Looking for Trouble and Finding It

Buying a Troubled Commercial Real Estate Loan

By Joshua Stein

When a real estate investor buys a troubled commercial real estate loan or a portfolio of troubled loans, the investor expects trouble. The purchase price reflects it. But the purchaser still wants to understand how much trouble it is buying, as opposed to rolling the dice and accepting whatever trouble comes along.

For that reason, a careful loan purchaser often asks its lawyer to review the loan files as part of the purchaser's due diligence. The purchaser's lawyer can help the purchaser understand what it is getting into and identify and assess issues before, rather than after, the purchaser becomes obligated to buy the loan. This article discusses some of the steps that counsel should take in that review.

Loan files are occasionally made available for review by the buyer's lawyer in paper form. More often, the files are provided in an on-line data room. For simplicity, this article treats the loan documents and loan file as if they have been made available on paper, although some mechanical details change when a seller provides a loan file on-line.

Getting Started

A lawyer performing a loan file review starts with the documents and checks to confirm that they conform to the summaries or data reports provided by the seller and that the documents are otherwise satisfactory. The seller's failure to provide summaries or data reports is usually a bad sign for the seller's general organizational and management capabilities and a really bad way to start. The loan review in these cases will probably turn out to be more expensive, difficult, and issue-laden than it would have been in a more typical situation. In either case, the lawyer will need to work with the client to figure out how best to understand and check the loan portfolio. This process will depend on the size and number of loans, the purchaser's agenda, and the other circumstances of the transaction.

If the purchaser wants to know that the loans meet certain criteria, its counsel will compare the loans to the required criteria, drilling down to whatever level of detail the client wants and is willing to pay for. The "Sample Due Diligence Checklist" on pages 40-41 offers a list of common problems that a loan purchaser usually wants its lawyer to check in the loan documents. It also mentions common glitches and deficiencies that turn up in any careful loan document review. This checklist encompasses only a limited level of document review. No matter how many data points are checked in a set of loan documents, a careful lawyer can always think of more points to check because any provision on any page of a document could later create problems.

In theory, a complete loan review requires checking every possible provision and reading every page of every document to identify any surprises or problems that might lurk in the file. As a practical matter, of course, few loan purchasers want to pay for such an extensive review, and extreme measures will rarely produce extra value—although, in theory, they could.

Joshua Stein is a partner in the New York, New York, office of Latham & Watkins LLP.

Andrew O. Alcala

 Published in Probate & Property, Volume 24, No 3 © 2010 by the American Bar Association. Reproduced with permission. All rights reserved. This information or any portion thereof may not be copied or disseminated in any form or by any means or stored in an electronic database or retrieval system without the express written consent of the American Bar Association.

The purchaser and its counsel need to decide just how deeply to dig and when to stop. This, of course, leaves open the possibility that a stone left unturned will turn out to be the one that hides a colony of tarantulas. The loan purchaser needs to understand and live with that risk. Counsel needs to plan for the likelihood of short memories; that is, the possibility that when the undiscovered risk hits, the loan purchaser will blame its lawyer for not having discovered it.

If a loan purchaser wants to add more data points to the checklist attached to this article, then its attorney might start by identifying special issues unique to a particular loan portfolio or the particular loan purchaser. Identifying these issues requires a discussion with the client. The lawyer might also supplement a loan review checklist to cover state-specific issues.

Even beyond the data points—whether these points form a long or a short list—anyone reviewing a loan file should bring to the task a general sense of how loan files "should" look and what might constitute a red flag for a potential problem. This general sense of potential problems comes from doing other loan reviews and loan closings, but, to start, the loan reviewer should look for anything that just does not seem right. Examples of red flags include restrictions on the lender, anything that would prevent the lender from enforcing the loan, or anything that looks overly complex, unusual, or sloppy.

A lawyer reviewing a loan file should also look for troublesome provisions such as gaps, defects in execution, inconsistencies, missing pages (particularly in notes, mortgages, loan agreements, and guaranties), and the like. Throughout, the reviewer should pay attention to "minor details" such as discrepancies between the name of the borrower and the name of the property owner (mortgagor), incorrect loan amounts, incorrect references to parties, or blank spaces.

The loan seller should be able to locate the original promissory note, original letters of credit, and any original certificates evidencing certificated securities pledged as collateral—these original certificated securities should be available in the case of a mezzanine loan, for example. The originals should not be in the actual loan files made available for the buyer's review, but the buyer's lawyer should be comfortable that the original documents exist and have not been lost. The seller should know (and be able to show) the location of these originals. The buyer should insist on receiving the originals at closing.

