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REIT Financing:
Unencumbered Asset Pool Eligibility Requirements in Unsecured Facilities

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This Chapman Insights article is part of our ongoing series on Real Estate Investment Trust (REIT) financings. Read the previous article, REIT Financing – Collateral Structures. Future articles will focus on other aspects of REIT financings, such as considerations when including joint ventures in the unencumbered asset pool, intercreditor issues when there are multiple debt facilities, and ESG provisions

An unsecured facility to a non-investment-grade REIT can be structured similarly to an asset-based facility—a borrowing base is applied to a category of assets, and loans are extended against that borrowing base. For example, in an asset-based facility, the category of assets may be receivables, whereas in an unsecured REIT financing the lender advances against a lease revenue stream from a pool of rental properties. In unsecured REIT financings the borrowing base is typically referred to as an "unencumbered asset pool."

Since a lender in an unsecured REIT financing does not have a secured claim on the assets of the REIT, its underwriting generally needs to obtain protection from both the eligibility criteria of the assets in the unencumbered asset pool and the financial covenants. In a secured asset-based facility, while there are generally some financial covenants, the primary focus is on the assets that secure the facility. In addition to general representations and covenants concerning the assets that comprise the collateral (such as confirmation that the loan party owns the asset and lien priority position of the lender), the lender will also have credit eligibility criteria applied to the underlying assets (such as geographic or industry concentration limits). The combination of meeting strict eligibility requirements and obtaining a security interest in those assets can contribute to many secured asset-based facilities having a relatively small financial covenant package. Unsecured REIT financings generally have an extensive financial covenant package that monitors both the unencumbered asset pool and the REIT enterprise. This financial covenant package, combined with the unsecured nature of the facility, results in a different approach to the eligibility criteria in a REIT financing.

First, given the unsecured nature of the facility, one of the lender's goals in the eligibility criteria for the unencumbered asset pool is to make sure no one else has or can be given a better position against the assets. This could occur either because a different lender actually has a security interest in the assets or because the REIT is operating through a series of subsidiaries where another lender is a direct creditor of a subsidiary, which results in the lender to the REIT being "structurally subordinated" to such other lender. In a distressed scenario, the lender could request that the REIT grant a lien on the equity of the subsidiaries that own the underlying real estate assets or that such subsidiaries grant mortgages on the underlying real estate assets. The eligibility criteria is designed to ensure that there would be no barriers to taking this collateral. The eligibility criteria is also designed to ensure that in a bankruptcy of the REIT, the lender would be *pari passu* with other unsecured creditors, be primed only by certain limited secured creditors, and have a path to recovery through the marketability of the assets.

Second, the eligibility criteria typically focus on the quality of the rental property itself, as opposed to the creditworthiness of the rental income (*i.e.,* the credit quality of the tenants). However, the economic strain created by COVID-19 did result in some loan agreements adding a requirement that a certain percentage of tenants (based on rentable area) remain solvent and/or current on rental payments.

Lastly, in an unsecured REIT financing to a non-investment-grade REIT, the eligibility criteria do not consistently include any concentration limits. Upmarket loans may require that the unencumbered asset pool as a whole maintain a minimum aggregate occupancy rate (where failure to comply with such a requirement requires the addition or removal of particular underlying real estate assets or a mandatory prepayment of a portion of the outstanding loan). In addition to such a requirement on the unencumbered asset pool that only affects loan availability, lower market loans may include a negative covenant that requires the unencumbered asset pool to maintain a minimum number of properties, with breach of this covenant resulting in a default of the loan facility.

Common eligibility criteria for inclusion in the unencumbered asset pool in an unsecured REIT facility include the following:

Ownership

- The borrower or a subsidiary that is a guarantor must own or lease (under a qualifying ground lease) the property.
- If the property is owned by a subsidiary guarantor, such subsidiary must be either (i) a wholly-owned subsidiary of the REIT or (ii) a non-wholly-owned but controlled subsidiary of the REIT. This requirement ensures the subsidiary guarantor controls the ability to grant liens and dispose of the property.
- Sometimes a lender will require that each guarantor only own one property. A single property requirement mitigates against a bankruptcy at the guarantor level affecting “good” properties along with the “bad” property that may have triggered the need for the bankruptcy filing.

Liens & Marketability

- The property cannot have any liens other than (i) tax liens not overdue or being contested; (ii) statutory liens not overdue or being contested; (iii) liens related to workers compensation; (iv) judgment liens subject to appeal, insured, and not in existence for longer than a short time period; and (v) easements that do not affect marketability.
- The property cannot be subject to a contractual negative pledge that could prevent the owner of the property from granting the lender a mortgage.
- No person may have a right or option to acquire the property.
- The property must be insured to the extent customary in the market for such property.

Income-Earning Ability

- The property must be improved.
- The property must have a certificate of occupancy issued to it; sometimes a minimum occupancy percentage is required.
- The property must be fully operational and open for business.
- The property must be in compliance with all zoning requirements and serviced by utilities, and appropriate access for use of the property must be provided.

Environmental Issues

- The property cannot have environmental issues that adversely affect the ability of the property to be income-producing or that would cause a lender to not take a mortgage on the property.
- The property cannot have uninsured environmental issues.
- The property cannot be located in a flood zone. Regulatory requirements may restrict a lender from taking a lien (and foreclosing) on real estate located in a flood zone.

Condemnation and Eminent Domain

- The property cannot be subject to a condemnation or eminent domain proceeding.

Location

- The location of the property is commonly limited to the United States, including certain of its territories (to limit enforcement expenses in a downside scenario), but may be more specific to certain geographic markets of the REIT.

Type of Property

- Sector REITs may have limitations on specific property types within the sector.
- Diversified REITs may have limitations on certain types or sectors of properties.

Management of Property

- Requirements that the management of the property not be outsourced to third parties are less common eligibility requirements. However, the risk related to management of the properties is frequently covered by the covenants, breach of which results in a default as opposed to the ineligibility of a single property.

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Unsecured REIT financings structured to limit availability based on an unencumbered asset pool share similarities with other financings that are underwritten to a borrowing base of assets, such as traditional asset-based lending against receivables and inventory and private equity subscription and capital call facilities. In each of these financings, defining the specific eligibility requirements that permit an asset to be in the borrowing base is a crucial first step. The various eligibility requirements together with the collateral package, if any, of a REIT financing combine to create a risk profile that the lender will balance with the broader covenant package of the facility.

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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