide servicing standards that require the servicer to administer the loan in an objective manner that maximizes the realization of the total debt for the benefit of all of the lenders.

2. Application of Payments

Second, the lenders must determine how unscheduled prepayments of principal (both voluntary and mandatory) are applied between the two components (e.g., *pari passu* or sequentially) both prior to and after an event of default. Additionally, the lenders must consider whether prepayments of principal will reduce the amount of the future advance component. In general, if the prepayment is made in connection with a release of collateral or to cure an event of default, the amount of additional proceeds available to the borrower should be reduced proportionately. Special attention should be paid to ensure that the prepayment provisions account for all possible prepayment scenarios and that the allocation of such prepayment between the components matches the parties' expectations.

3. Additional Restrictions on the Future Advance Component

Lastly, while the loan documents may have restrictions between the borrower and the lender as to who the future advance portion of the loan can be transferred to, in the context of a securitization, the co-lender agreement will likely have even more burdensome requirements as to who the future advance note(s) can be transferred to in order to protect against the risk of the collateral being negatively impacted by the Future Advance Lender's inability to fund or conflicting objectives of lenders. These requirements may include specific ratings requirements, higher asset tests and/or a rating agency confirmation.

An originating lender will need to determine whether or not the additional time and effort necessary to implement this structure is appropriate based on the lender's exit strategy. Of course, this would not be a worthwhile exercise if the lender plans to hold the entire loan for the full term of the loan, but borrowers and lenders should both be aware that if structured and drafted properly, it is possible for the lender to retain the ability to securitize the fully funded portion of a loan that includes future advance obligations.