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REIT Financing: Collateral Structures

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This Chapman Insights article is the first in a series on Real Estate Investment Trust (REIT) financings and focuses on collateral structures. Future articles will focus on other aspects of REIT financings, including asset pool eligibility requirements in unsecured facilities, considerations when including joint ventures in the unencumbered asset pool, intercreditor issues when there are multiple debt facilities, including private placements, and ESG provisions.

Background

A REIT may incur indebtedness for a variety of purposes, including to smooth out cash flow, as a bridge to an additional capital raise, and/or to leverage its assets for the purpose of acquiring additional assets. While there are many different forms this indebtedness can take — from bank debt to bond issuances — this article highlights considerations when the debt incurred is from a bank or bank group.

Lenders to a REIT have several different collateral structures available to them to meet their underwriting needs and the needs of the REIT. Loans may be unsecured or may be secured by mortgages, by a pledge of equity owned by the REIT, or by any combination of collateral.

As more publicly trading REITs have entered the market and attained an investment grade rating over the last decade, the capital structure of REITs has shifted. More REITs now have access to unsecured debt, whether unsecured bank debt or bond issuances. In some instances a REIT may have a strong preference for unsecured debt to signal strength to the public markets and ratings agencies, even if this means accepting a loan facility with a more conservative borrowing base and more restrictive covenant package.

Conversely, in particular industries a REIT may prefer to incur secured financing due to government programs affecting their underlying assets. For example, a REIT that focuses on residential property may prefer to incur secured financings because of the support certain residential properties receive from Fannie Mae and Freddie Mac.

This series focuses on REITs that primarily own property, as opposed to mortgage REITs (or “mREITs”) that primarily originate or purchase mortgages or mortgage securities. A REIT that owns properties typically will focus on either commercial (including, for example, office buildings, shopping centers, senior living facilities, logistics centers, and industrial complexes) or residential properties. A REIT may directly own the real estate or be an investor (either with a 100% ownership interest or as part of a joint venture) in a special purpose entity subsidiary (SPE) that owns the underlying real estate.

This article addresses structuring considerations among the different collateral structures.

Collateral Structure: Mortgages

A REIT that owns real estate may grant a mortgage on the underlying properties to secure its obligations to its lenders. As a creditor secured directly by a mortgage on the underlying REIT properties, the lender is in a very strong collateral position, but, of course, that extra protection comes with a cost in the form of higher expenses to the REIT. In addition to the benefits of having a security interest in the underlying properties, the process of taking a mortgage (and the due diligence it entails) often gives the lender a better and deeper knowledge of the credit considerations surrounding each underlying property.

Diligence for a mortgage will typically include conducting lien (and litigation) searches against the REIT and the underlying property and obtaining an independent appraisal of the underlying property, environmental due diligence (such as a Phase I Environmental Site Assessment), a survey, and receipt of a lender’s title insurance. In addition, if

the lender is a U.S. federally insured depository institution, federal flood plain laws and regulations require (with limited exceptions) that lenders secured by a mortgage complete a flood hazard determination and take additional steps if the property is in a flood hazard area. This diligence reduces the risk of fraud and increases certainty that borrowing base and financial covenant compliance certifications are accurate.

From a documentation perspective, in addition to the mortgage, the lender will typically file both a UCC-1 financing statement and a UCC-1 fixturing financing statement. In addition, depending on the terms of the underlying leases, a lender may pursue other documentation such as subordination and non-disturbance agreements and estoppels from the tenants of the underlying property.

A mortgage lien holder also has advantages in the event the REIT becomes subject to a bankruptcy proceeding, as there is reduced risk of being subject to a plan of reorganization that is not acceptable to the lender. The interplay between the REIT's rights as a debtor upon a bankruptcy filing and the lender's rights to foreclosure on the mortgage under state law (which can be lengthy state court processes depending on the jurisdiction) are beyond the scope of this article. In addition, in the event there are title defects in the REIT's ownership of the underlying asset, a mortgage lien holder will typically have recourse to the title company that issued the lender's title insurance policy.

