WAGONHEIM & ASSOCIATES

A FULL SERVICE MARYLAND BASED
COMMERCIAL AND CONSTRUCTION LAW FIRM

BANKER'S POCKET GUIDE

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2007
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Table of Contents

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To understand a business owner is to know that his or her company is almost as precious as a first born child. As with their own children, business owners have obsessed over their companies, seen them through tough times, and prided themselves when together they overcame challenges and grew strong.

This is the relationship of which you, as a commercial banker, hope to become a vital part. Relationships are the foundation of every lending portfolio. And business customers worth having do not generally pick their lender from and ad on the back cover of the yellow pages any more than one would choose child care in that fashion.

Unfortunately, just as the relationships are built on trust, they are also based on some measure of conflict. Being part of your customer's team means working with the business to secure the best loan package or credit facility available. Being employed by the Bank means presiding over legal documentation that is all about termination, default, and penalties.

> At its most basic, being on the front lines of a banking relationship means learning to most effectively wield the iron fist in the velvet glove.

This Pocket Guide is intended for those who understand that knowledge of the entire transaction – from earning the business to the ins and outs of the loan documents – is essential not only to doing the job, but to doing it well. I hope you find it helpful.

Good luck.

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Terms You Should Know

At some point in any transaction, there arises the challenge of translating what everyone agreed to into legal documents acceptable to the bank. This section is intended as a quick primer of relevant terms.

Affirmative Covenants. **Negotiable Point.** Affirmative Covenants are a list of post-closing items which the borrower agrees to satisfy throughout the term of the loan. The supply of specific financial information, usually including tax returns, and the maintenance of certain debt ratios are often listed as affirmative covenants.

Amortization is defined as the calculation of installment payments necessary to completely repay a debt, including principal and interest over a specific period of time.

Articles of Incorporation. The organizational or formation document filed with the Maryland State Department of Assessments and Taxation ("SDAT") in order to form a corporation.

Articles of Organization. The organizational or formation document filed with the SDAT in order to form a limited liability company ("LLC").

Bylaws. The written document which governs the terms under which a corporation is run including the responsibilities of officers and voting rules.

CERCLA. The Comprehensive Environmental Response, Compensation and Liability Act (42 U.S.C. §9601 et seq.) provides public and private mechanisms for the cleanup of and compensation and liability for hazardous substances contamination. Liability under CERCLA is strict, retroactive, and joint and several. Strict liability means that no fault, negligence or intent to violate the law is necessary for liability to arise.

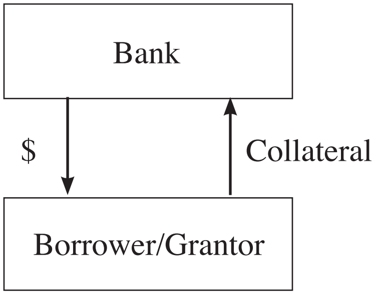
Joint and several liability means that if multiple parties are responsible for the contamination, one party may be held liable for the entire cleanup and remediation costs.

Confession of Judgment. A confession of judgment clause typically states that in the event of a default, the defaulting party consents to judgment being entered against it without prior notice or opportunity for a prior hearing. Thus, a confession of judgment clause saves the lender the time and expense of a protracted trial and will provide the lender with an immediate lien on any of the debtor's real estate located in the jurisdiction in which the confessed judgment is filed.

Debt Coverage Ratio. **Negotiable Point.** Debt Coverage Ratio is defined as the ratio of projected net income to debt service (often required to meet or exceed a certain percentage in the loan documents).

Deed of Trust. Like a mortgage, a deed of trust is an instrument which secures repayment of debt by creating a lien on the debtor's real estate in order for the real estate to serve as collateral for the loan. Deeds of trust must be recorded in the land records for the jurisdiction in which the real estate is located. Unlike a mortgage, a deed of trust names a third party to act as a trustee of the rights of the secured party. Banks will often name and officer or their attorneys to act as trustee under the deed of trust. Customarily, mortgages are used for residential transactions while deeds of trust are used for commercial transactions.

