Commercial Transactions: Settlement Basics

Description

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Overview: Over the years, other VLTA Examiner articles and VLTA seminars have covered the basics of underwriting a commercial transaction, but agents experienced in residential matters now need additional information about the role of the escrow agent, instruction letters, title search issues, ALTA/NSPS surveys and endorsements specific to commercial transaction. ALTAÂ® surveys, endorsements and commercial construction issues may be separate articles in the future.

I. Introduction to the Commercial Settlement Process

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A. Commercial Closings may include everything from a mom and pop store to a multi-national franchise, a strip mall to Short Pump Towne Center in Henrico County, a condominium complex being established to high rise apartment buildings, a bed and breakfast in a historic residence to a hotel such as the renovated Cavalier Hotel in Virginia Beach, flex warehouse space to raw land for development into a data center in Northern Virginia, a dry cleaner to large industrial development, refinancing the local shoe repair shop to the complex coordination of the U.S. Marine Corps re-division of Quantico. Look at your community. You can see the range of opportunities available.

B. RESPA/RESA â?? Keep in mind that commercial real estate transactions are **not** similar to large residential purchases. Consumer protection laws applicable to residential purchases do not apply to commercial transactions. RESPA is federal legislation that only applies to residential transactions, 1-4 family dwelling units. It does not apply in commercial transactions. RESA is Virginia statutes Â§55.1-1000 et. seq. and also only applies to residential real estate.

C. Commercial underwriting is not NOT your standard â??cookie-cutterâ?• residential underwriting. Commercial underwriting involves a nuanced understanding and application of additional requirements, exceptions and endorsements so you can quickly issue a commitment, pro forma policies and/or endorsements. It often requires regular interaction and communication with counsel for each of the parties and counsel for the lender, necessitating a sophisticated understanding of the transaction. And, commercial escrow and closing services very often require the negotiating of and compliance with instruction letters from counsel for the parties and lender (so up to three sets of instructions), drafting a very different settlement statement and showing very different fees and expenses (including things like rent and utility prorations, for example), as well as the disbursement of significantly more wires (20-30 wires are not uncommon) and accounting for much larger sums of money.

D. Although this is beyond basics the following commercial concepts will not be addressed: government contracts, multi-national franchising, negotiating commercial leases, 1031 exchanges, zoning approval (other than whatâ??s needed to issue an ALTA 3 endorsement), land use planning, commercial construction and the AIA forms. Nor will we cover Green Building, LEED and sustainability requirements. If any unfamiliar issues arise, contact underwriting counsel for assistance.

II. â??Too Many Cooksâ?• â?? The Role of the Escrow Agent

An old saying states â??Too many cooks spoil the broth.â?• Sometimes dealing with a commercial real estate transaction feels the same way. Instructions are provided by

a. Contract
b. Lender â??commitmentâ?•[i] letter, or term sheet, to the borrower
c. Lenderâ??s instructions to the settlement agent
d. Lenderâ??s counsel instructions
e. Buyerâ??s counsel instructions
f. Sellerâ??s counsel instructions
g. Title commitment

Often various instruction letters are transmitted the day before, or the day of, closing. The escrow agent must read all and resolve conflicts among the various instructions given. It can be difficult to negotiate the instruction letters at the last minute and stay up to speed on satisfying requirements, finalizing the settlement statement and reviewing all the closing documents. To the extent possible, it may be wise to set a deadline for instructions 4 or 5 business days ahead of closing, knowing that the parties may not comply. Make it clear, in writing, what you are agreeing to do, and what you decline to do. Point out conflicting instructions. Keep in mind that the lenderâ??s instructions often trump all, since they may have the most money involved in the transaction.

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To keep things organized the escrow agent should have a closing checklist, individualized for each transaction listing who is responsible for handling various obligations, such as making sure insurance and bonds are in place, due dates for each item and when it has been accomplished. A workflow spreadsheet will become your best friend. Depending on the complexity of the transaction, you may need separate spreadsheets for tracking parcels, title, real estate taxes, etc.

Logically the escrow agent would be the coordinator of all the disparate elements of the settlement, but thatâ??s not what really happens. In many cases, the purchaser or lender takes the lead in coordinating the transaction, often initiating an early push to complete everything quickly. This is sometimes followed by extended periods of inactivity, then a renewed, urgent push for updates or revisions as a deadlineâ??real or perceivedâ??approaches. Commercial real estate transactions often reflect a â??hurry up and waitâ?? dynamic. The best approach is to meet deadlines as reasonably as possible, set realistic expectations, and maintain professional standards, even amid pressure from other parties.

