COMMERCIAL LENDING REQUIREMENTS AND LOAN DOCUMENTATION IN VIRGINIA

Part IX. Real Estate Issues

By Douglas J. Sanderson

McCandlish & Lillard, P.C.
Fairfax, Virginia
dsand@mccandlaw.com

Previously in this seminar, you have examined the anatomy of a loan agreement, which is the fundamental engine of most commercial lending, along with the planning process, commitment letters, construction loans and all the other issues on the agenda to this point. The core issue of what is recorded in a real estate loan remains for examination, however – the mortgage, or, more accurately in the Commonwealth of Virginia, the deed of trust.

Both types of instruments are supportive of the promissory note that, despite its attracting very little focus today, actually is the key to enforcing the actual obligation to repay the lender. In addition many loans that are secured by real estate also involve separate assignments of leases and rents, and many, in fact most, in my experience, also involve guaranties of some sort, which, along with the underlying loans themselves, may be full recourse, limited recourse, capped, or non-recourse.[1]

A. Mortgages (Deeds of Trust) and Notes

A "mortgage" means a document by which the owner of real property pledges his/her/its title to a lender as security for a loan described in a related promissory note. It is a two-party instrument, between the "mortgagor," which is the owner, and the "mortgagee," which is the lender.

What is more typically used in the Washington, D.C. area, however, is not actually a "mortgage," but rather a "deed of trust," although the terms often are loosely used interchangeably. The "deed of trust" is a document by which the owner of real property pledges his/her/its title to one or more "trustees," rather than directly to the lender, to secure a loan. The trustee then owns bare legal title in trust for the beneficiary, which is the lender of the money. Thus the mortgage is a two party instrument, while the

[1] The promissory note and/or the deed of trust or mortgage also may contain provisions addressing whether they are limited in whole or in part as to the recourse that a lender will have.

deed of trust is a three party instrument. (Anyone here who does not know all this already is welcome to leave. Kidding.)

The main differences between the two are, first, in the impact on title ownership, and, second, in the manner of enforcement. With a mortgage, the owner retains full legal and equitable title, subject to a lien in favor of the lender/mortgagee. With a deed of trust, the owner transfers legal title to the trustee(s), who actually are the legal owners of the property, subject to a deemed "equitable" title retained by the owner and the interests of the lender/beneficiary.

This distinction sets up the difference in enforcement. A mortgage can be enforced only after application to a court, proof of a default in the underlying promissory note or the mortgage covenants and thus of the accrual of the right to foreclose, and a judicial authorization to do so. A deed of trust, on the other hand, can be enforced by a private sale conducted by the trustees – a "trustees' sale" – upon the request of the beneficiary. In Virginia, the trustees' sale process is reviewed after the fact by the quasi-judicial commissioners of accounts for the applicable jurisdiction. These commissioners ensure that the statutory requirements were satisfied regarding notice, advertising and disbursement of proceeds. *See, e.g.,* Va. Code § 55–59.1 through 55-62, 1950, as amended.

The protections to the borrower that might otherwise be provided by a court, in a mortgage foreclosure situation, are instead made the responsibility of the trustee, who by law has been held to be in a fiduciary relationship with both the lender/beneficiary and the borrower/property owner. In Powell v. Adams, 18 S.E.2d 261 (Va. 1942), for example, the Virginia Supreme Court held that

> The powers and duties of a trustee in a deed of trust, given to secure the payment of a debt, are limited and defined by the instrument under which he acts. He is the agent of both debtor and creditor. It is incumbent upon him to act toward each with perfect fairness and impartiality. Preston v. Johnson, 105 Va. 238, 239, 53 S.E.1.

18 S.E.2d at 262-3.

Most of the issues that arise in preparing or negotiating the deed of trust, as with all other loan documents, are foreshadowed by and thus based upon the terms and conditions of the loan commitment or term sheet. The Table of Contents from a good example of a comprehensive commercial deed of trust is attached hereto as Appendix 1. This Appendix illustrates a good, representative list, though not an exhaustive or impliedly complete list, of issues that a comprehensive deed of trust could contain.

