Regular features

Best practices in commercial real estate financing

A guide to commercial mortgage transactions in the USA

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Abstract
For any commercial real estate loan in the USA, the closing and documentation process combines traditional principles and practices of US real estate law — some dating back centuries to English common law — with the global capital markets, a fast-moving marketplace, and painful lessons learned in the USA's real estate depression of the early 1990s. Against that backdrop, lenders and borrowers must bring together dozens of processes, participants and other pieces to document and close any commercial mortgage loan. This paper focuses on all those elements, for comparison against commercial mortgage lending procedures in other countries and as a reminder of basic principles for commercial mortgage lenders and their advisors in the USA.

INTRODUCTION

Many US commercial mortgage lenders begin their mortgage origination process by thinking about how they expect it to end. If a lender plans to hold a mortgage loan in his portfolio, perhaps syndicating out pieces of it to other lenders, the lender merely needs to satisfy his own requirements and the expectations of similar lenders that are likely to buy into the deal.

Many other commercial mortgage lenders, though, originate their loans to include them in a future securitisation, a transaction where the sponsor creates a stand-alone pool of mortgage loans and then sells bonds or other securities funded solely from the income stream of the mortgage loans. The bonds' ratings will depend largely on the degree to which the mortgage loans meet rating agency standards

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and criteria. Lenders and their counsel must therefore pay special attention to those standards and criteria, some of which are highlighted here.

This discussion assumes the lender's collateral consists of commercial real estate with a stabilised income stream. This generally means the borrower has finished construction; tenant space has been prepared for occupancy and tenants have moved in; any 'free rent' periods under tenants' leases have expired; and the property has demonstrated a reliable and sustainable cash flow for some reasonable time. A 'stabilised' project does not need substantial construction or a 'turnaround' or 'repositioning' strategy.

If a project is to any significant degree not yet 'stabilised', then the financing risks, issues and closing process will vary substantially from those described here. Among other things, the loan will probably not be a candidate for securitisation.

Transaction components

This overview covers the following components of the commercial mortgage loan documentation and closing process in the USA:

- Preliminary steps and transaction sequence
- Document structure
- Borrower negotiations
- Common deal terms
- Structural elements often seen
- Credit enhancement; non-recourse lending
- Due diligence
- Tenant-related documents and deliveries
- Opinions of counsel
- The closing process
- After the closing.

This discussion cannot cover every possible issue and element of the US commercial mortgage loan documentation and closing process. It does, however, cover all the major concepts and related issues that usually arise.

Preliminary steps and transaction sequence

Application

Initial documents

As a matter of form, many mortgage lenders begin by preparing an 'application', describing the loan's business terms. It requires the borrower's signature and a relatively small payment, typically well under 1 per cent of the loan amount. The lender will usually agree to return this payment, minus the lender's costs, if the lender does not proceed. An application usually imposes no other obligations on the lender or borrower. The lender's credit committee then evaluates the application and decides whether to make the loan. Assuming the loan officers know the lender's business agenda, applications are rarely disapproved.

Term sheet
The lender may instead issue a non-binding document, a 'term sheet', which summarises the basic economic terms of the loan — amount, interest rate, security, term, recourse, and the like — as a basis for further discussion.

Commitment letter
If the borrower is willing to pay a significant fee (perhaps 1 per cent of the loan amount), the lender may 'commit' to make the loan on terms set forth in a commitment letter. Those terms usually still require that the lender review and approve further documents and deliveries for the transaction. Once a lender has issued a commitment letter, however, the lender rarely refuses to close the loan. The issuance of that letter also usually means the lender has obtained any necessary internal approvals, thus eliminating one possible obstacle to a closing. The commitment letter may also obligate the borrower to borrow the loan.

The legal/closing process
Closing process

After the lender and borrower have agreed upon one or more of the documents just listed, the transaction moves into the closing process. This requires both legal work and non-legal work, as described below, all typically coordinated by the lender's loan officer or underwriter, or both, in either case working with outside counsel and other advisers. To the extent that anything about the property raises issues, the parties and their counsel may need to set up measures to deal with those issues, perhaps along the lines suggested below.

Document structure
Loan documents

The following are the major documents a borrower signs for a US commercial mortgage loan, along with a range of certificates, third-party agreements and other items. Loan documents can vary dramatically (in scope, complexity, borrower-friendliness and degree of detail) from lender to lender, but the ideas and themes remain fairly consistent.

Promissory note
This document evidences the borrower's promise to repay the loan. It also sets out the interest rate, possible changes in the interest rate, the maturity date, late charges, prepayment rights and certain other payment obligations. For long-term securitised financing secured by stabilised commercial real estate, the interest rate will typically be fixed for five to ten years and will equal the rate on government bonds of comparable tenor plus a 'spread' of 75 to 300 basis points. Interest is usually calculated based on the actual number of days elapsed, multiplied by a daily rate that assumes a hypothetical year of 360 days. This assumption increases the annual interest rate by about 5/360 or 6/360 (times the stated rate). The borrower typically

pays interest monthly in arrears. Financial terms will first appear in the application, term sheet, or commitment letter.