Frequently lenders now require a national title underwriter, such as Old Republic Title, to be the disbursing agent, i.e., the escrow/settlement agent, rather than the attorney for the purchaser or the title agent. The more money involved, the more likely this is to occur. Consider the amount of malpractice insurance you carry versus the deep pockets of the title underwriter, the increase in wire fraud, the security levels of the average law office or title company, and you can see reasons lenders are making this requirement. Your Underwriter will work with you in these situations, but you need to contact them as soon as you are aware of the requirement.

In this light, the true role of the escrow agent is to manage the money, to make sure valid documents are signed and recorded, and to order the title policy be issued.

A. **Contract** â?? Typically, the commercial contract, or Purchase and Sale Agreement (â??PSAâ?•), as all other aspects of the transaction, will have been heavily negotiated before it is signed by the parties. Of particular importance is the review period, a specified amount of time for the purchaser to do a number of things to determine if it wants to proceed with the purchase of the real estate. The review period may also be referred to as the study period, feasibility period or due diligence period. During this time a full title search (minimum 60 years) and commitment will be produced with copies of all documents in the chain of title including all exceptions for various counsel to review, as well as various other investigations such as environmental studies, zoning requirements for the site, soil studies if construction is to occur, etc. One thing to note is that it has become more common for contracts to bifurcate the title period from the review period, requiring the title commitment to be delivered before expiration of the review period. For example, a contract may call for a 60-day review period, but a 30-day title period.
B. **Lenderâ??s commitment to borrower** â?? Loan conditions will be specified, including:

- whether this real estate will be the sole collateral for the loan
- whether the loan will be secured by real estate across multiple jurisdictions or states
- whether the purpose of the loan is for acquisition, development, construction, cash-out, or a combination of any or all of these
- whether the loan will include a hypothecation, when another person or entity, not the borrower, pledges property as collateral for the loan
- whether this will be an asset-based loan, secured by additional personal property such as inventory, equipment and receivables
- amortized loan or revolving credit line with term of years, interest rate, etc.
- whether guarantors are required, listing corporate and/or individual guarantor names
- hazard insurance requirements
- survey requirements
- title insurance requirements
- endorsement list
- projected closing date
- etc.

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Reviewing the lenderâ??s commitment to the borrower provides a blueprint of required tasks, and to some extent also identifies the borrower who may not be the purchaser.

The title agent, if different from the escrow agent, should also review the lenderâ??s commitment to the borrower and order a full title examination from an abstractor experienced in doing commercial searches. (see â??Dâ?• and â??IIIâ?• below).

C. **Instructions from Lender and Counsel for Buyer, Seller and Lender**

Review the letter of intent from the lender â?? determine the requirements for the loan commitment, the type of structure or structures involved. Order a full title exam â?? including all easements, assignment of rents, UCC Financing statements etc. Certain commercial enterprises will require a full environmental search as well. Again, request full copies of any environmental liens, holds, mineral rights leases, etc.

Review instructions from lenderâ??s counsel, purchaserâ??s counsel and sellerâ??s counsel. Identify and resolve any conflicting instructions. Each will ask you, as escrow agent, to sign their instruction letter. Do not do so until you have read all the letters and resolved any conflicts. In order to avoid

receiving all of the instruction letters at the last minute and having to review them and address any conflicts when your time is likely better spent on other matters, you may want to set deadlines by which you need to receive these instruction letters. You have an absolute right to negotiate what you are willing to do and those matters for which you are not responsible. Make sure itâ??s clear to all parties.

Generally, you will not receive instruction letters until a few days before closing. If youâ??re lucky, you may get a draft instruction letter a week before closing. The lenderâ??s title order, commitment and term sheet may not have all of the information you will need. Be proactive and make your requests for information and documents early on.

Is the loan a construction loan needing affirmative mechanicâ??s lien coverage? Commercial construction loans require considerably more extensive underwriting than residential construction loans under the MLA Statute. Commercial mechanicâ??s lien coverage underwriting is outside the scope of this article. Just keep in mind that it may take a couple of weeks or longer to secure mechanicâ??s lien underwriting approval from your underwriter.

Determine names of all individuals who will be required to sign loan documents and communicate the names to the borrower. Donâ??t wait until the day before closing to discover that one of the signers is on a cruise in the Mediterranean. You will also need the names of all corporate and individual guarantors if the transaction involves construction financing.

