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Navigating Loan Transactions: Borrower's Due Diligence Process

Corporate Structure and Governance Due Diligence

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Access to capital is crucial to the growth of a business. Securing a loan for your business can be a pivotal step in achieving your business goals. Entering into loan arrangements with a lender may seem like a straightforward process. However, the process can be complex (and expensive) without the proper guidance and preparation. This blog is the first of a series intended to introduce and de-mystify various aspects of the loan process.

To secure a loan, lenders and their legal counsel conduct an extensive "due diligence review" process that helps lenders understand the transaction risks and identify any legal documentation or other action necessary to reduce the risks to the lender. The success of lending transactions relies heavily on a thorough and comprehensive due diligence process. However, the due diligence stage can be daunting if a borrowing company does not have all of its organizational documents in order. In this blog, we will provide an overview of one critical component of due diligence needed for every lending transaction: *Corporate Structure and Governance Due Diligence*. In addition, we will discuss the best practices a borrowing company can implement to help expedite the due diligence review process, which will help reduce transaction expenses.

Corporate Structure and Governance Due Diligence Overview

This category of due diligence allows lenders to verify the legal existence and status of the borrower, confirm ownership structure, and identify key stakeholders. The documents that are collected as part of this category of due diligence are:

1. *Certificates or Articles of Incorporation/ Formation/ Association*: Lenders typically require recently certified copies (certified and issued by the state of incorporation/ formation no more than thirty (30) days prior to the closing of the loan), which must be ordered from the state department that maintains corporate and other entity records. The certified copies must also include all amendments to these documents.
2. *Bylaws/ Operating Agreement*: Lenders typically request a copy of the bylaws and stock ledger (if a corporation) or operating agreement (if a limited liability company) to understand the legal structure and ownership of the business and ensure that the individuals requesting the loan have the authority to do so on behalf of the borrowing company. These are legal governing documents that are drafted once the business is established to outline the internal governance structure and rules for decision-making within the company. Companies are not required to file them with the relevant state department; therefore, it is very important for companies to maintain up-to-date and accurate records of these documents along with any amendments.
3. *Employee Identification Number (EIN) Verification Letter*: Lenders use the EIN Verification Letter to verify a company's tax compliance and the accuracy of the information provided by the business during the loan application process. This helps prevent identity theft, fraud, or misrepresentation of business details. Companies can obtain a copy of their EIN Verification Letter by calling the IRS or mailing the IRS a written request. Sometimes lenders will accept a W-9 or SS-4 in lieu of the EIN Verification Letter.

4. *Licenses and Permits:* If applicable, borrowing companies must provide proof of compliance with industry-specific regulations, including any licenses or permits required to operate the business.
5. *Resolutions/ Written Consent*: Resolutions or written consents must be provided to evidence that authorizing action has been taken by a borrowing company's board of directors, member, or other authorized bodies, expressing their consent and approval of the borrowing company entering into the loan transaction. The resolution must be adopted as provided for and as required by the borrowing company’s governing document. It is recommended that the resolution be prepared by an attorney.
6. *Organizational Chart*: Organizational charts provide a visual representation of the hierarchy of the borrowing company and its parent and subsidiary entities for lenders to understand the company ownership and structure better, assess the risk associated with the borrowing company, and identify potential collateral, guarantors, and any other necessary parties to the loan transaction.

Best Practices

- *Organize Documentation in Advance*: Ensure that all documents mentioned above are up-to-date, accurate, well-organized, and easily accessible.
- *Due Diligence Readiness Assessment*: Conduct an internal due diligence readiness assessment before approaching lenders. Identify anticipated issues in advance and address them proactively.
- *Data Room Setup*: Establish a secure and organized virtual data room to streamline the sharing of due diligence documents with lenders and their legal counsel. This can facilitate a faster and more efficient exchange of information.
- *Legal Advisors*: Engage experienced legal advisors familiar with the due diligence process. Their expertise can help you prepare and present information in a way that aligns with lender expectations and can also help you maintain the confidentiality of your information to avoid any breaches of confidentiality obligations that your business may be subject to.

Takeaway: In the world of lending, due diligence is one key to a successful and sustainable relationship between borrowers and lenders. A prior understanding of the information and deliverables that a lender will require can help the borrower expedite the process and anticipate (and somewhat control) the costs involved in the transaction. Prospective borrowers are encouraged to work with their legal and financial advisors from the beginning stages of a transaction. Early involvement of counsel can enhance the overall success and efficiency of a transaction and provide borrowers with the necessary expertise and support to navigate the complexities involved. If your business is considering entering into a commercial loan transaction, the Wilentz, Goldman & Spitzer, P.A. Banking and Finance practice group is well-equipped to assist and provide such expertise and guidance to your business. Please note that the foregoing is not intended as legal advice as every transaction is different.

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