

## BEYOND THE LOAN DOCUMENTS – THE DUE DILIGENCE PROCESS IN COMMERCIAL MORTGAGE LOAN CLOSINGS

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Representing the lender in connection with a commercial mortgage loan closing typically encompasses three parts – the drafting and negotiation of the loan documents, the due diligence process and the closing process. Much has been written about the drafting and construction of commercial mortgage loan documents. Less attention has been paid to the due diligence process, which plays an equally important, if more quiet, role in the underwriting of a new loan.

The due diligence phase of a commercial mortgage transaction is the investigative phase. The potential borrower provides various financial data to the lender and makes certain representations and warranties in connection with the borrower's loan application which the lender typically relies on in the initial underwriting of the loan. The due diligence phase is intended to provide independent verification of the information provided by the borrower. A key part of the job of lender's counsel is to help the lender manage and minimize risk. The due diligence process is central to this task.

A mortgage lender's due diligence customarily focuses on two key areas: (i) the borrower and any other parties (e.g. guarantors) whose assets are a potential source of repayment of the loan; and (ii) the real estate and other assets which serve as collateral for the loan. The lender's primary objective is to generate a specified rate of return on its loan investment and to assure that there is an adequate source of repayment of the loan at maturity.

### **The Borrower**

The due diligence process is a shared responsibility of the lender and its counsel, and the allocation of individual tasks varies dramatically from one client to the next (one client's business issue is another client's legal issue; in-house counsel may take a greater or lesser role). Fundamental business questions to be addressed include: (i) the identity and creditworthiness of the proposed borrower (for purposes of this article we are assuming that the borrower and the property owner are the same entity, but that is not always the case) and any guarantor; (ii) the experience and background of the borrower (and any proposed property manager) in managing real property of the type that is the proposed collateral for the loan (e.g. retail centers, office buildings, multifamily, industrial or hotel properties); and (iii) the borrower's and any principals' reputation in the local commercial real estate community and their history regarding dealing with properties when they experience financial difficulty. Although the lender's business team may review most of the materials necessary to make these assessments, counsel needs to make sure Uniform Commercial Code ("UCC"), judgment, bankruptcy and lien searches are performed in the names of the borrower, its general partner or managing member(s), if applicable, and any guarantors. The purpose of such searches is (i) to determine if there are any bankruptcy or litigation proceedings or judgments filed against the searched parties, (ii) to verify the

representations and warranties made to the lender in the loan application process, and (iii) to confirm there are no unexpected liens or other claims on the property which will serve as collateral for the loan. Counsel should note that the above searches are of no value to the lender unless they are performed in the proper jurisdiction(s). For example, counsel may want to conduct UCC searches in accordance with the filing rules under Revised Article 9 of the UCC as adopted in the applicable jurisdiction and under the predecessor to Revised Article 9. Similarly, bankruptcy and judgment searches conducted in the jurisdiction where the collateral is located may be meaningless if the borrower's principal place of business is in another jurisdiction.

Legal review of the potential borrower, any guarantor, and any constituent entities of borrower or any guarantor focuses on confirmation that each such person or entity is who they say they are and that they have the authority to enter into the loan transaction. With respect to business entities, counsel needs to verify that all entities are duly formed in the jurisdiction of their formation, that the Borrower is qualified to business where the collateral is located, and that each business entity has the requisite power and authority to enter into the loan transaction. This will include reviewing copies (preferably certified by the issuing agency) of the filed articles of organization, articles of incorporation or certificate of limited partnership of the entity and the borrower's application for registration as a foreign entity if the property is located in a jurisdiction other than the borrower's jurisdiction of formation. Counsel should also obtain good standing certificates or certificates of fact from each applicable jurisdiction certifying that the entity is in good standing in the state of its organization and in any jurisdiction where it is required to be registered to do business as a foreign entity.