Defeasance is a substitution of collateral. Typically, a defeasance is coordinated to close contemporaneously with a sale or refinance. The borrower uses proceeds from the refinance or sale to purchase a portfolio of U.S. Government Securities that is sufficient to make all of the remaining debt service payments. The securities are pledged to the lender and the lender releases the real estate from the lien of the mortgage. The note which remains outstanding and the portfolio of securities are assigned by the borrower to an unaffiliated successor borrower who makes the ongoing debt service payments as scheduled. A defeasance may often be used to enable a borrower with an existing mortgage subject to prepayment penalties or prohibition to sell the underlying collateral in compliance with the terms of the underlying note.



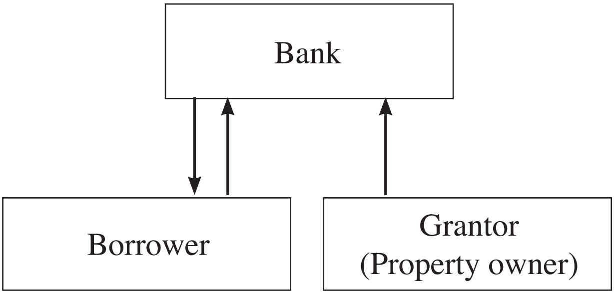
Derivatives are financial instruments whose value is derived from the value of something else. They generally take the form of contracts under which the parties agree to payments based upon the value of an underlying asset or other data at a particular point in time. The main types of derivatives are futures, forwards, options and swaps.

Events of Default. **Negotiable Point.** An event of default represents a breach of one or more of the agreements documenting the loan. Events of default typically include the borrower's filing for bankruptcy or failing to make payments as required. Other events of default may include unapproved changes in ownership, relocation, breach of financing covenants, or distribution of money to stockholders in excess of limits imposed by the bank.

Financing Statement is defined as a public notice filing of the existence of the creditor's security interest in specified collateral. A financing statement should be filed among the public financing statement records for the state in which the debtor is organized as well as in the locations where the collateral is maintained.

Guaranty. **Negotiable Point.** A Guaranty is an agreement by the guarantor to pay the debt of the borrower at maturity if the borrower is unable to repay it. Some guarantees are unlimited, while others specify a limit -- in terms of dollars, time, or both.

Indemnity Deed of Trust ("IDOT"). An IDOT is a deed of trust instrument in which the grantor pledges its real estate to serve as collateral for a third party borrower. (For example, Company A would pledge its real estate as collateral for a loan undertaken by Company B.)



Interest Rate Swap is a derivative in which one party exchanges a stream of interest payments for another party's stream of cash flows. The most common interest rate swap is one in which one party pays a fixed rate (the swap rate) while receiving a floating rate (usually pegged to LIBOR). An example would be if Party A agrees to pay Party B period interest rate payments of LIBOR plus 50 bps (0.50%) in exchange for periodic interest rate payments of 3.00%. Note that there is no exchange of the principle amounts and that the interest rates are on a "notional" (i.e., imaginary) principle amount. Also note that the interest payments are settled in net (if LIBOR plus 50 bps is 1.2% then Party A receives 1.8% and Party B pays 1.8%). The fixed rate (3% in this example) is referred to as the swap rate. At the point of initiation of the swap, the swap is priced so that it has a net present value of zero. If one party wants to pay 50 bps above the par swap rate, the other party has to pay approximately 50 bps over LIBOR to compensate for this.

Junior Liens. Mortgages held by other lenders subordinate to the first priority mortgage holder. Note: If a junior mortgage holder forecloses on the property, the first priority mortgage will be unaffected by the foreclosure sale and the purchaser at foreclosure will take title to the property subject to the first priority mortgage.

LIBOR. The London Interbank Offered Rate (or "LIBOR") is a daily reference rate based on the interest rate at which banks offer to lend unsecured funds to other banks in the London Wholesale Money Market (or Interbank Market). LIBOR rates are widely used as a reference for financial instruments such as interest rate swaps, floating rate notes, and variable rate mortgages.

