Negotiation points of a commercial loan

LEGAL EASE

By Tyler J. Carrell

When I tell people that a good portion of my practice is devoted to drafting and negotiating loan documents for commercial real estate financing, I sometimes receive a puzzled look. For many of us, when we apply for a mortgage, home equity line of credit, or other personal loan, the terms of that loan are nonnegotiable. For those loans, the only major decision a borrower makes is what bank to choose – which usually is based on the best interest rate and repayment terms that are offered. In a commercial context, it's more complicated. Here are some of the financial and nonfinancial considerations often negotiated in a commercial finance transaction.

LOWERING COSTS

While commercial financing has a lot of moving parts, a borrower is still concerned with lowering costs. The interest rate is certainly important, but it is not the only place where a borrower can incur costs. Many commercial loans include a "commitment fee," whereby the borrower compensates the lender for providing access to a potential loan, or more particularly, setting aside the funds for the borrower when the lender cannot yet charge interest. The commitment fee is generally either a flat fee, for example $10,000, or a percentage of the undisbursed loan amount. Since this fee is typically due at closing, the borrower often tries to negotiate this amount down. Along this same line, a borrower frequently tries to reduce closing costs. Finally, when it comes to repayment, a borrower will negotiate down any fees or penalties for prepaying the loan. Prepayment penalties are fairly infrequent in a personal loan context, but can be costly for a commercial borrower.

LIMITING RECOURSE

As with personal loans, lenders providing a commercial loan often require a personal guaranty. While a borrower usually cannot avoid a personal guaranty entirely, they may be able to negotiate a limited guaranty or what is often referred to as a "bad boy guaranty." By signing a limited guaranty, the guarantor typically promises to guarantee the borrower's loan up to a certain dollar amount, for a limited period of time, or for only certain types of losses. A "bad boy guaranty" tends to be triggered not by mere nonpayment, but more serious acts by the borrower including fraud, misapplication of funds, an unauthorized transfer of the collateral for the loan, or a bankruptcy filing.

TRANSFERABILITY

Obviously, when a lender considers whether or not to offer a loan to a borrower, it has vetting procedures to determine if the borrower is likely to repay the loan. Since the lender has specifically offered the loan because of the borrower's solvency and management, the lender frequently includes strict limits on transferability in the loan agreement. For example, the lender may require that the borrower promise not to transfer, sell or otherwise change the ownership of the borrowing entity. As with any business, it may be beneficial for a borrower to bring in an additional owner or investor, or some corporate disagreement may lead to a principal wanting to sell his or her interest. Consequently, borrowers often try to limit the change in control restriction; usually by asking that a change in ownership in the borrower be permissible up to a certain percentage (i.e. the borrower cannot sell more than 40 percent of its ownership interest without the lender's consent).

LIMITING DEFAULTS

If the borrower violates the restrictions on transferability, such violation may be an "event of default" under the loan agreement. An event of default can have harsh consequences including, the loan balance becoming immediately due and the borrower being held responsible for the lender's fees and costs. Due to the many conditions a borrower must abide by under the loan agreement, a borrower often tries to negotiate less severe penalties for a default or otherwise limit what constitutes a default. A common request from a borrower is that it receives one, a notice and two, an opportunity to cure a default before the lender may enforce default remedies. A borrower will also try to soften the lender's remedies, including asking for reduced late fees, or a lower default interest rate. The lender may not be willing to budge on many of these requests. However, I often see lenders be more forgiving for nonmonetary defaults, such a failing to provide financial statements when required, than for a pure monetary default, such as missing a loan payment.

In summary, simply because the lender and borrower agree to enter a commercial loan agreement does not mean the parties are finished negotiating. The borrower, the lender and their respective attorneys draft and negotiate many aspects of the loan agreement, from incidental costs, to the form of the guaranty, to the borrower's ability to change its management structure or transfer the loan, to what constitutes a default under the agreement. These negotiations require attention to detail, thoughtful language and open communication between the parties. However, if performed properly, the resulting loan documents will make both the lender and borrower comfortable with the terms and pleased they entered the transaction.

— Tyler J. Carrell is an associate at Gallagher & Kennedy. For more info about Mr. Carrell, visit gknet.com.