The authority of the borrower and any non-individual guarantors to enter into the loan transaction customarily is determined first by a review of a corporation's bylaws, a partnership's partnership agreement or a limited liability company's operating agreement, including all amendments to any such agreement (each a "Principal Governing Document"), and then by a review of any applicable resolutions and/or consents. The Principal Governing Document will show who is authorized to act on behalf of the entity and what special authorization or consent, if any, is required in order for the actions of the entity to be valid. For example, a partnership agreement may provide that the general partner is authorized to take all actions necessary on behalf of the limited partnership and that no further authorization is required except in connection with a sale or refinance of the partnership's principal assets, which requires the written consent of all of the limited partners. Under that example, if the general partner failed to obtain the written consent of all of the limited partners, the general partner would not have the proper authority to execute the loan documents and bind the partnership, and the loan documents could be rendered void. Approvals should be in written form, whether a copy of resolutions passed at a meeting and certified by the appropriate officer of the entity, or written consents, which may be required by the entity's governing documents or applicable state law to be unanimous or approved by some lesser majority. The lawyer's review of the consent or resolutions should reveal that, to the extent not covered by the entity's governing documents, the entity, and the persons or entities acting on its behalf, are authorized to enter into the loan transaction, mortgage the property, borrow money, execute and deliver the loan documents and perform all obligations of the borrower under the loan documents. In addition, the consent or resolutions should ratify any and all actions taken by the authorized persons in connection with

the loan transaction prior to the date of such consent or resolutions. Finally, lender's counsel should request an incumbency certificate signed by an authorized person, certifying to the names, titles and signatures of all persons authorized to execute any of the loan documents, and should cross-check the incumbency certificate against any relevant provisions in the entity's governing documents.

### **The Property**

Due diligence on the property serving as collateral for the loan has two prongs: (i) review of the property itself and its chain of title and (ii) review of the income sources from the collateral (e.g. leases), if any.

The purposes of the first prong are to examine whether the borrower owns or has appropriate title (such as a leasehold interest that lasts beyond the term of the loan) to all real property which is to serve as collateral for the loan and all personal property necessary to operate such property. The lender will require that the borrower deliver to lender's counsel a commitment for title insurance issued by a title company (usually chosen by the borrower) acceptable to the lender, together with a survey (map) showing the location of the real property and any buildings and other improvements located on the property .

The title commitment is the title company's contract to insure the priority of the lien of the lender's mortgage or deed of trust upon satisfaction of certain conditions. The initial title commitment delivered to lender's counsel should be accompanied by a copy of the deed by which borrower acquired title to the property, together with copies of all easements, property association covenants and other documents that are listed in the title commitment as affecting the property and having been recorded in the applicable land records office. Upon initial receipt of the title package, counsel should make sure he or she has received copies of each instrument listed as an exception in Section B-II of the title commitment. Copies of any documents not included in the package but listed on Section B-II should be requested. Each document should be reviewed, in conjunction with the survey review, to confirm its applicability to and effect on the property. Lender's counsel should review the deed to ensure borrower's ownership of the property is as lender understands it to be. The deed will contain a legal description of the property which should be carefully compared to the legal description contained in the title commitment. An explanation of any discrepancies should be requested and evaluated.

The title commitment should also contain endorsements which provide additional coverage above and beyond what the basic loan policy provides. Which endorsements are needed will vary depending on locality, type of policy used, and the lender's requirements, and should be reviewed for completeness and accuracy.

A thorough title review will encompass both the title commitment and the survey. As with the deed, the legal description of the property provided on the survey should be compared to the legal description contained in the title commitment and an explanation of any discrepancies should be requested and evaluated. If the legal description given on the survey is a metes and bounds description, it should be compared directly to the information plotted on the survey plat. If the written legal description references a subdivision plat previously filed with

the land records office, counsel should review a copy of the metes and bounds shown on the subdivision plat against the metes and bounds shown on the plat of survey for accuracy. Each exception instrument should be studied to determine whether the instrument does in fact impact the property and, if so, what sort of rights against the property it grants and whether any such rights (or the instrument itself) have been terminated (e.g. by another instrument or by self-operating provisions in the granting instrument) . Each valid instrument should be represented on the survey, either by illustrating the size and location directly on the plat or by identifying the instrument in a surveyor's note if the rights granted are of a type that cannot be illustrated. The survey should always include certain specific information such as the location of any improvements on the property, all access to the property, any encroachments on adjoining property, an arrow indicating North, the number and location of parking spaces, the location of utility lines and the location and direction of stormwater drainage. The lender will also request that the surveyor make certain certifications regarding the survey, and this certification should be reviewed to make sure it meets the lender's requirements.

