



## Negotiating the Loan Commitment to Obtain More Favorable Terms and Save Money

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From time to time, most commercial investors and developers will need financing in connection with a real estate project. Loan commitments, an integral component of the loan origination process, are a roadmap for the transaction, which describes: (1) the parties, (2) the transaction, (3) the loan amount, (4) the terms of the loan, (5) the pre-closing requirements that the borrower must satisfy (and expenses incurred in connection therewith) and (6) the procedure for closing. Negotiating the terms of the commitment at the outset can provide substantial economic benefits to the borrower. Further, as a result of this process, the lender will develop a greater understanding of the borrower's composition and business needs.

Of great concern to borrowers are the closing costs, term of the loan, interest rate and amortization period. However, there are many other issues that borrowers should address as well, some of which are discussed in this article. It is important to remember that a borrower's leverage to negotiate with a lender is at its highest level during the negotiation of the loan commitment, because at this stage the lender is motivated to get the deal.

### Closing Costs

Closing costs are a hot topic for borrowers. A borrower should request, up-front, a list of closing expenses and fees. This gives the lender an incentive to keep the costs down in order to pull in the deal.

A borrower may want to propose

that specific vendors provide certain third-party reports, and that the lender consent to updates to existing diligence reports. For example, if a borrower has an existing environmental report (or is purchasing the property from a seller who has a recent report in its possession), the lender might accept a reliance letter from the company that performed the existing environmental assessment. Reliance letters generally cost no more than several hundred dollars, while new environmental assessments may cost thousands of dollars. Similarly, existing surveys, property reports and property appraisals may be updated more cheaply and in less time than it would take to prepare new ones. If a borrower has an existing title insurance policy, the same title company will give reissue credit for a new title policy in many states, and it should take less time to produce a title commitment for the lender. Some lenders will require that a borrower be a "special purpose entity." This generally means that a borrower may have to change its structure, or at the very least amend its organizational documents. A borrower should try to avoid this; but if it cannot be avoided, the borrower should keep in mind that this will be another cost of obtaining the loan.

Lenders will customarily require a deposit from the borrower that will be applied to the costs of the aforementioned third-party expenses. The loan commitment should be clear about the circumstances under which the borrower will be entitled to a return of the deposit, or at least the unused portion.

### Loan Documentation

During the loan commitment negotiation process, many lenders are willing

to provide a set of form loan documents for review. This gives the borrower an opportunity to request that certain items be included in the loan commitment to ensure that the loan documents will be customized for the particular transaction and as favorable to the borrower as possible. The more detailed the negotiated commitment, the less time will be required to negotiate the loan documents.

Important issues to address at the loan commitment stage will vary depending on whether the loan is recourse or non-recourse to the borrower, and whether it will be obtained from a bank, an insurance company or a lender that plans to securitize the loan. The following list summarizes eight important issues pertaining to loan documentation that the borrower may raise with the lender during the negotiation of the loan commitment:

1. It goes without saying that the rate of interest that will be charged on the loan will be of primary importance to the borrower. Equally important, but sometimes overlooked at the commitment stage, is the method of computation of interest. Of the two methods of calculating interest (the 360/30 method and the 360/365, or "Bank method"), the 360/30 calculation based on a 360-day year consisting of twelve 30-day months results in what may be significant savings in interest expense to the borrower.
2. Lenders forecast earnings over a fixed term when underwriting a loan, and many loans will have a prepayment premium that will apply if the borrower prepays the loan prior to



maturity. The borrower should negotiate the circumstances in which a prepayment premium would not apply, such as repayment of the loan with casualty insurance or condemnation proceeds. A borrower should also request a waiver of the prepayment premium if the loan is repaid within the last 60 to 90 days before maturity.

3. A borrower who obtains a commitment for a loan of 70–80 percent of the value of the collateral property may need to find other equity financing for some or all of the remaining 20–30 percent. The borrower may need to grant a second lien on the collateral or a lien on the ownership interest in the borrower when the borrower is an organized entity (such as a limited liability company or a corporation). Borrowers should address this with the primary lender at the commitment stage to ensure that the loan documents will allow for subordinate financing on certain terms and conditions.
4. Most loans with commercial real estate as collateral will be made on the condition that the borrower escrow funds with the lender on a monthly basis to cover the cost of insurance and property taxes. Sometimes lenders will require escrow deposits for tenant improvements, leasing commissions, vacancy, and property repairs and replacements. Most of the time, a borrower would prefer to retain control of these funds. Often lenders will waive escrow requirements if it is negotiated on the front end, at least until an event of default occurs under the loan documents.
5. Another issue that should be addressed is the borrower's ability to use casualty insurance and condemnation proceeds to rebuild or restore the property. The loan documents will usually give the lender the unilateral option to apply such

proceeds against the existing debt. If the proceeds are applied to the debt, however, the borrower may not have adequate funds to restore the property. If the property is leased, the lease may require the borrower to restore the property, in which event the borrower needs to know that the proceeds can be used for restoration. Lenders will usually allow the proceeds to be used for restoration, provided that there is no event of default under the loan documents, that the borrower will inject cash to complete restoration, if necessary, and that the proceeds will be deposited with the lender and disbursed in the same manner as under a construction loan.