These diligence and documentation requirements can create significant expense per property. For a highly acquisitive REIT where such acquisitions result in the purchase of multiple discrete properties, the lender and the REIT will need to balance these expenses against the benefits gained from a mortgage — benefits may accrue to not only the lender as a secured creditor but also to the REIT from a presumably lower interest rate resulting from the lender's stronger collateral position.

Collateral Structure: Equity Pledges

A REIT will typically set up a separate SPE to acquire and own each property. The REIT can pledge the equity it owns in each such SPE.

Diligence for a collateral package that consists solely of equity pledges may be limited to personal property lien and litigation searches of the REIT and applicable SPEs and review of organizational documents, which is a significant cost saving to the REIT. Property level diligence, such as real estate lien searches, appraisals, environmental due diligence, and surveys, are not customarily delivered if the collateral package is solely an equity pledge. The risk to a lender to the REIT of being structurally subordinated to the claims of any creditor at the SPE level is mitigated through borrowing base eligibility requirements that we will discuss in the next article.

Absent a bankruptcy filing by the REIT, as a secured creditor with a lien against the equity of the SPEs, the lender may benefit from a quick exercise of remedies. A UCC foreclosure sale can be effected after commercially reasonable notice of sale (this is state law dependent, but generally ten days' notice under the UCC). The lender can also utilize UCC strict foreclosure to retain collateral in satisfaction of the debt (again, this is state law dependent, but generally requires twenty days' notice to the REIT and the REIT's failure to object). Unlike with respect to a mortgage lien holder, with an equity pledge there is no requirement for the lender to credit bid in a mortgage foreclosure sale. However, by foreclosing on the equity pledge, the lender, as the new owner of the SPE, steps into the shoes of the REIT and assumes not only all of the rights but also all of the liabilities the REIT had as an owner.

One potential risk in taking an equity pledge in addition to taking a mortgage is that the lender may have to respond to a "clogging the right of redemption" defense from the REIT, *i.e.* practically or legally eliminating the ability of the REIT to redeem the mortgage balance when the lender exercises its equity pledge and takes control of the mortgaged property through the equity pledge in as short of a period as ten days, without having to go through state court foreclosure process and the time afforded a mortgagor in that foreclosure process to redeem the property. While recent cases have found that taking a mortgage lien and an equity pledge (called a "dual track" approach) does not clog the right of redemption among sophisticated parties,[1] this risk remains given unsettled law in this area.

Collateral Structure: Unsecured

For a REIT that is able to access unsecured loan facilities, the lender still has a variety of tools to reduce risk. The lender may utilize a borrowing base with stricter advance rates (*e.g.,* higher haircuts) and eligibility requirements. In a borrowing base structure, the lender can negotiate for certain diligence items that would mimic diligence requested for mortgages (other than delivery of a mortgage). The REIT would then be able to assess, on a property-by-property basis, whether the cost of the diligence is worth the value of putting a particular property in the borrowing base.

The lender can require that the REIT own each borrowing base property in a separate SPE and that each SPE entity be a guarantor. This structure creates two benefits: taking the guaranty makes the lender *pari passu* with any other unsecured creditor with respect to the property, and segregating the properties mitigates against a bankruptcy at the guarantor level affecting "good" properties in addition to the "bad" property that is the subject of the bankruptcy.

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A variety of collateral structures are available to REIT financings. A lender may combine both the mortgage and equity pledge collateral positions to create optionality in a distressed situation. Many REIT financings progress from being secured by mortgages and equity pledges to being secured by only equity pledges, either upon the occurrence of certain objective criteria or with lender consent as the REIT grows. Even for unsecured structures, the lender can use the covenant requirements to mitigate against certain risks.

For More Information

If you would like further information concerning the matters discussed in this article, please contact the author, Sarah Kessler, any member of our REIT lending team, or the Chapman attorney with whom you regularly work.

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1 *See Atlas Brookview Mezzanine LLC v. DB Brookview, LLC* (New York State Supreme Court, Index No. 653986/2020)

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