Finally, lender will require certification from the borrower that it owns any and all personal property necessary for the operation of the property. In the majority of cases the borrower will not have any such personal property located on the property, in which case the certification should be worded to that effect.

A thorough examination of the property will include review of reports and permits such as an environmental report, zoning report (to confirm how the property is zoned and that such zoning specifically permits the intended use of the property), permits, plans and specifications and tax bills. The environmental report should be reviewed by an environmental law specialist; the other reports may be reviewed in conjunction with the lender's in-house legal staff or the loan correspondent.

### **The Leases**

Most commercial properties are by their nature income-producing properties for their owners and, except for owner-occupied properties, the borrower's principal source of funds for payment of the monthly debt service will come from the monthly income received from the tenants. The purpose of the second prong is to examine whether this monthly tenant income is adequate for debt service purposes. Analysis of the tenant-generated income stream thus begins with a review of the current leases on the property as well as any form lease the borrower uses for new tenants. Review of current leases should reveal that the space rented and the amount of rent paid by each tenant conforms to the information contained on a rent roll that the borrower provided to the lender during the underwriting process. Other important issues that merit careful focus due to their potential impact on cash flow and lender's ability to perform as landlord under the lease in the case of a foreclosure include offset rights, the application of proceeds received by the borrower/landlord in the event of a casualty or condemnation and the borrower/landlord's rebuilding obligations; ongoing obligations of the landlord under the lease such as additional tenant improvements or space expansion (watch out for expansion obligations of the landlord for property that is outside of the property being offered as collateral for the loan); early termination

rights by the tenant; free rental periods for the tenant; and exclusives.<sup>1</sup> In addition, tenants will be expected to provide estoppel certificates and in some cases subordination, non-disturbance and attornment agreements (“SNDAs”). An estoppel certificate requires a tenant to certify as to many of the factual terms of the lease, such as lease commencement and termination dates, rental commencement date, base rent and additional rent for common area expenses or other charges and square footage rented, and also requires the tenant to certify as to whether there are any outstanding defaults under the lease. An SNDA is an agreement between the lender and the tenant (and often the landlord) which creates privity of contract between the lender and the tenant. In a typical SNDA, the tenant agrees to subordinate any rights that may arise under the lease, in tenant’s capacity as a creditor of the landlord, to the lender’s rights as a creditor of the landlord, and often agrees to give lender notice and the chance to cure any landlord defaults under the lease and to limit lender’s liability for the defaults of any prior landlord. In exchange, the lender agrees that if it becomes the landlord under the lease following a foreclosure of the property, it will recognize the tenant’s right to occupy the leased space under the terms and conditions of the Lease.

In summary, although the term “due diligence” may have less cachet than other parts of a typical loan transaction, performing it carefully and well has the very important function of protecting the lender’s interests and ensuring the lender gets the benefit of its bargain, i.e., the property providing the lender with the security on which it agrees to lend money to the borrower meets the criteria the borrower has claimed in the process of applying for the loan. Although the borrower will be required to make representations and warranties as to much of this information, if those representations and warranties turn out to be false claims, that will be of little comfort to a lender holding a defaulted loan. A good way to perceive the due diligence required for a commercial mortgage transaction would be a piecing together of information to create a picture which hopefully will conform to the picture the lender envisioned when it agreed to make the loan.

A sample checklist for a typical commercial mortgage loan transaction follows.

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<sup>1</sup> Exclusives are primarily a retail concept and are a form of tenant territorial right. A retail tenant whose business focuses on a specific type of product (such as pet supplies, office supplies, etc.) will not welcome another establishment that sells primarily the same type of product in the same retail center. Provisions will be built into the lease prohibiting the landlord from renting space to retailers similar to the tenant without the tenant’s consent.

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Williams, Mitchell G. *Land Surveys: A Guide for Lawyers and Other Professionals, Second Edition*. Chicago: American Bar Association, 1999.