Loan agreement

For a complex commercial mortgage, the loan agreement will often govern the transaction. It includes closing conditions, representations and warranties, affirmative covenants (the borrower's agreement to do certain things, such as deliver monthly, quarterly and annual financial reports and preserve the collateral), negative covenants (the borrower's agreement not to do certain things, such as make certain transfers), rights and remedies, and miscellaneous provisions. Often the loan agreement will contain most or all of the financial terms that might otherwise go in the note. The note then becomes quite short, simply confirming that the borrower agrees to pay whatever the loan agreement requires.

Real estate security documents

Mortgage

In the mortgage, the borrower grants the lender a lien (security interest) against the borrower's real property, the central and most important component of the entire transaction. The mortgage gives the lender a wide range of rights and remedies against the property and requires the borrower to perform a range of property-related obligations. Most important, the mortgage empowers the lender to foreclose and eventually sell the real property through an auction process if the borrower does not repay the loan or if some other default occurs.

Some lenders include in the mortgage many provisions that might otherwise appear in a loan agreement. Such a mortgage eliminates any need for a loan agreement.

The mortgage does not give the lender any direct 'ownership' interest in the real property until the borrower defaults and the lender holds a foreclosure sale, makes the highest bid at the sale for the real property and acquires ownership.

Deed of trust

Some states (especially in southern and western USA) use a 'deed of trust' instead of a mortgage. In a deed of trust, the borrower technically conveys title (actual legal ownership of the property) to a trustee, who either sells the property to the highest bidder (if the borrower does not repay the loan) or reconveys it to the borrower (if the borrower does repay). In a mortgage, the borrower merely grants the lender a lien and a right to foreclose, as security for a loan. A few states, such as Georgia and Louisiana, have their own variations on mortgages. All the various real property security documents are, however, functionally the same.

Assignment of rents

After a default, but before the lender completes foreclosure, the lender may want to take immediate control of the rental income from

the real property. For that reason, the lender will require the borrower at closing to 'assign' all leases and rents to the lender, so the lender can in theory collect the rents starting at any time. The lender usually agrees not to start collecting rents until a default occurs. In most cases, this is accomplished through a direct assignment of the rents from the borrower to the lender, coupled with a simultaneous licence back from the lender to the borrower, allowing the borrower to collect the rents as long as no default exists.

Other security

Personal property

In addition to holding the lien that a mortgage creates in the borrower's real property, a US real estate lender will want its security to include all of the borrower's 'personal property' (movable property), such as equipment, service and other contracts, certain rights under insurance policies, construction materials, intellectual property rights, and other non-real-property assets. Such collateral is particularly important for hotels.

If the borrower defaults, the lender wants not only to be able to foreclose on the real property under the mortgage, but also to be able to exercise direct rights against the borrower's personal property. That way, the lender knows that after foreclosure it will (in theory at least) be able to take over everything it needs to operate the property. To achieve this goal, the borrower grants the lender a 'security interest' (or lien) in the borrower's personal property. This is usually built into the mortgage or loan agreement, but can sometimes constitute a separate document, particularly for non-standard types of personal property collateral.

Uniform Commercial Code

UCC financing statement

By recording the lender's mortgage in the land records, the lender should assure that its lien on the borrower's real property will be prior to the claims of any future creditor of the borrower. Perhaps surprisingly, recording of the mortgage is not enough to achieve the same result ('perfection' of the lender's lien) for the borrower's personal property, because the personal property is governed by a different body of law: the Uniform Commercial Code, which is substantially the same in all 50 states. The lender must therefore file notice of its security interest in the borrower's personal property separately under the Uniform Commercial Code. Although those filings no longer need the borrower's signature, they must still be prepared and filed when closing the loan.

Borrower's organisational documents

Before closing, the borrower will deliver certified copies of the documents under which the borrowing was formed. Lender's counsel will review those documents to confirm that nothing in them causes a problem for the loan and that the borrower has satisfied all its internal formalities to consummate the loan transaction.

For loans intended to be securitised, the lender's counsel will scrutinise the borrower's organisational documents in great detail, to assure that they comply with all applicable rating agency requirements. Those requirements will usually focus on assuring that the borrower is a 'single purpose entity' that exists solely to own the real property and conduct no other activities whatsoever. By using such an entity, it is generally believed that a lender reduces the likelihood of a bankruptcy, by reducing the likelihood that the borrower will have any other substantial creditors. The use of a single-purpose entity may also simplify and speed up any bankruptcy that might occur.

The rating agencies will also sometimes want a 'single purpose entity' to have an independent board member (or even two) who must approve commencement of any voluntary bankruptcy. The rating agencies' requirements for the borrowing structure are often quite technical and detailed. As a result, they can require more time, attention and effort in the closing process than 'minor details' like the loan amount, maturity date, interest rate and borrower's ownership of its real property.