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Ask buyer and lender for a comprehensive list of endorsements that they want for the final policies. Several endorsements are not gimmes and may require documentation to review and requirements to satisfy for approval to issue.

Determine at the initial stages of the transaction if a zoning endorsement (ALTA 3) is required. A zoning letter from the jurisdiction where the insured property is located is required and it may take weeks or months for the zoning letter to be issued by the locality. The lender or lenderâ??s counsel may ask that you order the zoning letter. Try not to get involved in ordering zoning letters. If you do order it collect the fee paid to the locality up front from the borrower. The borrower or borrowerâ??s counsel should be the one to order the zoning letter. For a zoning letter to be of most benefit it should specify the proposed use that the borrower intends to make of it, and the bank wants covered, and sometimes that can be a matter of interpretation under the zoning ordinance. You are most likely not an expert in zoning matters, and you do not want to find yourself in hot water if the zoning letter were to come back stating that the permitted use that you listed in your request for the zoning letter is not a permitted use under the local zoning ordinance.

A current and accurate survey is required to issue several endorsements. Your underwriter may accept a survey affidavit if the current owner has a recent ALTA/NSPS survey and is willing to sign a survey affidavit affirming that no changes have been made to the propertyâ??s footprint, and no new easements, restrictions, or other encumbrances have been recorded in the interim that are not reflected in the survey. Consult your underwriter if a survey affidavit would be available.

Avoid ordering ALTA/NSPS surveys on commercial properties and giving advice on table A items. The purchaser generally coordinates directly with the surveyor when ordering surveys, due to the additional cost and customization involved. The purchaser would have more familiarity with the property and the intended use and would be in a better position to determine the costs and benefits of the various products and services available from the surveyor.

D. **Title Commitment**

If you are the title agent as well as the escrow agent, you need to make sure the parties provide the information required in Schedule B-1. Do not allow closing to occur until the requirements are met. The terms to which you agreed in the instruction letters should make clear who is doing what to clear title issues. See below for more details.

III. Title Search and Commitment

The title agent should order a full title examination from an abstractor experienced in doing commercial searches. Confirm with the customer how soon the commitment is needed. Obtain a time and cost estimate from the abstractor to confirm deadlines can be met. Confirm with the purchaser and seller exactly which parcels you need to search. Itâ??s not unusual for the contract to lack clarity about exactly what property is under contract. Do the same with the lender if the transaction involves financing.

Since commercial closing timelines can range from weeks to years, and a commercial title search may cost anywhere from a hundred to a couple of thousand dollars, you may need to invoice your customer for out-of-pocket title expenses. It is good practice to pay third-party abstractors within the initial billing cycle because they wonâ??t answer your call for a quick turnaround on a title search if you have a half dozen or more outstanding invoices. But you donâ??t want to be out of pocket for tens of thousands of dollars worth of title searches that you are floating to your customers for transactions that may not close for another year or longer.

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The length of the title examination should be **a minimum of 60 years, could often be 100 years** and may need to go back to the land grants from the King, depending on the property involved and the amount of insurance. For example, you may need to have the search go back 100 years or longer if your transaction involves raw land for future development or is in a jurisdiction that is known to have older restrictions recorded in the land records (back to the 1880s in some localities) or a history of mineral rights severance.

Although underwriting guidelines allow us to rely on existing ownerâ??s title policies, in commercial transactions pay attention to which agency produced the title, the underwriter involved, and whether the deed from the insured was a general warranty deed or not. Remember, if the purchaser is obtaining title by anything other than a general warranty deed, a prior title policy will not provide coverage and will not be available as a possible indemnitor in the event of a loss.

Around the time of the War of 1812 Virginia deeded land to the United States for the purpose of constructing a fort, Ft. Monroe[ii]. The deed, recorded in the early 1800s, contained a reverter clause stating that if the property ever stopped being used as a fort ownership reverted to Virginia. During the base closings in 2000s most decommissioned sites were sold at auction. A very thorough and diligent title insurance agent in Tidewater did a full search back to the original deed to the United States and discovered the reverter clause which changed matters considerably as to ownership of this property, and prevented a title loss.

Beyond the length of time involved, an experienced commercial title examiner knows to search for memoranda of lease, out parcel conveyances, adjacent properties to determine boundary lines have no gaps, gores or overlaps, assignments of rent, etc. Full copies of all documents should be provided for your review, not just the most recent deed and deed of trust. All of the attorneys involved in the

transaction, but especially the lenderâ??s counsel and purchaserâ??s counsel, will want full, legible copies of all easements, restrictions, liens, encumbrances, and any other matter affecting title. The surveyor may ask for them as well, rather than obtaining independent copies.

