The Misleading Simplicity of Small Deals

By Michelle Jester and Trina Christiansen

At times, the temptation exists to circumvent or shorten the due diligence process on a smaller lending transaction. While it may seem like common sense, it is important for lenders to have a clearly defined due diligence process and ensure it is followed on all transactions, regardless of loan size or collateral type pledged. The following outline may be useful in either developing your own due diligence process or fine tuning your existing process.

A lender's due diligence must take place on at least two main levels – the borrower(s), including any guarantor(s)s, and the collateral.

Borrower(s) and/or Guarantor(s):

- The lender must collect financial and business information on the borrower(s) and guarantor(s). The financial information will consist of a minimum of three years tax returns and current financial statements. The business information will consist of organizational documents, business plan, and growth projections.
- All of this information must be carefully analyzed in order to identify inconsistencies, problem areas and measure the financial history of the borrower. Questions should be asked and more information and documentation gathered, if appropriate, on areas of concern. The lender should also determine the repayment source and analyze whether payments are realistic based on historical information and revenue projections. Searches, including bankruptcy, judgments and liens, should also be conducted on the borrower(s) and guarantor(s).

- Once a loan is made, financial information should be collected at least annually on the borrower(s) and guarantor(s) and analyzed by the lender. The lender should have a policy in place to collect the financial information as well as what analysis should be completed annually. The ongoing financial information provides insight into whether the borrower(s) is achieving its financial projections and financial covenants. If not, a meeting should be scheduled to discuss the problem areas and develop a feasible recovery plan before the issues become more serious.

TIP: If you are lending in an area or taking a collateral type that you are unfamiliar with, your time spent on learning industry norms will prove to be invaluable – or you may want to consider passing on the loan.

Many of the above due diligence items seem obvious and simple to follow; however, current financial information is sometimes absent from a file or original revenue projections/profit margins haven't been supported by the information submitted or industry standards for the type of loan or product.

Collateral:

The lender must collect information on the collateral itself – whether it is real property or personal property. The collateral type dictates the process that should be followed. The key is to understand what collateral the lender is taking as security, how the security interest is properly granted and the appropriate process to perfect the interest as to third parties. Due diligence on the collateral should not be circumvented, unless the lender is willing to rely on the financial strength of the borrower(s) and any guarantor(s) for its sole source of repayment.

Real Property:

- The lender should obtain title work, an appraisal, environmental review, survey, flood search, rent rolls, leases, and other relevant information. The person reviewing each document should know what they are looking for and ask questions on items of concern and address any discrepancies. Outside counsel can often assist with this whole process or a particular area of concern on a smaller deal.
- The individual examining title should understand what they are analyzing in the commitment or exception documents and know what to ask for in the lender's title policy and endorsements. Without proper review of the legal description, an invalid description or even scrivener's errors can be costly to correct later.
- Surveys are invaluable for developed property as they will depict where the improvements are physically located on the real estate and reveal gap, overlap, access, setback, encroachment and easement issues.

TIP: Skipping areas of due diligence or misunderstanding the scope and purpose of a particular piece of due diligence may have severe consequences later.

Personal Property:

- For personal property, such as equipment, inventory, general rights of payments, and general intangibles, lenders should perform UCC searches on the party who is pledging the collateral. For entities, the proper search venue is the Secretary of State where the entity is organized and for individuals the state of residency. Once obtained, the results should be analyzed to make sure no other creditor holds an interest in the property and if they do, it is released or subordinated to your lien. It is equally important that the lender perfect its lien by completing the UCC Financing Statement properly and filing it in the correct office timely and with any continuation or amendments when appropriate.
- Certain personal property, such as motor vehicles, specific equipment, and manufactured homes, have certificates of title. Searches on these items should be conducted with the department of motor of vehicles. The lender's lien will need to be filed against the certificate of title. Personal property such as chattel paper or stock if certificated, require possession for perfection, so the lender should ensure the borrower(s) has the original of such items and they are delivered to the lender.

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We've all heard the coined phrase, "The devil is in the details." Implementing and following a sound due diligence process on all transactions, no matter the loan size, will help mitigate potential loss upon a loan default. ■

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