As of \_\_\_\_\_

**LOAN CLOSING CHECKLIST**

LENDER:

BORROWER:

GUARANTOR:

SECURED  
PROPERTY: [Address of Property]

LOAN AMOUNT: \$

CLOSING DATE  
ON OR BEFORE:

**I. PARTIES AND WORKING GROUP**

1. Lender Contact (L):
  - Name
  - Address
  - Phone
  - Fax:
  - Closing Contact: [Name & Phone #]
  - Email: [Contact email]
  
2. Lender's Counsel:
  - Elizabeth C. Lee, Esq.
  - Womble Carlyle Sandridge & Rice, PLLC
  - 1401 Eye Street, N.W., Seventh Floor
  - Washington, D.C. 20005
  - Phone: 202-857-4437
  - Fax: 202-261-0034
  - Email: elee@wcsr.com
  - Other Contact: Elizabeth M. R. Salgado, Esq.
  - Phone: 202-857-4504
  - Fax: 202-261-0064
  - Email: esalgado@wcsr.com
  
3. Borrower (B) and
4. Guarantor (G)
  - Name
  - Address
  - Phone
  - Fax:
  - Closing Contact: [Name & Phone #]
  - Email: [Contact email]

**Error! Unknown document property name.**

5. Borrower's Counsel:      Name  
   Address  
   Phone  
   Fax:  
   Closing Contact: [Name & Phone #]  
   Email: [Contact email]
6. Loan Correspondent:      Name  
   Address  
   Phone  
   Fax:  
   Closing Contact: [Name & Phone #]  
   Email: [Contact email]
7. Title Company:              Name  
   Address  
   Phone  
   Fax:  
   Closing Contact: [Name & Phone #]  
   Email: [Contact email]
8. Surveyor                      Name  
   Address  
   Phone  
   Fax:  
   Closing Contact: [Name & Phone #]  
   Email: [Contact email]

<u>Responsibility</u>	<u>Item</u>	<u>Submitted</u>	<u>Approved</u>
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**II. DUE DILIGENCE ITEMS:**

B	1. Leases		
	a. Certified Rent Roll	_____	_____
	b. Leases to be reviewed by Lender’s Counsel and Mortgage Banker:		
	(i)	_____	_____
	(ii)	_____	_____
	c. Compliance with Lender’s Lease Requirements:		
	(i)	_____	_____
	(ii)	_____	_____
	d. Tenant Estoppel Certificates:		
	(i)	_____	_____
	(ii)	_____	_____
	e. SNDAs:		
	(i)	_____	_____
	(ii)	_____	_____
	f. Leases to be reviewed by Mortgage Banker :		
	(i)	_____	_____
	(ii)	_____	_____
	(iii)	_____	_____
	g. Estoppels:		
	(i)	_____	_____
	(ii)	_____	_____

<u>Responsibility</u>	<u>Item</u>	<u>Submitted</u>	<u>Approved</u>
	(iii)	_____	_____
	(iv)	_____	_____
B	2. Appraisal	_____	_____
B	3. Certified Copy of Management Agreement:	_____	_____
B	a. Subordination	_____	_____
B	4. Maintenance Agreements (If none, include certification thereto in closing certificate)	_____	_____
B	5. Plans and Specifications	_____	_____
B	6. Property Condition Report	_____	_____
B	7. Seismic Report (If Required)	_____	_____
B	8. Zoning Compliance Letter	_____	_____
B	9. Environmental Phase I Report (See attached requirements):	_____	_____
	a. Contract for services	_____	_____
	b. Follow up reports, if any	_____	_____
	c. Insurance Certificate (professional liability) <sup>1</sup>	_____	_____
B	10. Permits and Certificates:		
	a. Building Permit	_____	_____
	b. Certificate(s) of Occupancy	_____	_____
	c. Wetlands and other environmental	_____	_____

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<sup>1</sup> LeAnn has asked Donna to add the location to the Insurance Certificate. If this cannot be done by closing, delivery of the revised Certificate can be made post-closing.

<u>Responsibility</u>	<u>Item</u>	<u>Submitted</u>	<u>Approved</u>
	d. Operating Permits (elevator, pool, restaurant, etc.)	_____	_____
	e. Subdivision Approval	_____	_____
B	11. Insurance (See attached requirements):		
	a. Casualty	_____	_____
	b. Liability	_____	_____
	c. Rent Loss/Business interruption	_____	_____
	d. Environmental Liability	_____	_____
B	12. Title Insurance:		
	a. Commitment	_____	_____
	b. Copies of exceptions and appurtenant easements	_____	_____
	c. Pro forma title policy	_____	_____
	d. Insured Closing Letter(s)	_____	_____
	e. Endorsements:		
	(i) Comprehensive (ALTA Form 9)	_____	_____
	(ii) Usury	_____	_____
	(iii) Zoning (with parking) (ALTA Form 3.1)	_____	_____
	(iv) Same as Survey	_____	_____
	(v) Environmental	_____	_____
	(vi) Access	_____	_____
	(vii) Separate Tax Parcel	_____	_____
	(viii) Subdivision	_____	_____