Maturity Date

Perhaps the most important economic term of any loan is its maturity date—an obvious and nonsubtle term of the loan. The purchaser's lawyer should watch for loans that have matured and ask what the lender has done about the matured loan. If there is no sign that the lender has done anything, this in itself creates an issue and merits further inquiry. Lender inaction over time can give a borrower substantive rights.

Standard Forms

In a typical loan portfolio, the lender usually, but not always, uses the same general loan document forms for every loan within that portfolio. A loan reviewer should review one set of these form documents thoroughly, to be comfortable that the portfolio's "base forms" fall within the typical industry range and contain nothing extraordinarily unusual or bizarre.

If a particular portfolio includes randomly selected starting points for each set of loan documents or a handful of loan documents, the loan review process will be slower and more costly. The lawyer should consult with the loan purchaser to decide how to handle the situation.

After becoming comfortable with the base forms for the particular portfolio, the loan reviewer should focus on the ways in which the documents for each loan differ in material and adverse ways from the base documents. In this way, the reviewer can look for the deal-specific terms to make sure they are consistent and to identify unusual terms that may prove troublesome from the lender's perspective, such as lender obligations or restrictions on the lender's ability to enforce or transfer the loan.

The reviewer should watch for unusual or special agreements with a particular borrower, because these will produce variations from loan to loan, resulting in possible pitfalls. Often these special, non-uniform agreements are not fully thought through or well written. These agreements often appear just before the signatures of a document, probably in the loan agreement if one exists, although they could appear anywhere. Special terms may sometimes appear as a side letter, perhaps with a statement that the side letter goes away if the borrower sells the property, the lender sells the loan, or other events occur. The loan reviewer should watch for correspondence that appears to be routine but that is really a side letter changing the loan documents.

Guaranties

The reviewing lawyer should scrutinize any guaranties in the file and summarize their terms. Common guaranty flavors include (1) a full guaranty of all obligations; (2) a guaranty of completion of construction; (3) a guaranty of nonrecourse carveouts relating to damage to collateral, bankruptcy, or certain violations of the loan documents; and (4) a guaranty triggered by a defense asserted against the lender's foreclosure proceeding or other exercise of remedies. The existence and scope of the guaranties in troubled loan portfolios often become the main event in loan enforcement actions.

Counsel should not assume that a guaranty says what the parties think it says. This is one area where the loan reviewer should place little weight on the seller's loan summary. The reviewer should read independently every word that defines the scope of the guarantor's liability and the conditions that trigger liability.

The reviewer should also watch for provisions in a guaranty suggesting that the guarantor's liability will terminate under certain circumstances. If the guaranty includes these provisions, counsel must try to determine whether the guaranty has actually terminated or whether the guarantor may have asserted (or be able to assert) that it has.

 Published in Probate & Property, Volume 24, No 3 © 2010 by the American Bar Association. Reproduced with permission. All rights reserved. This information or any portion thereof may not be copied or disseminated in any form or by any means or stored in an electronic database or retrieval system without the express written consent of the American Bar Association.

The reviewer should focus in on exactly what has to happen for the guaranty to terminate. Is it an objective event? A determination made by the lender? Every word matters.

If the guaranty covers only part of the loan, the lawyer should consider what will happen if the borrower repays part of the loan, whether through a foreclosure sale or otherwise. The reviewer should parse through the words of the guaranty and consider how any loan payment might affect the guarantor's exposure (that is, the lender's credit support). If the guaranty covers only interest, when does the guaranty end?

The loan reviewer should scrutinize each guaranty with particular care for defects in execution, such as blank spaces, page breaks that do not make sense (possibly because of last-minute substitution of pages), blanks in acknowledgments, or missing information. Did the parties negotiate any strange conditions to the enforcement of the guaranty? Sometimes the conditions sounded perfectly reasonable at the last minute when they were added to the guaranty, but in practice they can create serious enforcement issues on default.

Title Insurance Policies

In even the most limited loan file review, the buyer's lawyer typically seeks to confirm that each file contains a lender's title insurance policy—not just a title report or a commitment to issue a policy. For each policy, counsel should check that the secured amount, the borrower, and the lender all conform to the loan documents. The lawyer also should skim through the exceptions listed in the title policy, just to be sure they contain nothing problematic.

Any of the following will probably raise issues: (1) other mortgages; (2) purchase options, rights of first refusal, or other preemptive rights; and (3) unusual agreements, as opposed to the usual easements, memoranda of lease, and property-related agreements between adjacent landowners. If the counterparty to an unusual agreement consists of a utility company or a municipality, the agreement will probably be benign, except perhaps to the extent that it requires significant payments by the property owner. Agreements with counterparties that are not customary in a real estate development can cause more concern.

