

EXPERT ANALYSIS

Tips for Negotiating a Commercial Loan Application

By **Everett S. Ward, Esq.**
Quarles & Brady

In a time of tight lending standards, it makes sense to know all you can about the loan application process. These applications are an important, but sometimes overlooked, component of the mortgage financing process. A properly drafted loan application, among other things:

- Identifies the correct borrower and guarantor (if any) and describes the proposed loan structure and the information the lender will use to underwrite and approve the loan.
- Contains any transaction-specific provisions required by the lender and the borrower.
- Lists the lender's due diligence and closing requirements and contains a timetable for the borrower to satisfy those requirements.
- Describes the fees and expenses that are payable by the borrower in connection with the proposed loan.
- Establishes the conditions under which either the borrower or the lender may terminate the loan application process, as well as the respective rights and obligations of the parties in the event of a termination.
- Provides the basis for the lender to prepare the commitment letter if the loan is approved.

By identifying and incorporating important deal terms into the loan application, the borrower and its counsel can avoid costly misunderstandings with the lender and can also expedite the due diligence, loan commitment and closing processes.

The borrower's counsel should discuss the client's business objectives before commencing the review and negotiation of the loan application and should establish a timeline for finalizing the loan application. Circumstances (for example, an opportunity to take advantage of declining interest rates) or the borrower's own business objectives (for example, an immediate need for capital) may cause the borrower to emphasize speed over undertaking extensive negotiations in completing and submitting the loan application.

It may be useful for the borrower's counsel to request and briefly review certain key provisions in the lender's standard loan document forms (for example, default, transfer and casualty and condemnation provisions) for purposes of determining whether the borrower should negotiate modifications to those provisions in the loan application. Both the borrower and its counsel should

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expect that the application will form the basis for the lender's loan commitment, and that the borrower may not have the opportunity at the commitment stage to modify the deal described in the application.

THE PARTIES AND BASIC LOAN STRUCTURE

To really understand the loan application process, and to succeed in incorporating the major deal terms into the application, you must become familiar with the parties and the most fundamental aspects of the loan.

Borrower and guarantor

The loan application must correctly identify the borrower and any guarantor of the debt. If the borrower is a to-be-formed entity, then the loan application should clearly state that fact, as well as identify the relationship of the borrower to the person or entity executing the application on the borrower's behalf.

Collateral for the loan

The loan application must identify the correct property and/or other security that will constitute the collateral for the loan. This may seem like a somewhat innocuous task, but the failure to accurately identify the collateral in the loan application can cause problems for the borrower and the lender:

- In multi-property portfolio loans;
- When the client owns several different properties that have similar names; or
- If the loan collateral consists of only a portion of a multi-phase property.

If the lender must perform new due diligence and loan underwriting work on the corrected collateral, then that task will adversely impact the borrower's loan closing timetable. The loan application should state whether the loan will be cross-collateralized and/or cross-defaulted with any other loan.

Loan amount and term

The application should list the loan amount and the loan term requested by the borrower. If the lender did not perform any underwriting or other due diligence before completion of the loan application, then the lender will reserve the ability in the application to adjust the loan amount based on the results of the underwriting. The borrower should have the right to terminate the loan application (and receive a refund of all or a negotiated portion of any application fees) in the event that for any reason the lender is unable to make a loan in the same amount and for the term set forth in the application.

The application should list the maximum loan-to-value and minimum debt service coverage ratios that the lender will use in determining the loan amount. The borrower can apply these ratios to its internal valuation of the property in order to make a preliminary assessment regarding whether the borrower-determined value of the collateral will be sufficient to support the requested loan amount. The internal financial information used by the borrower in determining the LTV and DSC ratios may differ from the information used by the lender to make those determinations, so the loan application also should include at least a brief description of the lender's underwriting methodology.

Information as to the lender's underwriting procedures will provide the borrower with a basis for confirming the accuracy of the lender's loan collateral valuation and verifying that the lender has correctly applied its own underwriting standards in determining the loan amount.