Mezzanine Financing. Typically, mezzanine financing involves a loan that is subordinate to a first mortgage loan on real property and is secured by a pledge of the equity interests in the owner of the property. The ability of the mezzanine lender to enforce its rights against a collateral is usually governed by an inter-creditor agreement among the two lenders and the borrower.

Mortgage. Like a deed of trust, a mortgage is an instrument which secures repayment of debt by creating a lien on the debtor's real estate in order for the real estate to serve as collateral for a loan. A mortgage must be filed in the land records for the jurisdiction in which the real estate is located. Mortgages are two party instruments from the debtor/grantor (called the "mortgagor") to the lender/grantee (called the "mortgagee").

Negative Covenants. **Negotiable Point.** Negative Covenants are the flip-side of the coin from Affirmative Covenants in that they specify things that the borrower should not do or allow to happen. Typical Negative Covenants include limitations on indebtedness, loans to principals, the creation of subsidiaries, transactions with affiliates, and the transfer of assets outside of the ordinary course of business.

Operating Agreement. Executed by all of the Members of a limited liability company ("LLC"), an Operating Agreement acts like the Bylaws in a corporation by providing the rules under which the LLC is governed. **An LLC is not required to have a separately drafted Operating Agreement under Maryland law.** If the LLC does not have an Operating Agreement, the provisions of the Maryland Limited Liability Company Act will serve as the *de facto* Operating Agreement.

Opinion Letter is a letter drafted by the lawyer for the borrower and guarantors in the loan transaction to provide the lender with comfort regarding certain specified legal aspects of the loan transaction. Lenders generally rely on opinion letters to ensure that the borrower and/or guarantors will be bound by the obligations it or they undertake. In practice, however, Opinion Letters offer very little to the Bank in the way of concrete assurances due to the customary inclusion of broad, standard disclaimers.

Phase I Environmental Site Assessment. A "Phase I" is a limited inquiry into the environmental characteristics of a property conducted by an environmental professional. Typically, it includes a records review, site visit, and the preparation of an analytical report.

Phase II Environmental Site Assessment. Typically, a Phase II takes place only after a Phase I assessment identifies possible contamination. The scope of a Phase II may differ, depending upon the issues raised by the Phase I assessment. A Phase II may include soil testing and further investigation for groundwater contamination.

Prepayment Rights. **Negotiable Point.** In Maryland, a borrower in a commercial transaction may not prepay a loan unless the documents expressly provide that right. The theory is that prepayment deprives the lender of the benefit of its bargain through a reduction of the interest received over the negotiated life of the loan.

Negotiated points include: (1) prepayment at any time without penalty; (2) prepayment limited to a certain percentage of the loan; (3) prepayments in a minimum amount; (4) a maximum number of prepayments over the life of the loan; (5) prepayments accepted without penalty only after a certain period of time; or (6) prepayment allowed without penalty in certain limited circumstances (i.e., condemnation of the real estate).

Recourse/Non-recourse. **Negotiable Point.** A "non-recourse" transaction is one in which the borrower is not personally liable for the debt. Upon default, the lender's sole remedy would be to foreclose upon the mortgaged real estate. Depending upon bank policy, recourse, limited recourse and non-recourse provisions may be negotiated, depending upon the type of transaction involved.

Security Agreement is a legal document by which the debtor grants a security interest to the lender in the collateral.

Security Interest is defined as a legally recognized interest in personal property, real estate, or fixtures which secures the payment or performance of an obligation. "Perfection" of the security interest means the complete protection by the lender of its rights against third parties which may also have rights in the collateral. Perfection is usually obtained by the lender either by taking physical position of the collateral or by filing financing statements among the public financing statement records for the state in which the debtor is organized.

Subordination Agreement. Subordination Agreements are used to make the claim of one party junior to (or of a lesser status than) a claim in favor of another. It is generally used to grant first lien status to a lien holder who would otherwise be secondary to another party. Typically, the need for a Subordination Agreement arises when a condition of the loan is that the bank be placed in first position even though an existing mortgage or lien will remain on the property post-closing. The agreement of the existing lien holder is necessary in order to allow the lending institution in the current transaction to obtain "first position" despite having created subsequent to the other lien.