At the extreme, a recorded agreement with an individual that is not a tenant or adjoining property owner should cause special concern, because it is atypical and likely to create trouble down the road. If the title policy offers no clue at all about the nature of a particular exception, the reviewer should consider reading the entire recorded document.

In reviewing title, the reviewer should watch for signs that the borrower has entered into an agreement for the deferral or abatement of real estate taxes or has agreed to pay additional taxes or make additional payments to governmental authorities under some circumstances (for example, "community fund development taxes" or "development agreements"). These agreements can sometimes trigger future surprises and problems, and unlike subordinate liens, a foreclosure will not necessarily make these problems go away.

Depending on the circumstances, including timing and budget, the buyer may wish to—and usually should—obtain an updated snapshot of title and UCC filings for each property. This will disclose judgments, mechanic's liens, certain types of litigation, additional mortgages, delinquent real estate taxes, and other issues. In some cases, the buyer may want a full current title report providing more extensive information.

In reviewing updated title information, the lawyer should focus only on items that were recorded after the mortgage was acquired or, if recorded earlier, did not appear as exceptions on the seller's original title insurance policy. Items of either type would otherwise merit the same scrutiny as similar items in the closing date policy, except that the fact that they did not appear in the original title coverage should raise eyebrows. So, the threshold for questioning one of these new items is probably lower than for items disclosed in the title policy.

Opinions of Counsel

Typically every loan document file contains an opinion of borrower's counsel that covers (1) internal borrower formalities, for example, that the right people signed the documents, and (2) enforceability, such as opinions that the documents establish rights and obligations and provide remedies for breach. Occasionally, a loan originator makes a business decision not to obtain opinions of borrower's counsel, based perhaps on experience that indicates that whatever possible problems an opinion is supposed to prevent just do not arise very often in the real world. If the file does not contain an opinion of counsel, a loan reviewer may want to get some comfort about the areas usually covered by an opinion.

To get comfort about internal borrower formalities, the reviewer should look at the signature block for the borrower on the note, mortgage, or loan agreement. The lawyer should then review the borrower's organizational documents and consents or resolutions, and confirm that they support the authority of the signer. The reviewer should follow the same process for any guaranties signed by entities. Signatures by individuals do not require this type of homework.

Confirming that the documents are enforceable under state law is a somewhat more abstract process. Loan documents are almost always enforceable, subject to typical limitations that do not vary much from loan to loan. But defining these limitations in writing consumes entire forests of paper both at closings and in bar association reports. It is fair to say, though, that a buyer considering these issues for a particular set of loan documents simply wants to assure itself that the documents are no less enforceable than any typical set of similar documents. Toward that end, a loan reviewer should look for problems or issues that might lead a court to disregard significant parts of the document. Theses problems could include, for example, missing signatures, unusual or bizarre loan terms, internal inconsistencies, or sloppy or incomprehensible documents. As a practical matter, these problems do not arise much in modern

 Published in Probate & Property, Volume 24, No 3 © 2010 by the American Bar Association. Reproduced with permission. All rights reserved. This information or any portion thereof may not be copied or disseminated in any form or by any means or stored in an electronic database or retrieval system without the express written consent of the American Bar Association.

commercial mortgage loan portfolios, but they are always possible.

Stepping back from the loan documents, a reviewer should watch for signs of actual problems that have arisen in areas covered by an opinion of counsel, such as a notice from the borrower or the borrower's counsel challenging the validity or enforceability of the documents. As a practical matter, the frequency of these problems will probably be minimal, even if the lender did not go through the process of obtaining opinions of counsel.

Beware of Other Players

The reviewer should watch for anything that suggests that the loan is not the only loan backed by the property in question. Red flag items include an intercreditor agreement or a set of loan documents with another lender, whether that lender holds another mortgage on the property or a lesser form of collateral such as an equity pledge or a preferred equity interest in the borrower.

Intercreditor relations have proven to be a minefield in the current real estate collapse. Even supposedly standard intercreditor agreements often create problems. A loan reviewer should understand clearly what agreements exist, what notices have been given under those agreements, and the nature and status of the intercreditor relationship.

Of particularly crucial importance is whether the intercreditor agreement limits the transferability of the loan in a way that the loan purchaser may find burdensome. If so, that raises a red flag, not only for the intercreditor agreement but also for the rest of the loan file. The loan purchaser must demand that the seller fix the problem for the current loan sale and also, very likely, for any future resale of the loan.

Letters of Credit and Other Third-Party Documents

If the file suggests that a loan includes a letter of credit for any purpose, the reviewer should figure out whether the lender is supposed to be holding the letter of credit and when this letter of credit will expire. An expiration date that is within 60 days of the loan purchase date should raise a red flag. At some point, counsel should find out where the original letter of credit resides, who issued it, and whether the issuer has been taken over or shut down by the government.