Borrower negotiations

Negotiations

The process

Depending on the type of loan, borrower's counsel will have more or less leeway to comment on and try to improve the loan documents from the borrower's perspective. The negotiation process is probably the single largest cause of delay, imperfect documents and unexpected legal expense in the mortgage loan closing process. The borrower will typically pay the lender's attorneys' fees. The borrower will, however, almost always regard those fees as being too high — as if caused by uncontrollable outside forces or the greed of lender's counsel — and ignore the fact that unexpected legal fees arise largely from the borrower's own efforts to improve the loan documents or the borrower's failure to give the lender information and documents when and as needed.

Prevention of negotiations

To limit negotiations, a lender may have the commitment letter cover as many business and legal points as possible, so that these points will not be re-negotiated in the loan documents themselves. Occasionally, a lender might use 'pre-negotiated' documents that build in concessions the lender usually grants to most borrowers, with the understanding that further concessions are unlikely.

A borrower may tell its counsel to limit loan document negotiations to the minimum necessary to correct any mistakes or major problems. Any lesser problems or issues can, in the view of such a borrower, be resolved through reasonable discussions if the need ever arises — although this is not necessarily true for a loan that will be securitised. Though this approach will save substantial

time and money in the closing process, it is quite rare. In most cases any substantial commercial mortgage loan closing will be preceded by extensive negotiations on a wide range of issues, many of which have only quite limited (if any) practical significance.

Securitised deals

If a loan will be securitised, the borrower will typically expect to obtain slightly cheaper money at the cost of (among other things) having less of an opportunity to negotiate the loan documents. The lender must, correspondingly, keep in mind the specific requirements of the rating agencies and assure that the final loan documents comply with those requirements. The rating agency requirements quickly become the 'bible' for commercial mortgage loans. Even if a lender does not plan to securitise a loan, that lender will often refer to the securitisation bible for guidance.

Common deal terms

Financial terms

The following are some legal and business terms that arise in commercial mortgage loan documents (or, more typically, the term sheet, application, or commitment letter), and often produce negotiations. In each case, if a loan will be securitised, a lender will need to consider these issues against the backdrop of rating agency requirements.

Prepayment restrictions

Prepayment

One of the most hotly contested business issues in any loan negotiation is usually the borrower's right to pay the loan before the scheduled maturity date. For a floating rate loan, this is typically not a major issue. If, however, the lender has 'locked in' a fixed rate, then a prepayment may cause the lender a loss by depriving it of the profit it expected to earn over the remaining term of the loan. Whether and to what degree the borrower must make up for that loss will be the subject of extensive negotiations. This issue is crucially important for loans that will be securitised, because any possibility of a prepayment may reduce the attractiveness of the bonds and hence hurt ultimate execution of the securitisation.

Financial covenants

Covenants

Occasionally a borrower agrees to comply with certain financial covenants on a continuing or periodic basis after the closing. For example, the lender may have the right to commission an appraisal and to require the borrower to repay the loan (if the value of the property has dropped) so that the loan to value ratio never exceeds a certain percentage. A lender may also require the net operating income of the property to exceed a certain multiple of the loan payments on a quarterly basis. For example, the loan documents might provide that if net operating income drops below 1.3 times the debt service (a 'debt service coverage ratio' of 1.3), then the lender can require the borrower to pay down the loan as necessary

to increase the debt service coverage ratio to 1.3. More typically, the breach of any such financial covenants merely requires the borrower to apply any excess cash flow to amortise the loan (or as cash collateral for the loan), but creates no risk that the borrower may need to inject additional capital to avoid default.

Future advances and earn-outs

The lender may agree to advance further funds for leasing commissions, other leasing expenses and capital improvements. These will usually be disbursed in instalments as the work progresses, with disbursement procedures to try to assure the borrower finishes work before running out of money.

If the borrower plans to complete its leasing after closing, the lender may also agree to make further advances ('earn-outs') once the borrower achieves various income levels. The loan documents will tie earn-outs to a formula, limiting the loan to some percentage of value and/or debt service coverage ratio.

If future advances or earn-outs are too large a piece of the loan, then the transaction stops being a 'routine' permanent financing of stabilised real estate. Instead it becomes a construction or development transaction of a type not readily appropriate for securitisation. The pricing, deal structure, issues and risks will all change.

Property controls

Loss of property

If the building is destroyed or acquired for governmental purposes, the loan still needs to be paid. Loan documents typically address these concerns at great length, with the overall goal of assuring that at all times the lender either has a lien on the real property or a reliable first claim to monetary compensation in place of the real property.

Lender controls

A lender will want enough control over the real property to assure that the borrower cannot destroy or reduce its value. Lenders may, for example, want to approve any alterations, demolition, expansion, new leases, lease amendments, change of use, or change in management. Conversely, the borrower will desire as much flexibility as possible, to avoid the need to seek lender approval for transactions the borrower regards as routine and not meriting lender involvement. The borrower will be particularly concerned about these issues for loans that will be securitised. After securitisation, the borrower cannot predict who will administer the loan or how responsive and cooperative they might be.

Transfers and borrowings

The loan documents will prohibit the borrower from transferring the real property or incurring any significant additional indebtedness, whether secured or unsecured. In addition, the lender will want to

understand the exact nature of the borrower's ownership structure (who owns what interests in the borrower, and who ultimately makes decisions), and limit transactions that would change the ownership structure in a way that would defeat the lender's expectations. The borrower, on the other hand, will want flexibility to accommodate changes in its internal investment structure.