Tenant Estoppel Certificates are written certificates issued by the tenant to the lender in which the tenant represents that the material terms of its lease agreement with the borrower have been satisfied and the tenant does not have any claims or rights of offset against the borrower under the lease.

Title Insurance is a contract of indemnity that protects against loss incurred by the named insured if the status of title to the property or interest insured is not as stated in the title insurance policy.

Title Report. A land owner is said to have “title” to the land. A title report, therefore, provides details as to the ownership status, including the owners of record, any encumbrances, easements, or other limitations on the ownership of the property. An accurate title report is critical to ensuring that the lender is obtaining collateral necessary to support the loan.

Title Search. A title search is conducted by the title company to trace ownership of the property for a specific period up to the present day. A title search can be particularly important, not only to verify who owns the property now, but also to determine if previous owners (such as gas stations) may indicate an area for further due diligence.

What You Should Know About Real Estate Title

In every real estate-backed transaction, the lender must be assured that: (1) the real estate is exactly as represented; (2) the real estate does not carry with it any unusual risks or limitations; and (3) the owner of the real estate is exactly who the bank thinks it is. In order to address these concerns, banks require title insurance and some forms of property survey to be conducted prior to closing.

Title. After assignment of the transaction to a title company selected by the Buyer and acceptable to the Lender, the title company will issue a title commitment. This is the title insurance underwriter's proposal for a title insurance policy and reflects the underwriter's conclusions as to encumbrances and other matters affecting title based upon a title search.

The title policy includes:

- Insuring Provisions – details of coverages that are included by the policy, pre-printed on the front of the policy jacket.

- Exclusions from Coverage – also pre-printed on the policy jacket, no coverage exists for the excluded problem, whether or not it exists, and whether or not it would otherwise be a matter identified in the insuring provisions.

- Conditions and Stipulations – the true structure portion of the policy which defines terms, sets out requirements for both insurer and insured, and governs the interpretation of the insuring provisions and exclusions.

- Schedule A – a typed schedule which provides the effective date of the commitment, proposed amount of insurance, type of policies to be issued, the name of the proposed insured, the person in whom title is currently vested, the estate of interest in land to be covered, and the legal description of the property to be insured.

- Schedule B – these are the requirements of the title company to issue the policy and may be satisfied through due diligence and sometimes requires affidavits of the owner.

- Schedule B-1 – exceptions to the coverage of the policy. Exceptions are different from exclusions in that coverage given under an insuring provision may exist and, but for the existence of the exception in Schedule B, coverage would probably be provided. These exceptions would include defects, liens, encumbrances created after the effective date of the policy but prior to the date of acquisition of the estate or insured interest, as well as any lien or right imposed by law and not covered by the public records. This schedule will also include "special exceptions" such as easements or other instruments affecting the property.

- Schedule B-2 – shows other matters to which the title to the estate or interest in the land is subject, but the matters (if any) are subordinate to the lien of the insured mortgage upon the estate or interest.

- Endorsements. Rather than delete exclusions or exceptions to coverage, many insurers will write endorsements to cover any defects. This both generates additional income (endorsements vary in costs depending upon the nature of the endorsement and the insurer) and removes any assertion that there was knowledge of a defect. States vary significantly in the endorsements which may be written.

Surveys. A survey consists of a drawing of the property made by a state licensed individual and will describe the property in one of a variety of ways.

The most common method of describing a property is a narrative description of the boundary lines using courses, distances and references to natural or artificial monuments. This is called a "metes and bounds description." If the property is located in a subdivided area, a lot and block description may be used.

Only a survey can confirm the boundaries of the property and the other characteristics of the property such as the location of easements, improvements, waterways, flood zones, etc.

When the title commitment excludes from coverage discrepancies or conflicts in boundary lines or encroachments, a survey is needed to confirm that no such problems exist so that the title policy may be issued without that exclusion. Title and survey should be reviewed together, and review of the status of the property is not complete without both pieces.