Documents involving third parties (for example, hotel managers or franchisors) can contain consent requirements or other burdensome provisions that could make the loan hard to transfer or enforce. In a hotel loan, the lawyer should look for a nondisturbance agreement between the lender and the hotel manager. Agreements of this type obligate the lender to keep the manager in possession of the property upon a foreclosure. The crucial issues are the conditions under which the lender can disturb the manager's possession—that is, kick the manager out—which is often exactly what the loan purchaser will want to do after a foreclosure.

In contrast, nondisturbance agreements with tenants rarely cause concern, unless the borrower entered into the lease in violation of the loan documents, on below-market terms, or on a sweetheart basis.

For a construction loan, the reviewer should look for letters from the general contractor and architect confirming that if the loan goes into default they will continue working for the lender or its designee. Usually these letters require the lender to bring payments due to the contractor or architect current as a condition to the continuance of work. This requirement is acceptable, but if one of these agreements contains approval requirements, significant fees, or other obstacles or burdens, the loan reviewer should flag these provisions. The loan reviewer also should look for letters of this type that cannot be assigned to a purchaser of the loan. Any such restriction would create a problem for this sale or any subsequent resale of the loan.

Outside the Four Corners of the Documents

When a loan purchaser has its counsel review the loan file, the lawyer needs to look for something more—much more—than what is in the loan documents. The loan documents can be perfect, but they do not tell the whole story. The value of the loan often depends on events and history entirely outside the loan documents. Therefore, a lawyer reviewing the loan file needs to try to discover all other trouble that lurks in the file.

To start with, counsel should look for amendments to the original loan documents, whether express (a "first amendment of loan agreement," for example) or implied (a letter agreement that makes a conceptual change to the loan, for example). The loan seller may not know just how many amendments actually exist, so a careful loan reviewer should search for more amendments than the seller has listed.

Any recent amendment should provide a good flavor of the problems that have arisen in this particular loan. Older amendments will not reflect recent history. Given marketplace trends and the state of the financial world, more recent history often will raise more concerns than older history.

When a loan file contains an amendment of any sort, the loan reviewer should ask whether the loan seller took all the right steps to protect its position when it executed the amendment. In general, subject to state-by-state variations, for any material amendment the lender should have had the borrower sign a modification to the mortgage then should have recorded that modification. At the same time, the seller should have obtained an updated title search and an endorsement to the seller's original title insurance policy, confirming that the amendment did nothing to impair the priority of the mortgage. If the endorsement lists any new exceptions, items that may have achieved priority over the lender's mortgage require special scrutiny. Failure to take these steps can create risks, which the purchaser needs to understand.

If a loan has a litigation file or other litigation history, that file will provide helpful information, not only about the relationship between the borrower and the lender but also about other problems at the property, such as disputes with tenants or contractors. Often the file contains only selected papers from pending litigation—but enough of a

 Published in Probate & Property, Volume 24, No 3 © 2010 by the American Bar Association. Reproduced with permission. All rights reserved. This information or any portion thereof may not be copied or disseminated in any form or by any means or stored in an electronic database or retrieval system without the express written consent of the American Bar Association.

clue to reveal that the litigation exists and that more digging is needed. If the file contains any suggestion that the borrower or a major tenant is in bankruptcy, the reviewer should focus immediately on the bankruptcy court docket and seek the help of a bankruptcy lawyer.

Looking at Letters and E-mails

For information on the recent history of a loan, the loan reviewer should scrutinize the loan correspondence file, which should include significant e-mail communications about the loan. The seller's inability or refusal to make that file available, or to confirm that it is complete, raises a red flag for the entire transaction. A review of the correspondence file should start with the most recent items and should go backwards over time.

Does the correspondence file show any sign that the borrower has made claims against the lender or vice versa? Does it show that disputes are getting ready to start? Does it indicate possible assertion of lender liability (the borrower relied, the lender misled the borrower or did other bad things, the parties agreed to something informally, and so on)?

Does the file suggest that a third party has made demands, such as a mechanic's lien claimant, a hotel manager, other creditors, some other counterparty to agreements with the borrower? What is the scope of the demand, what does it suggest, and how are the parties responding to it?

Issues and Problems

The loan reviewer should look for evidence in the file suggesting that someone else has already identified an "issue" with the loan documents. Common issues include gaps in collateral, undefined or conflicting defined terms, inconsistent or unclear obligations, restrictions on lender flexibility (requirements to obtain borrower consent, for example), and an unintentionally narrow scope for the borrower's construction obligations (perhaps omitting an obligation to complete or pay for tenant improvements).