Review certificates of take and deeds to the Commonwealth of Virginia and the State Highway Commissionerâ??s Office for state highway plat book and page references. The plats may be partially or fully recorded in black and white with the instrument. However, the highway plats will generally show the areas being taken in red or other colors. You may need to request the highway plats from the abstractor who completed the title search.

The title examination should review the following and make appropriate requirements or exceptions for matters found. Itâ??s important to read the documents involved in the transaction rather than to just take exception to them.

a. Fee Simple Title â?? read all the deeds in the chain of title
b. Rights of First Refusal
c. Leasehold Interests â?? do they autosubordinate to new mortgages; are estoppel agreements recorded
d. Taxes â?? Real Estate valuation, Special Assessment issue
e. Easements â?? review full copies
f. Restrictive Covenants â?? read them (language to look for: rights of first refusal; reversions; options; repurchase rights; forfeitures)
g. Liens
h. UCC financing statements â?? do a SCC search as well as in the land records
i. Storm Water/Sewer assessments
j. Judgments, Pending Litigation, Bankruptcy and Tax Lien Search
k. Mineral Rights
l. Environmental Liens
m. Anything that shows up in the title search

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The title commitment should also require rent rolls and copies of unrecorded leases for review. However, since these are often not provided, you should include a standard exception for rights of parties in possession under unrecorded leases. Estoppel certificates from lessees can also be required but may meet with the same result. Lenderâ??s counsel may require that you delete the exception for parties in possession under unrecorded leases and list all unrecorded leases as subordinate matters under Schedule B part II of the loan policy. Consult your underwriter before doing so.

Lenderâ??s counsel or purchaserâ??s counsel will likely request a pro-forma policy before closing. Resist doing so until after title is approved. Otherwise, you will need to make revisions to both the title commitment and pro forma policy.

Commercial loans most frequently involve an entity purchaser and/or seller rather than an individual, so it is critical to know the documents required to form entity and how to read them, and the types of documents (consents, resolutions, etc.) necessary to fill in any gaps as to the authority of a particular entity to act, or a particular individual to act on behalf of an entity. Making sure proper parties are signing documents depends on the type of entity involved. Current business practices often require commercial properties to be owned by Single Purpose Entities (SPE) to limit liability to that specific property and protct other assets. In these cases, the borrower is a new entity with no significant assets.

The lenderâ??s commitment letter to the borrower will require either additional collateral or someone to serve as guarantor in the event of a default. Any time the lender requires a guarantor, any indemnity agreements that need to be signed for title purposes, such as in construction transactions, also need to be signed by the guarantor the lender requires.

Another common complexity with entity owners is that they are often owned by an entity. Title agents may find it challenging when asked by title companies to tract ownership back to an individual or a publicly traded corporation. What documentation is needed depends on the type of entity involved.

By now you should be familiar with entity requirements, so they wonâ??t be restated here. Remember a couple of matters. You need satisfactory evidence that the entity is complying with its governing documents, along with proof of who has authority to sign â?? whether itâ??s a deed in a sale or a note and deed of trust in a purchaser or refinance. Confirm whether the action is within the â??ordinary course of businessâ?• [iii]; whether the entity has been terminated[iv]; whether thereâ??s been a name change or a conversion from one entity type to another; whether the trustee of a trust has registered with the clerk of court; and whether or not someone is trying to use a power of attorney for an entity officer or manager.

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[i] Lenders no longer issue â??commitment lettersâ?• to borrowers. The letters are generally more casual than what previously existed but still provide an overview of the transaction.

[ii] http://www.dailypress.com/news/hampton/dp-nws-hampton-fort-monroe-5-year-20160915-story.html

[iii] Determining whether a transaction is in the ordinary course of business is exceedingly difficult when the by-laws say the purpose of the business is â??any lawful business.â?• If the entity is in the business of buying and selling real estate a sale of a parcel of land is in the ordinary course of business. But if the business is a retail store then the parcel being sold may be the only parcel owned by the business so it would be outside the ordinary course of business. The settlement agent has to investigate to determine that there is proper authority for the real estate to be sold, which may mean a vote by the majority or even 100% of the shareholders. To verify that as a general rule you need something signed by all the shareholders.

[iv] Termination can be voluntary, involuntary or administrative.



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