One additional concept that often may be negotiated between the lender and the borrower(s) and/or any guarantor(s) is the concept of recourse. "Recourse" is the right to

demand payment from the maker or endorser of a negotiable instrument. Absent language limiting the extent of the recourse that a lender will have to recover payment from a note maker, landowner signing a deed of trust, and/or guarantor upon a default, recourse is full and unlimited.

However, real estate loans to a limited liability business entity of any formal kind (i.e., a corporation or limited liability company, or even a properly structured limited partnership) that are not guarantied by third parties are virtually non-recourse, in effect, even without any language in the loan documents, if the entity is small enough that a default in the loan will signal an inability to pay anything beyond what the property might yield upon a trustee's sale. In such a case, the lender is relying on the value of the property to cover its risk in the event of a default.

A lender may accept limitations on recourse in its loan, though, which would be evidenced by provisions in each of the loan documents, or a cross-reference in them, spelling out the nature of the limitations. These could range from expressing that the lender will seek no recovery from any assets of borrower other than those securing the loan (non-recourse), to expressing a non-recourse provision with a few or many carve-outs, to simply capping the liability for which the lender can seek to hold the borrower liable beyond the recovery from the security. A good example of non-recourse language with significant carve-outs is attached hereto as Appendix 2.

B. Assignments of Leases and Rents

Beyond the deed of trust/mortgage, the document most often recorded in the land records to secure a real estate loan is an assignment of leases and rents. A listing of contents from a comprehensive and typical separate assignment of leases and rents is attached hereto as Appendix 3, although the assignment of leases and rents need not be an independent document, and instead can be included in the deed of trust, and often is. *See, e.g.,* Appendix 1, Section 1.2.

This document should identify all present leasehold interests of third parties – tenants – in and to the real estate that is being secured by the deed of trust, and should provide notice, to all persons having a reason or duty to check the land records office of the jurisdiction where the land is located, that the lender has made a loan to the landowner and, to secure it, has received rights in and to the leases themselves and in the rents and other proceeds from them.

Well drafted, the assignment of leases and rents should clearly indicate that the landowner (1) has presently assigned these interests and rights, in order to strengthen the lender's position if there occurs a bankruptcy, and (2) retains the right, generally expressed by means of a license granted by the lender back to the landowner, to collect all rents and deal with the leases as though they remained solely the property of the landowner, except as stated in the assignment. *See, e.g.,* Appendix 2, Sections 3.1 and

3.2. Such exceptions could include, for example, the obligation of the owner not to terminate a lease without lender's consent, unless the tenant goes into default beyond any applicable cure periods.

C. Other Real Estate Related Documents

The major documents that are keys to concluding a real estate secured loan most likely are the title insurance commitment and the guaranty. The former is not a loan document at all, of course, and is intricate enough to bear its own CLE seminar. For our purposes, it must suffice to say that the lender will require that the title to the land that it intends to secure as collateral be good and marketable, and that various endorsements that provide special coverages are commonly requested.

The latter is a loan document, which may be required by a lender that is not willing to risk the loan, or perhaps that will not issue its best interest rate, without receiving additional assurances of repayment from one or more third parties. Most often lenders might ask entity owners to be guarantors. In all cases the lenders should be expected to draft the guaranty with provisions that show a financial interest on the part of the guarantor(s) in the business entity whose loan the guarantor(s) is guarantying. Beyond this point, the language of guaranties is widespread enough to not require much additional discussion.