In a retail project, counsel should look for signs that tenants are in bankruptcy or default or refusing to accept their space. In summarizing any of these situations, the reviewer should keep an eye on the other characteristics of the tenant in question. A problem with a kiosk or a newsstand lease with a year left to run creates less concern than a problem with an anchor tenant that is having trouble opening at the beginning of its 30-year lease. If a major or anchor tenant appears to be having problems, the reviewer should dig to see whether smaller leases have "co-tenancy" clauses; that is, provisions allowing the tenant to reduce its rent or even leave if a particular large tenant has shut down for a certain period.

The loan reviewer should look for evidence in the file suggesting that someone else has already identified an "issue" with the loan documents.

Ultimately, the most important issue in a troubled loan will be the value of the collateral. This value drives everything, both in and out of bankruptcy. Although lenders do not necessarily rush to obtain an updated appraisal because a current appraisal can create issues of its own, a purchaser typically wants to obtain some form of information about the current value of the collateral. A loan reviewer should watch for information in the file that could offer clues about the current value of the collateral.

This information could include, for example, current rental levels and vacancy rates (particularly when compared with those in place when the loan closed), protracted vacancies, tenants in bankruptcy or default or that have simply vanished, information about significant unexpected physical problems at the site (for example, a bad roof, aluminum wiring, Chinese drywall, mold, and exposure to the elements), environmental problems, land subsidence (a problem that actually did occur in one loan the author handled), or recent low selling prices of condos in a condo project.

What efforts has the lender already made to enforce the loan? In California, for example, certain enforcement efforts can imperil the lender's right to use other remedies to realize on the collateral. Notices of default and acceleration are typically harmless and often helpful, depending on the loan purchaser's plans, but counsel should note anything beyond that.

If a loan is heading toward default, the lender will typically obtain an updated environmental report. The loan reviewer should check to confirm that these updated reports were obtained and that they are dated within the last few months. One place to start is opening the report and seeing if it suggests that anything has changed since the original closing. A loan purchaser may instead wish to rely on the environmental work performed for the original closing, and if this purchaser is satisfied that the original work was adequate, it will require nothing more than an environmental update for the purchase or a possible foreclosure. But, if the purchaser has reason to believe that the property's condition has changed, new problems have arisen, or the original environmental work was sloppy, the purchaser may want an entirely new environmental report.

The reviewer should look for a notice that an insurance carrier has cancelled the insurance or threatened to do so. This situation often happens in troubled projects, either because of the borrower's failure to pay premiums or physical conditions on-site. In either case, the lender should have taken action to protect its interest in the collateral. If the lender has done nothing about the problem, the project may be uninsured.

Conversely, the lender's insurance coverage may obligate the lender to report to the insurance carrier certain adverse events that the lender knows about at the property (vacancies, change of use, hazardous conditions,

Published in Probate & Property, Volume 24, No 3 © 2010 by the American Bar Association. Reproduced with permission. All rights reserved. This information or any portion thereof may not be copied or disseminated in any form or by any means or stored in an electronic database or retrieval system without the express written consent of the American Bar Association.

for example). If the loan file suggests that these events have occurred, counsel should look for evidence that the lender in fact made the required reports and should try to figure out what happened next (typically the file will reflect a notice of cancellation or increase in premium, thus expanding rather than shrinking the lender's insurance problem).

The reviewer should watch for suggestions or signs that a borrower committed any form of fraud. For example, an internal lender memo can disclose concerns along these lines. Common real estate fraud, or signs of possible fraud, can include misapplication of construction loan proceeds; transactions between related entities, particularly in quick succession; multiple borrowers at the same address; the same notary public appearing too many times; variations in the appearance of the same person's signature; loans being used to repay other recent loans; delivery of false disbursement documents; diversion of lease termination payments or other incoming payments; misapplication of funds that should have been delivered to limited partners or other passive investors; false financial reports; forged mortgage release documents; inaccurate financial statements; leases or other transactions that simultaneously involve this property as well as other property outside the lender's collateral pool; unknown title insurance companies or agents; and failure to disclose material problems at the property. If the file contains anything that raises eyebrows along these lines, indicating possible fraud, the loan reviewer should identify the issue and report it in an appropriately discreet way.

Most post-closing history of a loan will not relate to issues that are "legal" in nature, except to the extent that demands have been made under the loan documents or disputes have arisen about interpretation of the loan documents. A lawyer reviewing a loan file should watch for nonlegal disputes or problems and report them as part of the file review process. In most cases, though, it will not make sense for the lawyer to investigate or analyze these issues further.

