COMMERCIAL LOAN DOCUMENTS

by Michael R. Garner

When making a commercial loan, the lender usually requires the borrower to sign and deliver these basic loan documents:

Promissory Note: The promissory note evidences the borrower's obligation to repay the money to the lender. The note typically contains information such as the loan amount, the interest rate, payment amounts, due dates and other repayment terms. A borrower should sign only one promissory note, as lenders often resell the loans on secondary markets, and the borrower should never have more than one note evidencing a single debt obligation; if multiple notes end up in the hands of two or more lenders, each lender could take the position that the borrower must repay the full amount to it. The borrower does not want to spend time and money proving it only borrowed the loan amount once.

- Non-recourse obligations: Sometimes the borrower's note obligations are "non-recourse," that is, if the borrower defaults, the lender can only look to the collateral as its remedy; it cannot sue the borrower for a personal judgment to repay the loan. Non-recourse notes hit their high-point during the years when an extraordinary number of loans were securitized or conduit loans. However, even for those loans, there were often "carve-outs" to the non-recourse aspect. The lender would retain the right to pursue the borrower personally for the lender's damages caused by the borrower's wrongful conduct— as it was originally phrased, if the borrower were "lyin', cheatin' or stealin.'"

Deed of Trust: The deed of trust is commonly called a "mortgage" although in Washington, the deed of trust is used far more frequently than a mortgage. The deed of trust secures the borrower's obligation to repay, by pledging the borrower's real estate, any improvements on real estate and fixtures (items which have been affixed to the improvements on the real estate) as collateral for the loan. Should the borrower default on the loan, a lender's most common remedy is not to sue on the promissory note but rather to foreclose on the secured property and take the collateral in lieu of payment on the note. The basic premise behind this strategy is fairly obvious: if the borrower had the money to pay the note, it probably would not have defaulted on the loan. Alternatively, if security for the loan exists, the lender can obtain title to it and presumably resell it for fair market value.

The deed of trust usually contains the following provisions, although sometimes they are contained in separate, stand-alone documents:

- Assignment of Leases and Rents: In a commercial setting, the borrower has leased portions of the property to various tenants, and is collecting rents from the tenants. As a condition of the loan, the lender requires the borrower to assign its interest in the leases and the rents to be collected thereunder, to the lender. However, the document typically permits the borrower to collect and use the rents in its business operations so long as the loan is not in default. Should the borrower default, then the lender may notify the tenants to make all future rent payments to the lender which can then control the funds and apply them to the loan payments and other financial obligations owing from the borrower to the lender.

- Security Agreement: The security agreement is given by the borrower for personal property in the improved real property which is not affixed to the improvements. For example, if the collateral were an apartment building, the landlord might own stoves, refrigerators, beds, tables, dressers, etc. which are not affixed to the improvements. The security agreement is the instrument by which the borrower pledges or grants the lender a security interest in that property. This is important to the lender in that oftentimes a property would not be operated after foreclosure unless the lender also had the right to obtain the personal property located at the secured real estate and use it in its operations after foreclosure.

- UCC-1 Financing Statement: Just as the deed of trust is recorded to give notice to the world of the lender's lien on the borrower's real property, the lender files a UCC-1 Financing Statement to give notice of its lien on the borrower's personal property.

Guaranty: Most borrowers are legal fictions, that is, they are corporations or limited liability companies with limited assets. As the lenders typically rely on the financial strength of the individuals who own the borrowing entity (e.g., the shareholders of a corporation or the members of a limited liability company), one or more of the individual owners must personally guaranty the repayment of the note as a condition of the loan. In corporate settings, parent corporations or LLCs are often asked to guaranty the debt obligations of their subsidiaries.

Environmental Indemnity: One other document is typically not considered a "loan document" yet is critical to the transaction. A lender is concerned about its exposure for environmental liabilities—for example, it fears its borrower will introduce contaminants or hazardous waste to the property and then default on the loan, the lender will foreclose and acquire the property, and then the federal or state agencies will come in and require the lender to pay all clean-up costs for the contamination caused by the borrower. Under existing law, the likelihood of this scenario ever happening is very remote, but lenders are conservative and want protection against it. Therefore, they require that their borrower agree to (a) keep the property in compliance with all federal and state environmental laws, including refraining from storing; transporting, manufacturing, disposing or otherwise introducing contaminants to the property, (b) pay all costs of remediation which might be assessed by an applicable governmental agency; and (c) indemnify and hold the lender harmless from any such remediation costs. These obligations are typically embodied in a document bearing a title something akin to "Environmental Indemnity." These indemnities are signed not just by the borrower but also by the guarantors.

Under Washington law, all loan obligations are extinguished by foreclosure. Therefore, if the environmental indemnity were considered to be a loan document, it would also be extinguished by the lender's foreclosure and be of no value or use to the lender after foreclosure. To ensure the environmental indemnity survives foreclosure, the lender requires the borrower to agree the environmental indemnity is not a loan document, and that the borrower and guarantor's obligations under the environmental indemnity will survive foreclosure and essentially protect the lender from environmental claims forever.