Structural elements often seen

Structural elements

Depending on the circumstances of the loan, the deal structure may also include certain structural elements beyond the four corners of the basic loan documents. These common elements might include the following.

Lockbox and cash controls

Cash controls

Any mortgage — even any assignment of rents — still exposes the lender to the risk that once a loan goes into default the borrower might interfere with the lender's efforts to collect rent. The borrower could do this either through state court litigation or by declaring bankruptcy before the lender gains control of income. If the loan documents allow the borrower to collect rent, then in bankruptcy that income may potentially be outside the lender's control, and employed to finance the borrower's war against the lender.

As a result, particularly for riskier loans, some commercial mortgage lenders control rental income from the moment of closing, typically by requiring tenants to mail rent every month to a 'lockbox' the lender controls. The borrower and lender then enter into a lockbox agreement, which governs collection and application of rent. Usually the lockbox administrator will apply funds first for real estate taxes and insurance; second for operating expenses; third for debt service; and fourth to go to the borrower (or as cash collateral for the loan if the borrower is out of compliance with financial covenants).

Leasehold financing

Ground leases

A borrower sometimes does not have a so-called 'fee' interest in the real property security (outright ownership or freehold) but instead holds only a long-term lease. Any such lease can be mortgaged to secure a loan, just as if the borrower owned the property outright. A lender that finances a leasehold will, however, want the lease to contain a variety of protections for lenders, sometimes continuing for many pages. For example, the lender will want to know that the lease cannot be modified or terminated without the lender's consent. The closing process for a leasehold loan will also include some additional elements. These transactions are often more complicated, difficult, risky and expensive than loans secured by a fee interest in real property that the borrower owns outright.

Reserves

If the lender identifies future capital or leasing requirements for the

property, the lender may want to establish 'reserve' accounts to pay for those requirements. The lender wants to assure that the real property asset will be able to carry itself without infusions of capital from other sources during the term of the loan. The reserves can be funded at closing, in monthly instalments over time, or both. The lender will control them.

Rate caps

Rate hedging

If the loan bears interest at a floating rate, but interest rates later rise, the relatively stable cash flow of the property may be inadequate to cover debt service payments. To mitigate that risk, a lender may ask the borrower to purchase an interest rate cap. This will often be structured so that any payments under the cap go directly to the lender to be applied to pay interest. Lenders may also require other hedging measures.

Equity pledges

Equity

The documents for any mortgage loan will allow a lender to foreclose on the borrower's real estate if the loan goes into default. Sometimes a lender will go a step further and obtain rights regarding the borrowing entity itself. For example, the lender may ask the owners of the borrower to pledge to the lender all the equity interests (eg partnership interests, membership interests, or stock) in the borrower. This way, if the loan defaults, the lender can either foreclose on the mortgage or pursue a similar procedure against the equity in the borrower. In the latter case, the lender ends up owning the borrower rather than the property itself.

As a variation, the lender might invest in the borrower and receive a preferred return on that investment, before other investors receive anything — a 'preferred equity' structure much like 'preferred stock', entitling the lender to certain special rights in the borrower.

Although a mortgage lender might sometimes require measures like these as additional security, they appear more typically when a second (non-mortgage) lender provides an additional layer of financing secured only by one of these measures — so-called 'mezzanine financing'.

Multi-bank loans

Syndication

Particularly for larger loans to well-regarded borrowers, a lender will often originate the transaction and then sell pieces of it to other banks, forming a syndicate to invest in the loan. Loans of this type will usually not be designed for securitisation, and may lack elements that the rating agencies require. They will, however, contain provisions that govern the relationship among members of the bank group and the degree to which the lead bank (the 'agent') can modify the loan documents, waive defaults, and otherwise deal bilaterally with the borrower. The legal terms of these loans are fairly consistent from loan to loan, beyond deal-specific peculiarities.

This is because potential syndicate members will want each deal to be a 'market' deal, consistent with marketplace expectations for comparable syndicated loans.

Credit enhancement and non-recourse lending

Guaranties

Guaranties

A US mortgage lender will sometimes obtain guaranties covering some or all of the borrower's financial obligations: interest, real estate taxes, all or part of the loan principal, or the like. Any such partial guaranties can be quite tricky to define and negotiate, because of the need to define precisely what is being guarantied, and what happens if the borrower pays some obligations but not others — particularly if that payment occurs through a foreclosure sale. The guarantors will usually be the borrower's parent company or ultimate principals, depending on circumstances and negotiations.

Letters of credit

In some cases, the lender may require a letter of credit to support certain specific obligations of the borrower or the loan as a whole. Letters of credit are, however, unusual in routine real estate loans.

Environmental indemnity

One borrower obligation that will often be supported by a third-party guaranty will be the borrower's obligation to indemnify the lender against environmental problems at the property. A lender will often be unwilling to accept just the borrower's indemnity, because that indemnity is only as good as the borrower's credit. If the borrower's only asset is the real property, then any possible environmental contamination may destroy the borrower's credit at the same time that it destroys the value of the borrower's real property. Therefore many lenders routinely insist on obtaining environmental indemnities from the borrower's principals. Highly desirable borrowers sometimes succeed in rejecting these requests.