Construction Loans

If the loan financed construction, then anyone acquiring the loan will want to understand what construction items the loan has already paid for, how much of the loan has already been advanced, and how the disbursement process has proceeded to date. The correspondence or loan administration file should contain a reasonably complete history of disbursements. In a typical construction loan, the borrower requests loan disbursements every month. Before honoring such a request, the lender will analyze the financial status of the job. In particular, the lender will try to confirm that the loan is "in balance," meaning that the remaining undisbursed funds (after the current disbursement) equal or exceed the remaining cost to complete. The disbursement requests and the loan balancing process are among the most important pieces of construction loan administration.

Beyond that, a construction lender typically has a third-party vendor or consultant monitor the construction project, the disbursement process, and the borrower's compliance with its construction obligations. The reviewer should watch for recent reports about these issues, because these reports can indicate problems.

Common problems include cost overruns, suspension of work, stolen or missing materials or equipment (appliances or copper pipe, for example), excessive change orders without lender approval (particularly to reduce quality or cost), schedule delays, budget reallocations (if not based on demonstrated savings and approved by the lender), bankrupt subcontractors (most often the electrical subcontractor, it seems), and incompatibility or lack of coordination between design features (for example, the main sewer line mistakenly crosses through the chimney over the large fireplace in the community room).

A troubled construction loan usually has large piles of unpaid bills from contractors, architects, and other creditors. A loan reviewer should watch for these and try to quantify them. Certain bills (typically for costs associated with physical improvements to the real estate) could produce mechanics' liens, which could in some states or under some circumstances have priority over the lender's mortgage. This is a matter of state law, but even without local law expertise, a loan reviewer can focus on the underlying issues such as the amount of the claim, the date it was asserted, what documents were recorded, and whether the claimant is asserting a lien.

Development projects require a sequence of governmental approvals, which become less controversial, political, and uncertain toward the end of the approval process. A thumbnail summary of the usual sequence is as follows: (1) zoning or rezoning, if necessary; (2) subdivision and mapping (often coupled with conceptual approval for the project); (3) building permit; (4) temporary certificate of occupancy (often short-term with multiple renewals); and (5) final or permanent certificate of occupancy.

If a project has gotten beyond the first two of these steps, then the approvals risk is generally manageable. If not, then the project's feasibility is in doubt until the essential approvals have been obtained. Anyone reviewing a construction loan should try to ascertain just how much approval risk still remains in the project. A project that has broken ground typically has gotten past these issues.

To the extent that approvals are in place, counsel should watch for any sign that they may be in jeopardy. Signs of this type may include notices of noncompliance from governmental agencies or looming deadlines. Major construction projects often attract challenges from competing developers or property owners, often in the form of a so-called community group.

The reviewer should watch for any sign that the borrower or lender has received a notice that the property violates a building or other code in any significant way. Almost every project has some degree of code violation, if only for failure to post required warnings or signs. Instead of focusing on those minor matters, the reviewer should watch for code violations that seem major or could require significant work or delay to remedy.

A loan that financed the

 Published in Probate & Property, Volume 24, No 3 © 2010 by the American Bar Association. Reproduced with permission. All rights reserved. This information or any portion thereof may not be copied or disseminated in any form or by any means or stored in an electronic database or retrieval system without the express written consent of the American Bar Association.

development of a condominium or other for-sale housing project can raise its own set of problems. These include marketing reports showing few or no units sold; notices from governmental consumer protection authorities indicating, for example, disputes or a withdrawal of approval to sell; leasing of apartments that were intended to be sold; any suggestion that the borrower wants to convert the project to a rental; notices from purchasers seeking to rescind their contracts; or other disputes with purchasers. The loan reviewer should search the file for these types of communications.

A loan typically contains budget line items or reserves to pay for particular items—interest, real estate taxes, roof repairs, re-tenanting costs, and so on. To the extent that these items or reserves are not exhausted, they remain available to help solve problems and carry expenses of the property and the loan. To the extent they are exhausted, this lack of reserves will increase the pressure on the borrower and the lender. If the loan file offers any clues about these matters—particularly about how much remains in the reserves—the loan reviewer should highlight that information because it will matter.

The reviewer should also try to determine whether the documents give the borrower the right to take funds out of the reserves without lender concurrence. This borrower control should raise concerns, because a borrower in trouble will often grasp at any funds available to try to stay above water. Even if the loan documents seem to give the lender total control over reserve accounts, the reviewer should watch for any sign that the lender has permitted the borrower to administer the reserve account (including making withdrawals) without lender involvement. This factual situation may face the reviewer, even if the documents say that the lender must approve all borrower withdrawals from the reserve account.

A developer typically tries to pull fees from a project—"to keep the lights on" in the developer's offices and take care of the developer's staff. A lender typically wants the developer to defer, subordinate, or waive these fees. If the original budget did not already waive or subordinate the developer's fees, these measures are typically part of the first budget revision that becomes necessary when the job starts to go over budget. The reviewer should try to determine where the parties stand in that process and watch for any sign that the developer is receiving fees that it should not be pulling out of the project funding, although this situation will not be easy to find.