6. Use of standard loan documents. Especially with multi-tenant properties, borrowers will want to obtain the right to enter into leases and otherwise deal with leases in the ordinary course of business without lender involvement. Usually, there will be some parameter on the borrower's discretion to lease the property, such as maximum lease terms, tenant improvement allowances and square footage. The borrower should negotiate these parameters in the commitment to ensure maximum latitude.
7. As a general rule, loan documents prohibit the transfer of any interest in collateral. This concept is broader than it may seem at first glance. A "transfer of an interest" includes, *inter alia*, transferring title to the property, transferring an ownership interest in the entity that owns the property, leasing the property, granting an easement across the property, settling litigation involving the collateral property (as discussed later in this article). Most lenders want to ensure that the principals involved at loan origination stay in control of the borrowing entity throughout the term of the loan. Lenders will often allow transfers of

interests in a borrower entity for estate planning purposes (i.e., among family members or to family trusts or limited partnerships) so long as the original controlling group or individual remains in control after the transfer. Additionally, lenders will often allow a one-time transfer of the property, upon payment of a one percent fee and upon the condition that the transferee is satisfactory to the lender and assumes liability for the loan.

8. An important concept in non-recourse lending that has received recent attention in the courts is the recourse liability of the borrower (and guarantors, if any) for certain "bad boy" acts. Bad boy acts, or "carve-outs to non-recourse liability," include fraud, waste, misapplication of rents and bankruptcy, along with the transfer of any interest in collateral, as discussed above. Sometimes these carve-outs can be overreaching. The borrower should request the list of carve-outs, if not included in the loan commitment, and negotiate limits before the commitment is executed. Lenders rarely change carve-outs if they are not modified at this early stage.

A great example of a lender's ability to impose full recourse liability for violation of the carve-outs to non-recourse liability is a case decided in a 2007 Massachusetts federal district court. *Blue Hills Office Park LLC v. J.P. Morgan Chase Bank*, 477 F. Supp. 366 (D. Mass. 2007) In summary terms, the case involved a borrower that settled a zoning appeal and transferred \$2 million in settlement proceeds to an account owned by an affiliate of the borrower. The borrower did this without informing or obtaining the consent of its lender. The lender, upon discovery of the foregoing events, declared a default under the loan and demanded payment in full of the loan

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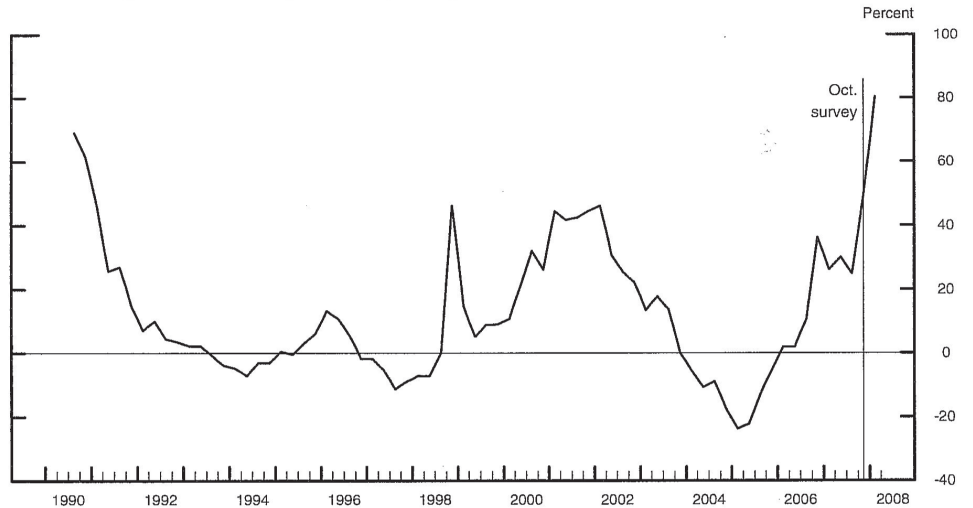


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from the borrower and guarantors pursuant to the carve-outs to the non-recourse liability contained in the loan documents. The judge held in favor of the lender and issued a \$17.5 million *full recourse* judgment against the borrower entity and its individual guarantors. As Judge Young said from the bench during trial: “[D]on’t mess around with the collateral. . . . [I]f you mess around with the collateral, that’s when you’ll be liable for the entire amount of the deficiency.”

In conclusion, standard loan commitment letters are becoming more stringent in today’s marketplace. According to a survey of senior loan officers published by the Federal Reserve Board, about 80 percent of domestic banks tightened lending standards on commercial real estate loans during the last quarter of 2007. According to this survey, “the net fraction of domestic banks reporting tighter lending standards on [commercial real estate] loans was the highest since this question was introduced in 1990.” The chart (next two columns)

Net Percentage of Domestic Respondents Tightening Standards for Commercial Real Estate Loans



(Federal Reserve Board, January 2008 Senior Loan Officer Opinion Survey)

demonstrates the tightening of credit standards, with the trend beginning in 2005. A dramatic uptrend beginning in mid-2007 and continuing through the present is apparent from the foregoing chart.

This article does not contain an exhaustive list of recommendations that experienced counsel might make during the loan application process. The main point is that in a tight credit market where lenders have a reduced risk tolerance, borrowers looking to obtain fi-

nancing should retain legal counsel and negotiate with lenders at the outset to save time, headaches and legal fees during the loan closing process. ■

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