Non-recourse lending

Non-recourse and carveouts

Except to the extent that the lender requires one of the measures described in the last few paragraphs, most long-term financing of stabilised income-producing real estate is closed on a non-recourse basis. If the borrower defaults on the loan, the lender can foreclose on the real property — eventually force an auction sale and perhaps take ownership — but the borrower and its principals have no liability if the value of the real property turns out not to be enough to repay the loan. Lenders are willing to take this risk based on their assessment of the value of the property and the requirement that at closing the value significantly exceed the loan amount.

'Carve-outs' to non-recourse treatment

During the US real estate depression of the early 1990s, lenders

learned that borrowers can use 'pure' non-recourse lending as a sword rather than as a shield. When loans went into default, the borrowers could litigate at length with the lender, while the lender's collateral deteriorated and unpaid interest accumulated. The lender would typically obtain the real property sooner or later, but never recoup losses suffered during the battle with the borrower. In many instances, lenders paid substantial amounts to the defaulting borrower to have the borrower turn the property over to the lender without a fight. Today lenders try to solve these problems in advance by requiring the borrower's principals to personally guaranty payment of certain obligations under the loan documents. These guarantied obligations are referred to as the 'non-recourse carve-outs'.

They might include, for example, costs of litigation and any losses the lender incurs because the borrower diverts rental income, does not pay real estate taxes, damages the collateral, fails to disclose important information, gives the lender false financial statements, defends a foreclosure action, or the like. The 'non-recourse carve-outs' — for which the principals of the borrower could become personally liable — would even include the principal and interest of the loan if, for example, the borrower were to voluntarily file bankruptcy.

Relationships and reputation

Because US mortgage lenders make most of their loans on a relatively pure 'non-recourse' basis, they rely primarily on the real estate. Although relationships and reputations matter, the real estate itself is far more important. If a borrower ultimately decides to 'walk away' from a particular project, by 'giving the lender the keys', many mortgage lenders would still regard that particular borrower as a potential borrower in the future — provided that the borrower 'walked away' gracefully and without litigation or disputes.

Due diligence

Importance of property-related due diligence

Because most long-term financing of stabilised commercial real estate is non-recourse, any commercial mortgage lender must understand and be very comfortable with the real property, because ultimately the lender may own the real property (and recover nothing more) if the borrower cannot, or chooses not to, repay the loan. A borrower always has that choice under non-recourse financing. That fact imposes discipline on lenders and forces them to conduct extensive due diligence before any mortgage loan closing. Much of this due diligence will be performed by outside contractors. The following are the major elements of a lender's due diligence.[1]

Appraisal

In an appraisal, an independent third party, engaged by the lender, seeks to understand all the elements of the lender's collateral and

assess its value. The primary measure of value will usually be a capitalisation of net income, but the appraiser will also consider replacement cost, comparable sales, and long-term sustainability of current net income. Because of concern about sloppy appraisals predating the real estate depression of the early 1990s, Congress enacted a statute, the Financial Institutions Reform, Recovery, and Enforcement Act, which required federally regulated lenders to obtain appraisals that met certain standards ('FIRREA appraisals'). In response, the appraisal industry developed a set of appraisal standards. All serious appraisers say they comply with FIRREA requirements.

Engineering

The lender will engage an independent engineer to assess the physical condition of the real property and identify any necessary repairs or replacements, and their likely timing and cost. To the extent that the lender is concerned about these items, the lender may build reserves into the loan as described above. The engineer may also report on whether the property complies with applicable building and zoning laws.

Environmental

Environmental issues

To protect the lender against the risks of environmentally contaminated real property (including, in the worst case, potential lender liability), the lender will require an assessment of the environmental condition of the real property, including the possible existence of asbestos. These assessments have become quite standardised and routine. At a minimum, a lender will require a 'Phase I' environmental assessment, an overview of the environmental condition of the property based on its history, surface inspection, and similar non-invasive measures. If the 'Phase I' discloses any possible issues, the lender will usually require a 'Phase II' (more detailed and invasive) assessment, perhaps requiring soil samples or other subsurface examinations.

To the extent that an environmental assessment discloses problems, the lender must consider them in the same manner as physical or engineering issues. If the problems are to any degree significant, the lender would typically think twice about making the loan at all. Lenders sometimes require environmental insurance to back up the environmental assessment — particularly for some securitised loans — but lenders and borrowers often regard the cost as too high.

Financial review

Audit

A lender will review the financial performance of the property to try to confirm its cash flow and overall performance, as originally presented during the application and commitment stage. This may

require some form of audit, including a review of the property's leases, as described below.

A commercial mortgage lender will not rely for repayment on the credit of the ultimate sponsors of the project — they will have no liability for any non-recourse loan — but may nevertheless try to confirm the sponsors' credit. The lender will take some comfort if the sponsors can, if they choose, invest more money in the asset if it becomes necessary. Sponsors with money are better than sponsors without money.