What You Should Know About Legal Documentation.

For all of the trees it kills, the legal paperwork is simply the vehicle for confirming all of the loan terms agreed between the bank and the customer while ensuring adequate protection for the bank.

A typical transaction involves documentation of the following terms:

The Bank's Obligation. Typically, a **Loan Agreement** will be used to document whatever it is the bank is agreeing to do. This typically means either funding a loan on the date of closing or making a pool of money available for future draws.

Repayment Terms. The agreed repayment terms are typically documented either in the **Loan Agreement** or in a separate **Promissory Note**. Needless to say, there are countless methods of repayment and terms such as the amortization period, interest only periods, balloon payments, prepayment rights, and interest rates often form the heart of the negotiations between the bank and its customer.

Assurance of Repayment. While the borrower promises to repay the loan(s) and the Promissory Note or Loan Agreement, the borrower's promise, standing alone, may not be enough to convince the bank to lend the money. In other words, the bank may require additional security. The security could be in the form of one or more **Personal Guaranties or Corporate Guaranties** from people or companies in addition to the borrower, the pledging of real estate, and/or the pledging of non-real estate collateral. SBA guarantees, and the documentation that goes along with them, also fit into this category.

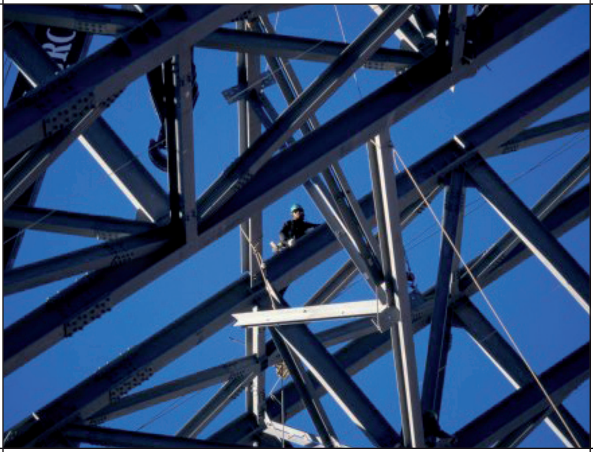
Pledge of Collateral. Collateral represents the bank's last resort. In the event of a default and if the guarantors do not make good on their promises, the bank often requires some asset which it can secure and sell in order to obtain repayment.

The pledging of real estate as collateral is normally documented through the recordation of a **Mortgage, Deed of Trust,** or **Indemnity Deed of Trust**.

The pledging of non-real estate collateral may be effectuated through the execution of a **Security Agreement** along with the filing of a **Financing Statement** (or UCC-1) among the public records in the jurisdiction in which the property is located.

In addition to documenting the collateral, consideration must be given to securing the bank's right to that collateral in comparison to the rights of other secured creditors. The Bank can determine its place in the "pecking order" of secured creditors through the use of one or more **Subordination Agreements**, rather than allowing priority to be determined through filing date.

What You Should Know About the SBA 504 Program



<u>*Summary and Purpose.*</u> The U.S. Small Business Administration created the 504 Program to help small businesses finance long term assets such as real estate and fixtures. While document intensive, the SBA 504 Program is often an ideal funding vehicle for construction, expansion of manufacturing facilities, and the purchase of office buildings or condominiums.

<u>*Structure.*</u> Alone under the SBA 504 Program is basically a partnership between the borrower, the SBA, and a lending institution qualified and licenses by the SBA. The loan contains the following three parts:

1. A first mortgage loan provided by the borrower's SBA-licensed lending institution. This first loan will be in an amount up to 50% of the total financed amount. The bank's note is separate from the other facets of this transaction, carries its own rate, terms and conditions. The private lender charges a market rate for its loan with a minimum term of 10 years.

2. A second mortgage loan of up to 40% of the project cost would be created by the financial institution, guaranteed by the SBA, and recorded in second position.

3. A down payment from the borrower in the amount of 10% (or more) of the total project cost. The down payment can be made in cash, equity in land, building, existing equipment, or other fixed assets that are part of the project.