<u>Responsibility</u>	<u>Item</u>	<u>Submitted</u>	<u>Approved</u>
	(ix) Deletion of Creditors' Rights Exclusion	_____	_____
	(x) Deletion of Arbitration Condition	_____	_____
	(xi) Utility Facility	_____	_____
	(xii) Contiguity	_____	_____
	f. Title Insurance Policy	_____	_____
B	13. Survey:	_____	_____
	a. Legal description	_____	_____
	b. Certification	_____	_____
B	14. UCC Searches on Borrower and Guarantors:		
	a. UCC (State and local)	_____	_____
	b. Tax and litigation/judgment searches	_____	_____
B	15. Financial Statements and Federal Tax Returns:		
	a. Financial Statements of Borrower/Guarantor	_____	_____
	b. Tax Returns of Borrower/Guarantor	_____	_____
B	16. Certification of No Personal Property (include in closing certificate)	_____	_____
B	17. Federal Tax I.D. Number Borrower (_____)	_____	_____
B	18. Organizational Documents of Borrower:		
	a. Certified Copy of Articles of Organization with all amendments thereto	_____	_____
	b. Operating Agreement with all amendments thereto, certified by manager or sole member	_____	_____
	c. Authorizing Resolution, certified by manager or sole member	_____	_____

<u>Responsibility</u>	<u>Item</u>	<u>Submitted</u>	<u>Approved</u>
	d. Certificate of Good Standing from State of Organization	_____	_____
	e. Certificate of Good Standing from State Where Property is Located	_____	_____
B	19. Organizational Documents of Guarantor:		
	a. Certified Copy of Certificate of Limited Liability Limited Partnership with all amendments thereto	_____	_____
	b. Amended and Restated Limited Liability Limited Partnership Agreement with all amendments thereto, certified by General Partner	_____	_____
	c. Authorizing Resolution, certified by General Partner	_____	_____
	d. Certificate of Good Standing from Sate of Organization	_____	_____
B	20. Organizational Documents of [Guarantor], Inc.:		
	a. Certified Copy of Articles of Incorporation with all amendments thereto	_____	_____
	b. Bylaws with all amendments thereto, certified by [Officer] of the Corporation	_____	_____
	c. Authorizing Resolution, certified by [Officer] of the Corporation	_____	_____
	d. Certificate of Good Standing from State of Organization	_____	_____
B	21. Existing Financing Documentation:		
B	a. Payoff letter	_____	_____
B	22. Property Taxes:		
	a. Tax Bill	_____	_____

<u>Responsibility</u>	<u>Item</u>	<u>Submitted</u>	<u>Approved</u>
	b. Tax Service Letter (post-closing)	_____	_____
	c. Confirmation of separate tax parcel	_____	_____

<u>Form</u>	<u>Document</u>	<u>Drafted</u>	<u>Final</u>
<b>III. LOAN DOCUMENTS:</b>			
L	1. Loan Commitment	_____	_____
L	2. Promissory Note	_____	_____
	3. Payment Guaranty	_____	_____
L	4. Indemnity Deed of Trust, Security Agreement and Fixture Filing	_____	_____
L	5. Indemnity Absolute Assignment of Rents and Profits and Collateral Assignment of Leases	_____	_____
L	6. Environmental Indemnity Agreement	_____	_____
L	7. UCC Financing Statements:		
	a. Local Land Records	_____	_____
	b. Secretary of State	_____	_____
	8. Non-Recourse Indemnity	_____	_____
L	9. Borrower's Closing Certificate	_____	_____
L	10. Opinion Letter from Borrower's Counsel	_____	_____
L	11. Loan Closing Statement (Settlement Statement)	_____	_____
L	12. Escrow Closing Instructions	_____	_____
	13.	<u>    X</u>	<u>    X</u>
	14.	<u>    n/a</u>	<u>    n/a</u>