Property management

Management and contracts

In closing a mortgage loan, a lender will also ask about who manages the property and under what terms. In the common case where an affiliate of the borrower manages the property, the lender will want to assure that the management contract is on competitive terms. In any case the lender will want to know it can easily terminate any manager if the project runs into trouble. A lender may also want to review service and other contracts for the property to confirm the property's finances, learn more about the property, and confirm that the contracts are easily cancellable and on normal terms.

Linking back to the documents

Sometimes, a lender's 'due diligence' will disclose issues that require lender's counsel to add requirements to the documents. For example, the lender may learn that a tenant is entitled to a future payment towards construction. The lender may want to provide for how the borrower will obtain this money — often by establishing monthly reserve deposits during the period before the tenant payment is due.

Tenants and leases

Tenant-related documents and deliveries

In any commercial real estate loan, the primary source of value and reliable cash flow to repay the loan has always been and still is rental income from commercial tenants. Any mortgage lender wants to understand and validate the leases in place at closing, and assure that those leases will remain reliably in place after the closing, even after a possible foreclosure. To achieve those goals, the lender will take at least the following actions to confirm the existence and amount of the property's cash flow.

Lease review

Soon after the closing process begins for any loan, the borrower will deliver copies of all leases to the lender's counsel or a due diligence contractor. Depending on the nature of the loan, the size and importance of each lease, and the lender's desires, each lease may be reviewed, checked against the rent roll, and/or summarised in a lease abstract. The goal is to assure that the leases generate the cash flow the lender expected, and nothing in the leases will interfere with cash

flow or produce unpleasant surprises. At some point copies of all leases will be 'certified' to the lender as being true and correct.

Estoppel certificates

The lender will require the borrower to obtain an 'estoppel certificate' from every tenant or from selected major tenants. In an estoppel certificate, the tenant confirms that the lease exists and has not been amended, and that the tenant has no claims against the landlord. A careful borrower will want the lender to agree at the very beginning that the borrower need not obtain these certificates from more than a certain number or percentage of the tenants. To a borrower, obtaining these certificates is perhaps the second most tedious and difficult part of any loan closing.

Non-disturbance agreements

Both mortgage lenders and tenants often want to see separate agreements between the lender and the tenant confirming that each party acknowledges that the other exists and has an interest in preserving the lease. The tenant agrees, among other things, that any amendment or cancellation of the lease will require lender consent. These agreements also address the possibility of a foreclosure under the mortgage, assuring the tenant that it will not be 'disturbed' in its possession (hence, 'non-disturbance') if the lender ever forecloses, so long as the tenant is in good standing under its lease.

Under such circumstances, the lender usually insists that after foreclosure it will have no liability for any problems caused by the borrower before the foreclosure. It is this last requirement that sometimes makes the negotiation of these agreements the single most tedious and difficult part of any loan closing.

Security deposits

If a tenant delivered a deposit or letter of credit to back its obligations under its lease, the lender may want to control that deposit or letter of credit, to assure that if the lender ever forecloses, the deposit or L/C will be available to the new owner, typically the lender. This requirement varies, depending in part on the existence and terms of any lockbox and personal guaranties.

Leases in context

The process of dealing with tenants and leases — the four measures just listed — can easily become more complex and expensive than everything else necessary to close the loan transaction. A mortgage lender that wants to control costs and simplify its transactions will work with counsel to try to identify ways to minimise the time and trouble of handling tenants and leases.

Opinions of counsel

In addition to the borrower-lender loan documents described above, a lender will require one or more opinions of counsel, as follows.

Opinions

Borrower's opinion of counsel

The lender will ask borrower's counsel to issue an opinion of counsel confirming, among other things, that the borrower legally exists and that the right people signed the documents and were authorised to do so. Borrower's counsel must also opine that the documents are 'enforceable'. Because general principles of US law mean that not all documents are always entirely 'enforceable' under all circumstances, borrower's counsel will customarily try to summarise in any opinion of counsel the various exceptions and legal issues that could limit the enforceability of the documents. This exercise has become relatively standardised, with the result that it rarely causes extensive negotiations or delays. It does mean that a longer opinion usually gives less comfort than a shorter one, particularly in California.

Issues of state law

If the real property is located in a state where the lender's main closing counsel does not practice law, then local counsel may be engaged to advise on a handful of issues specific to that particular state. The lender will often ask local counsel to issue an opinion relating to matters of that state's law. These will usually include regulatory, licensing, filing and tax requirements that might apply to the lender. Any lender doing business in a particular state should not, however, merely rely on local counsel opinions about these latter issues. Such a lender should instead consider them at a corporate legal level as part of its overall strategy.

Substantive consolidation opinion

Every lender is concerned about the risk that the borrower will be subject to bankruptcy proceedings. Even worse, a lender fears that a borrower might be dragged into the bankruptcy of its affiliate, or that an affiliate might be dragged into a bankruptcy of the borrower, in each case based on the theory that the two entities were really operated as one.