Ordinarily, as part of the process of acquiring a troubled construction loan, a construction consultant explores the costs to complete the project and advises on any issues or budget shortfalls in the loan and construction process. A lawyer reviewing the loan file also should watch for these issues.

As a practical matter, the lender that takes over a construction project usually needs to finish construction, or to bring in a new developer to finish construction, to have a salable asset. For this reason, the purchaser of a construction loan needs to know what completion will cost. To the extent that undisbursed funds remain in the loan, these funds can mitigate the completion burden, but on some level the source of funds does not matter because the funds are the lender's (or the loan purchaser's) money, one way or the other. Once the developer stops putting money into the project—whether before or after losing the project to foreclosure—the lender is the only source of necessary completion funds.

Previous Assignments of the Loan

If the seller acquired the loan by a prior assignment, the file should include a recorded assignment of the mortgage, an assignment of the other loan documents, and a copy of the endorsement (or sometimes an allonge) that transfers the loan to the purchaser. If there have been multiple assignments, the reviewer should check the documents for each of them. Courts have been tormenting lenders by forcing them to demonstrate a full valid chain of ownership for any loan they try to foreclose. These issues have dramatically slowed and complicated the foreclosure process, at least in the residential market. Purchasers of commercial loans should expect much the same treatment when they take their turn in the ever-lengthening foreclosure line.

A loan purchaser should know how much of the loan has been disbursed, as well as how much remains to be disbursed. Usually those add up to the total stated loan amount, but not always. For example, sometimes the borrower can obtain advances only through a certain date in the near future, and a significant amount remains unfunded on the date of the review. The lawyer should review the disbursement information, if it is available.

Wrapping Up the Loan Review Package

As the preceding discussion demonstrates, the range of problems in troubled real estate loans can be quite broad. Notwithstanding the breadth of the potential problems described above, a loan may have other problems that go beyond the litany of horrible possibilities discussed in this article. Anyone reviewing a loan file must remain vigilant and avoid getting lost in the weeds. Above all, the reviewer should tailor the scope of review to reflect the specific assignment from the client and understand that the scope of this assignment will vary depending on the client's approach to the transaction, appetite for risk, budget, and many other circumstances.

To the extent that the loan review does disclose problems or potential problems, counsel often should do more than make a notation on a checklist or review form. Instead, if something looks potentially serious the reviewer should bring it to the client's attention (or to the attention of the senior person on the loan review team), so that the client will focus on the risk, ask appropriate questions, and if necessary raise the issue with the seller. ■

 Published in Probate & Property, Volume 24, No 3 © 2010 by the American Bar Association. Reproduced with permission. All rights reserved. This information or any portion thereof may not be copied or disseminated in any form or by any means or stored in an electronic database or retrieval system without the express written consent of the American Bar Association.

Sample Due Diligence Checklist
(Commercial Mortgage Loan Acquisition)

This due diligence checklist highlights hot buttons and common problems that often arise when reviewing a typical commercial mortgage loan. The loan reviewer should highlight any potential concern by adding a checkmark or asterisk in the left column. Though this form may appear relatively short, any review form takes longer to fill out than one would intuitively expect because of the need to (1) find everything, (2) be 100% correct, (3) fill out the form correctly and clearly, and (4) proofread.

Borrower	
Entity Type	
Property	
Closing Date	
Amendments	
Assignments	

FLAG	DOCUMENT / TERM	COMMENTS AND DETAILS	PAGE
	LOAN AGREEMENT ("LA")		
	Economics		
	• Principal		
	• Interest Rate		
	• Amortization		
	• Prepayment Lock		
	• Prepayment Formula		
	• Maturity Date		
	• Extension Options		
	Covenants		
	• Tax and Insurance Escrows		
	• Quarterly and Annual Financials		
	• LTV or Debt Service Coverage Ratio; Effect of Noncompliance		
	• Property-Specific		
	• Single-Purpose Entity		
	Lender Approvals		
	• Budgets		
	• Change of Management or Management Agreement		
	• Leases (or at Market)		
	• Major Alterations		
	• Transfers (Collateral, Equity Interests)		
	Lender Burdens		
	• Future Advances		
	• Nondisturbance for Tenants		
	• Partial Release of Collateral		
	• Transfer Restrictions on Lender		
	Property Issues		
	• Construction		
	• Environmental		
	• Reserves, Unusual		
	• Tenant Bankruptcy		
	Jury Trial Waiver		
	Unusual Provisions		
	NOTE ("N")		
	Correct Obligor, Consistent with Filed Organizational Document		
	Monthly Payment >/= Interest Accrued		
	Acceleration on Default		
	Attorneys' Fees		
	Jury Trial Waiver		

 Published in Probate & Property, Volume 24, No 3 © 2010 by the American Bar Association. Reproduced with permission. All rights reserved. This information or any portion thereof may not be copied or disseminated in any form or by any means or stored in an electronic database or retrieval system without the express written consent of the American Bar Association.