In addition to the first and second mortgage instruments, principals owning 20% or more of the borrowing entity will be responsible for providing personal guarantees.

Logistics. The SBA 504 Program is document intensive in that two sets of documents are typically required -- one from the bank and one set from the Small Business Administration. In addition, the SBA conducts its own form of due diligence on the borrower to ensure that the borrower meets the qualifications necessary for inclusion in the program. Once the transaction is complete, the borrower will make one payment -- to the bank -- which will then assume responsibility for allocating the payment to the SBA guaranteed loan and the bank's loan, as required by the financing documents.

Often, the Lender will issue two loans – the first facility will be the lender's first mortgage. The second facility will be a temporary loan (typically featuring a term of approximately 120 days) which will be satisfied by an SBA-backed facility of the agreed term, funded at a second closing.

Term. The SBA portion of the loan is usually 20 years, while the conventional portion is usually 10 years.

Pros and Cons. The primary benefit to the SBA 504 Program is that it enables a borrower to obtain up to a 90% loan to value, in comparison with an 80% LTV in most other circumstances. As a consequence, the borrower only has to provide a 10% contribution. Depending upon the project, this can be the difference between going forward or going home.

One of the drawbacks to participation in the SBA 504 Program is the rigid requirements imposed by the Small Business Administration. These include background checks, processing fees, and significant restrictions on the prepayment of the SBA–Guaranteed Facility.

What You Should Know About the SBA 7(a) Program

Much like the SBA 504 Program, SBA 7(a) Programs are conducted through an authorized lender. In effect, the SBA provides a guaranty to the lender of a certain percentage of the loan. In effect, the customer will receive a loan from the lender with a 7(a) structure and the lender will receive an SBA guaranty on a portion or percentage of this loan.

All applicants for an SBA 7(a) loan must meet certain criteria established by the Small Business Administration. The SBA maintains limits on size, income, must be a for-profit entity, and must be able to demonstrate repayment ability. Other eligibility factors include type of business, use of proceeds, and the availability of funds from other sources.

The maximum amount of a loan under the SBA 7(a) Program is $2,000,000.00. The maximum amount of an SBA guaranty (or exposure) is $1,500,000.00. The SBA guaranty is available only to the lender and does not flow through directly to the borrower.

Generally, loans for working capital purposes will not be allowed to exceed seven years. The maximum maturity of loans used to finance fixed assets other than real estate will be limited to the economic life of those assets -- but in no instance will the loan exceed 25 years. A 25 year maximum will generally apply to the acquisition of land and buildings.

As with an SBA 504 transaction, the Small Business Administration provides certain documentation and conducts due diligence on the borrower. Accordingly, the lender must observe not only its own policies and practices, but those determined by the SBA, as well.

What You Should Know About Wagonheim & Associates

- Wagonheim & Associates is a business law firm rated "AV" (excellent to preeminent) by Martindale-Hubbell, the country's most prominent and respected law firm rating service.

- W&A serves as counsel to lenders of all sizes throughout the State of Maryland. Our attorneys and support staff have extensive experience in handling real estate and non-real estate backed loans and small business transactions through middle market lending levels. W&A attorneys have successfully brought to closing transactions of varying complexity ranging from the straightforward to more complicated transactions involving defeasance, interest rate swap agreements, and numerous types of collateral existing in multiple states.

- W&A is extremely responsive to borrower concerns and offers a number of flexible fee arrangements including capped fees and reduced rates on a case-by-case or institution-wide basis. W&A will never allow its fees to jeopardize the relationship between our client and its customer.

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- Admitted to practice in Maryland and Pennsylvania
- Published author of The Art of Getting Paid as well as countless articles on commercial law and general business topics.
- Representation of clients throughout the mid-Atlantic area in a wide variety of businesses including institutional lenders, venture capitalists, real estate developers, contractors, and businesses representing a countless number of industries.
- Extensive experience as counsel to lenders, borrowers, and sellers in transactions throughout the United States.
- AV-Rated (excellent to preeminent) by Martindale-Hubbell.
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