Although this actually occurs only in the most extreme and unusual circumstances — never or almost never in typical real estate loans — the rating agencies are so concerned about it that they often require borrower's counsel to issue a 'substantive consolidation' opinion to give comfort that the courts will not 'substantively consolidate' the borrower and its affiliate. These opinions force everyone to focus on the borrower's structure and operating procedures, but are not themselves of great value (except to the extent that they satisfy the rating agencies).

Zoning opinion

Occasionally, a lender will require an opinion of counsel to confirm that the project complies with zoning laws (limitations on use, size, minimum distance from boundaries, and so on). More typically, zoning is handled as part of the 'engineering' due diligence described above, or as part of the lender's title insurance.

Opinion of lender's counsel

In US mortgage loan transactions, the lender's counsel usually does not issue an opinion of counsel. Some foreign banks do occasionally require such opinions, typically limited to enforceability of the loan documents. The lender's counsel will sometimes issue a letter to the lender, confirming that counsel closed the loan in accordance with the application, term sheet, and/or commitment, except as set forth in counsel's letter.

Closing

The closing process

Once the parties negotiate their documents and the lender completes its due diligence, the parties still need to close their loan. The following are some common elements of that process.

Title insurance

Title searches

Any mortgage lender wants to know that its mortgage creates a valid lien on the borrower's real property, and that no one else has any prior claims to that collateral, except claims that the lender has understood and approved. Once the lender records its mortgage in the land records, it knows that if the loan goes into default the lender will be able to hold an auction sale of the borrower's entire interest in the property as that interest existed at the moment of recording. A foreclosure of the mortgage can cut off and terminate any subsequently created interest in the property. US lenders universally rely on 'title insurance' for comfort about the 'priority' of their mortgage. That comfort is an important part of any real estate loan.

Before the loan closes, the title insurance company searches the land records and identifies anyone who already has any interest in the property. This information is a matter of public record. The role of the government is limited to maintaining public land records that anyone may examine, but the government offers no assurance about who owns what. The burden is on the lender to have the title insurance company 'search title'. If the lender likes what the search shows, the lender closes the loan and obtains a policy of title insurance. In that policy, the title insurance company assures the lender that its mortgage creates a valid lien and is subject only to certain other 'prior' interests in real property as listed in the policy of title insurance. The borrower pays a one-time premium for this insurance, between 3 and 20 basis points on the principal amount of the loan, depending on the state.

A policy of title insurance gives a lender a certain degree of comfort about a short list of issues, including the borrower's ownership and prior encumbrances, the validity of the mortgage, and some other similar matters. Title insurance does not cover — and the lender therefore still bears — many real estate and credit risks arising from the transaction. Claims under any policy of title insurance are rare.

Other searches

As part of the title search process, the lender or its counsel will also order other searches for the property. These may cover litigation, judgments, bankruptcy, unpaid federal taxes, building and other code violations, certificates of occupancy (which allow the building to be legally occupied), and various locally required filings.

Survey

As part of the title insurance process, the lender also obtains a 'survey', a carefully prepared diagram showing the boundaries of the borrower's real property. It also shows building locations and some other major physical characteristics of the property. The lender will require the surveyor to certify a number of matters about the physical condition of the property, and issue the survey in favour of the lender. The lender and its counsel can then confirm two things: first, that they are obtaining a mortgage on the 'right' real estate; and, secondly, that they are satisfied with the physical condition of the property, at least as it appears on the survey.

Funding

Funding and payoffs

As a mechanical matter, the loan needs to close in such a way that the lender maintains control of the loan proceeds until the parties have signed all the documents, the lender's title insurance is in place, and all other closing requirements have been satisfied. As the agenda for this process, the parties usually agree on a 'closing statement' or 'statement of sources and uses', showing the entire financial side of the closing. The process of finalising those numbers often causes last-minute negotiations and delays.

The closing

In a 'New York style closing', all parties meet in a single conference room. Each signs its documents and puts them on the table (a 'table escrow'). When every party is satisfied, the 'new' lender wires the loan proceeds directly in accordance with the approved closing statement, usually at least in part to an 'old' lender being repaid.

In an 'escrow closing', common for multistate transactions and transactions outside New York, all parties deliver their documents to a third party, usually a title insurance company, and the lender wires the loan proceeds to the title insurance company against a set of 'escrow instructions'. The lender controls the loan proceeds until the borrower has satisfied all conditions in the escrow instructions.

Taxes and more taxes

Transaction taxes

About a quarter of the states impose taxes on mortgages, including New York (up to 2.75 per cent in New York City, the highest rate in the country), Florida, Maryland, some other southern states and Minnesota. These taxes often apply only to any increase in

mortgage debt beyond the mortgage debt that existed before the closing. At closing, the title insurance company collects mortgage recording taxes, then pays them to the appropriate authorities.

In addition to taxing a mortgage, some states also impose a tax on any possible foreclosure, treating it as just another taxable transfer of real estate. New York, for example, imposes a tax of up to 3.025 per cent of the property value or loan balance upon any foreclosure. Mortgage lenders need to consider these taxes in underwriting loans.