FLAG	DOCUMENT / TERM	COMMENTS AND DETAILS	PAGE
	No Offsets		
	Unusual Provisions		
	Correct Entity's Signature		
	Location of Original Note		
	MORTGAGE ("M")		
	Mortgagor = Note Obligor		
	Present Transfer Language		
	Correctly Identifies Secured Note		
	Stamped as Recorded; Book/Page		
	Recorded in Jurisdiction Where Real Property Is Located		
	Borrower Must Pay Taxes		
	Borrower Must Insure Property for at Least Loan Amount		
	Casualty/Condemnation Proceeds First to Lender and/or Restoration		
	Foreclose on Event of Default		
	Power of Sale		
	Obtain Receiver Without Notice		
	Jury Trial Waiver		
	Borrower Must Sign Estoppels		
	Unusual Provisions		
	Correct Entity's Signature		
	Notarized (Correctly and Completely)		
	Legal Description Attached; Confirmed; and Referred to in Document		
	All Other Exhibits Attached		
	UCC FINANCING STATEMENT		
	Debtor = Note Obligor		
	Debtor Name Matches Filed Organizational Document		
	Broad Collateral Description, Fully Defining All Terms Used Without Reference to Other Documents		
	Copy Stamped "Filed" and Filing Date		
	Expiration Date of Filing		
	GUARANTY		
	Guarantor		
	Scope of Guarantied Obligations		
	• All Loan Obligations		
	• Partial (Summarize Exact Scope)		
	• Completion		
	• Nonrecourse Carveouts		
	Conditions Triggering Guaranty		
	Termination of Guaranty		
	Correct References to Borrower, Closing Date, Other Loan Documents		
	Missing Pages, Inconsistent Page Breaks, Defects in Execution, Blank Spaces		
	OPINION OF COUNSEL		
	Correctly Addressed to Lender		
	Duly Formed, Good Standing		
	Duly Authorized and Executed		
	Enforceable		

 Published in Probate & Property, Volume 24, No 3 © 2010 by the American Bar Association. Reproduced with permission. All rights reserved. This information or any portion thereof may not be copied or disseminated in any form or by any means or stored in an electronic database or retrieval system without the express written consent of the American Bar Association.

FLAG	DOCUMENT / TERM	COMMENTS AND DETAILS	PAGE
	No Violation of Law, etc.		
	Future Holders of Loan May Rely		
	Signed and Dated		
	TITLE INSURANCE POLICY		
	Copy of Issued Policy		
	Named Insured = Mortgagee		
	Coverage = Principal		
	Legal Description:		
	• Matches Mortgage		
	• Matches Survey		
	Survey Shows Improvements, No Major Issues Readily Visible		
	Prior Mortgages or Liens		
	Real Estate Taxes Paid		
	Unusual Exceptions or Issues Disclosed		
	AMENDMENTS		
	List Dates		
	Summarize Amendment Terms (Continue on Separate Sheet If Necessary)		
	For Each Amendment, Confirm:		
	• Estoppel Confirmations from Borrower or Guarantor, or Apparent Disputes as to Loan Terms		
	• Recording of Mortgage Modification		
	• Title Search		
	• Update Endorsement for Title Policy		
	POSSIBLE ISSUES		
	Appraisal Disclosures (Property Problems)		
	Cash Management		
	Cross-Collateralized (Additional Collateral)		
	Environmental Problems		
	Governmental Notices or Violations		
	Ground Lease		
	Litigation (Borrower, Major Tenant, etc.)		
	Lost Documents		
	• Assignments to Seller (Recorded)		
	• Endorsements to Seller		
	• Note		
	Management Agreement Not Readily Terminable by Lender		
	Major Lease(s) to Review		
	Missing Pages		
	Multiple Borrowers		
	Other Financing (Mortgages, Mezzanine, etc.)		
	Real Estate Taxes—Unpaid or Assessment Problems		
	Reciprocal Easement Agreement, Condominium Documentation, or Similar		
	Syndication of Loan		
	Zoning or Entitlements Problems		
	Unusual Provisions, Other		

Additional Comments:____

 Published in Probate & Property, Volume 24, No 3 © 2010 by the American Bar Association. Reproduced with permission. All rights reserved. This information or any portion thereof may not be copied or disseminated in any form or by any means or stored in an electronic database or retrieval system without the express written consent of the American Bar Association.