Appendix 1

COMMERCIAL DEED OF TRUST -- TABLE OF CONTENTS

Appendix 2

(Carve-out Language)

X.XX Non-Recourse. Subject to the qualifications set forth in this Section 2.10, Lender agrees that collection of the indebtedness shall be enforced solely against the collateral described in the Loan Documents. Subject to the qualifications set forth in this Section 2.10, Lender agrees not to seek, take or obtain against Borrower any deficiency judgment for amounts remaining unpaid under the Loan Documents after all the security for the Note has been applied to payment of all amounts owed to Lender under the Loan Documents. Nothing herein shall prohibit Lender from bringing a foreclosure action, an action for specific performance or any other appropriate action or proceeding to enable Lender to enforce any and all rights under this Agreement, the Note, Equity Pledge and the other Loan Documents, in respect of the collateral given to Lender pursuant to this Agreement, the Equity Pledge and other Loan Documents. Notwithstanding the foregoing, each of Borrower and Guarantor, jointly (except where specifically provided to the contrary) and severally, shall be fully and personally liable for payment and performance of all obligations set forth in the Loan Documents, including the payment of all principal, interest, and other amounts under the Note, if any of the following shall occur: (i) fraud, gross negligence, willful misconduct, misrepresentation, or misapplication of funds, whether from sales proceeds, deposits, rents, insurance proceeds or condemnation awards; (ii) physical waste or willful destruction of the Property or the removal of any Personal Property; (iii) voluntary bankruptcy filing by Borrower, or involuntary filing against Borrower (if such case is not dismissed within ninety (90) days), (iv) any interference by Borrower or Guarantor with Lender's pursuit of its rights and remedies under the Loan Documents (including, without limitation, any of the following (a "Fraudulent Transfer"): any fraudulent transfer by Borrower or any Guarantor of any of its assets or any transfer or other disposition by Borrower or Guarantor, whether or not fraudulent, of any of its assets, which transfer is made with the intent to render, or has the effect of rendering, such assets unavailable for levy and application to such Person's obligations hereunder or under the Guaranty or other Loan Documents (except to the extent such Person receives fair value for such asset, and such replacement asset is subject to levy and application to such Person's obligations hereunder to the same or greater extent as the relinquished asset)); (v) claims or judgments against Borrower by tenants, service providers, contractors, brokers, or other parties to the extent not covered by available insurance proceeds (unless Borrower shall have contested same and posted a sufficient bond or made other arrangements satisfactory to Lender within thirty (30) days after receipt of notice of such judgment or claim) (provided, however, that personal liability for the claims and judgments set forth in this clause (v) shall be limited to the extent cash was available to pay such claims and judgments but not applied to the payment thereof, unless such claims or judgments result from the Borrower's gross negligence or willful misconduct); (vi) failure to pay taxes or other governmental charges (provided, however, that personal liability for the taxes and other governmental charges set forth in this clause (vi) shall be limited to the extent cash was available to pay such taxes and other governmental charges but not applied to the

payment thereof unless the imposition or applicability of such taxes or other governmental charges results from the Borrower's gross negligence or willful misconduct); (vii) any breach of any representation, warranty, covenant, or obligation concerning Hazardous Materials contained in the Environmental Indemnity; (viii) any mechanic's or materialman lien against the Property, or unsatisfied claim(s) against Borrower for work performed or materials provided with respect to the Property (unless Borrower reasonably contests same and has complied with the requirements of Section 5.5 hereof); (ix) any violation of the due-on-sale or due-on-encumbrance provisions or indebtedness limitations of the Loan Documents, including any refinancing of the Senior Loan without payment in full of the Loan; (x) a failure by Borrower to notify Lender within five (5) business days of any default by Borrower under the Senior Loan; provided, however, that (except as to Senior Loan defaults which do not require Senior Lender to provide written notice) Borrower shall have received written notice of such default from Senior Lender; (xi) failure by Borrower or Guarantor to provide required periodic financial statements or to provide Lender with periodic access to the Property for on-site inspections which is not cured following notice as provided in Section 7.1(b); (xii) modification or amendment of Borrower's organizational documents or of the Senior Loan Documents without prior written Lender approval; or, (xiii) the failure of Borrower or any Guarantor to maintain the levels of Tangible Net Worth or Liquid Assets required pursuant to this Agreement, if such failure is the result of a Fraudulent Transfer.

Appendix 3

ASSIGNMENT OF LEASES AND RENTS – LISTING OF CONTENTS

[SPECIAL LOCAL LAW PROVISIONS]