Real estate taxes

In addition to transaction taxes, municipalities impose annual real estate taxes of 1 per cent to 5 per cent of the value of the real property. If the borrower does not pay its real estate taxes, then the municipality can eventually hold a 'tax sale', auctioning off the property, terminating all private ownership and security interests (including the mortgage), and distributing the sale proceeds to whoever is entitled to them.

At closing, therefore, the lender will ask the title insurance company to confirm that real estate taxes have been paid. The loan documents will also require the borrower to pay real estate taxes. In some cases (particularly if the lender requires a lockbox or the loan is relatively risky), the loan documents will require the borrower to make monthly 'escrow' deposits to pay periodic bills for real estate taxes and insurance.

Insurance

At closing, the borrower must show the lender that the real property is covered by all insurance that the loan documents require. These coverages will typically include property, liability, rental income, boiler, and sometimes flood and (particularly in California) earthquake coverage. The borrower must not only have the right insurance, but must also obtain confirmation from the insurance company that the insurance will benefit the lender. The lender may engage a third-party insurance consultant to approve the insurance requirements in the loan documents and the borrower's insurance programme.

Post-closing

After the closing

Post-closing follow-through

Immediately after the closing, the lender's counsel needs to assure that the documents are organised, any loose ends resolved, any necessary filings made, and all post-closing activities completed. These follow-through activities are often crucial to the long-term quality of the loan. In the rush to close a typical loan, the borrower will often propose (and the lender will often agree) to accept certain required deliveries after the closing. Any such post-closing deliveries generally take longer and require more attention than they should,

unless the lender gives the borrower a meaningful financial incentive to complete them quickly.

Monitoring and servicing

Once a mortgage loan has closed, the lender must monitor and 'service' it. This function can sometimes create problems for foreign banks not otherwise active in US real estate lending, although other foreign banks routinely service their own loan portfolio without incident. Counsel will typically not be involved in loan monitoring or servicing, except when particular problems arise. With the rise of securitisation, a number of 'servicers' are in the business of monitoring and administering commercial mortgage loans. Any lender new to the USA should decide, well before its first closing, how it will service its mortgage loan portfolio.

Real estate taxes

The single most important 'servicing' function for any loan will be monitoring payment of real estate taxes. Depending on the locality, a lender may need to make a filing with the real estate tax officials, to request notice of any tax delinquency or other problem.

Troubled loans

Defaults

Active monitoring of a loan should help the lender obtain 'early warning' of any financial or other problems at the property. If those problems occur, a mortgage lender will often want to monitor the property even more closely and perhaps institute measures to give the lender greater control and involvement without declaring a default. Those discussions can be sensitive and should not commence without advice from counsel.

In undertaking such discussions, US lenders sometimes fear 'lender liability' — a borrower's claims against a lender based on the theory that the lender misled the borrower or even caused the default and hence cannot foreclose and may even owe the borrower money. After a series of creative and successful 'lender liability' lawsuits in the 1980s, the tide turned, with the result that the risk of lender liability claims is usually rather low, particularly outside of states such as California and New Jersey.

Courts in the USA have come to realise that when a loan is in trouble, it just might be the fault of the borrower that failed to pay, rather than the fault of the lender that did not capitulate to whatever concessions the borrower wanted. If a lender conducts itself in loan workout discussions in a reasonable and straightforward way, exposure to 'lender liability' risks should be low. Whenever these discussions begin, a lender should enter into an agreement with the borrower to reconfirm that the lender will not be bound except by final approved documents.

Foreclosure

If the lender's efforts to 'work out' the loan fail, the lender may

eventually need to foreclose. In that process, the lender ultimately forces an auction sale of the property, with the proceeds being applied first to repay the debt. The procedures and timing of foreclosure vary widely from state to state.

Bankruptcy

Federal bankruptcy law

Although state law governs the foreclosure process, the resolution of any troubled loan will often be determined under federal law: the bankruptcy code. A borrower facing foreclosure will often voluntarily commence federal bankruptcy proceedings just before the foreclosure sale. These federal proceedings will instantly 'freeze' the state court foreclosure. The bankruptcy process supposedly preserves the 'going concern' value of a business and its contributions to the community, such as jobs, by preventing the company's creditors from ripping apart the company piece by piece. Towards that end, bankruptcy law lets borrowers modify their loan obligations under certain circumstances, and take other steps to 'reorganise', even over the objections of some of their creditors.

Although US mortgage lenders generally fear borrower bankruptcy, they also know that it lets lenders participate more actively than they otherwise could in management and control. If the borrower cannot satisfy the federal standards to 'reorganise', bankruptcy may be quicker and cheaper than foreclosure to resolve the loan. Finally, Congress and the courts increasingly recognise that single-asset real estate borrowers are not true operating businesses of the type that bankruptcy was intended to protect. Hence, the appeal of bankruptcy as a real estate borrower's last refuge is diminishing and can reasonably be expected to diminish further over time.

Notes

(1) For a complete checklist of US real estate due diligence — both for lenders and for equity investors — please see Stein, J. and Hisiger, J. I., (2001) 'Questions to ask for any commercial real estate acquisition or financing: Expectations and practices in New York', *Briefings in Real Estate Finance: An International Journal*, June, p. 55.