The description of the loan term in the application should include any rights that the borrower may have to extend the loan term, as well as all conditions precedent to the borrower's exercise of those extension rights.

Selection of interest rate(s) and method(s) of calculating interest

If the loan application does not state the actual interest rate, then the document must state whether the loan will be a fixed-rate loan, a floating-rate loan or some combination thereof, as well as the lender's methodology for establishing the interest rate and calculating the interest amount.

For example, lenders often use the yield on a specified U.S. Treasury security plus some basis point spread to determine fixed-rate loan pricing. Lenders may also base floating-rate loan pricing on the lender's "prime" rate plus a basis point spread or the 30-, 60- or 90-day London Interbank Offered Rate plus a basis point spread. The lender typically will use one of the following three methods to actually calculate the interest amount:

- A year consisting of 360 days and each month in that year consisting of the actual number of days in that month (the actual/360 method).
- A year consisting of 365 (or 366) days and each month in that year consisting of the actual number of days in that month (the actual/365 method).
- A year consisting of 360 days and each month in that year consisting of 30 days (the 30/360 method).

If the loan will have a fixed rate, the application should provide the borrower with the right to lock the interest rate before closing, and should include:

- The procedures that the borrower must follow in order to lock the interest rate.
- Any timetable for interest rate lock.
- Any payments that must be made to the lender in order to permit the borrower to lock the interest rate.

Some lenders will permit a borrower to lock the interest rate well in advance of the closing date in exchange for making a "rate lock deposit" equal to a negotiated percentage of the loan amount. This early rate-lock right can allow the borrower to take advantage of favorable shifts in interest rates. The rate lock deposit will be returned by the lender if the loan closes in accordance with the terms of the commitment; however, the lender customarily has the right to keep all or a portion of the deposit as compensation in the event the borrower fails to close the transaction. The parties sometimes can negotiate the form of payment for the rate-lock deposit (*e.g.*, cash, letter of credit or guaranty) as part of the loan application process.

When the interest rate will change from a fixed rate to a floating rate (or vice versa) during the loan term, the application should describe the timing and process for converting the interest rate.

Prepayment restrictions or provisions

The loan application should contain any rights of the borrower to prepay all or a portion of the debt, as well as any prohibitions on prepayment. When loan prepayment is permitted, the application should describe the applicable prepayment formula (*e.g.*, yield maintenance, prepayment fee/premium or defeasance).

The loan application must identify the correct property and/or other security that will constitute the collateral for the loan.

IMPORTANT TRANSACTION-SPECIFIC PROVISIONS

Whenever possible, the borrower and its counsel should include some or all of the following types of loan document provisions in the application.

Recourse liability

The loan application should include the actual limitation-on-liability provisions that the lender will use in the loan documents. Counsel for the borrower should review and, if necessary, negotiate these provisions as part of the loan application process. In particular, the borrower's counsel should identify for his client those types of loan document defaults, if any, which could result in full personal liability for the borrower and/or any guarantor under the loan documents.

Any special provisions relating to any guarantor of all or a portion of the loan (for example, limits on guarantor liability or special guaranty release provisions) also should be set forth in the loan application.

Collateral substitutions and releases

If the borrower will have the right during the loan term to substitute collateral for the initial collateral and/or obtain a release of all or a portion of the collateral, then the loan application should contain an overview of the loan document provisions relating to collateral substitutions and releases.

Insurance requirements

The borrower should have the lender include as part of the loan application a list of the lender's insurance requirements. (See Appendix 1 at the end of this article for a sample provision.)

Transfer provisions

If the borrower is a joint venture, an affiliate of a real estate investment trust, an entity that is undertaking a tenant-in-common transaction or any other entity that may require some flexibility in connection with possible future transfers of ownership interests in the borrower or the property that is the loan collateral, then the application must describe the necessary permitted transfers. The transfer provisions may need to be broad enough to allow for a change in control of the borrower entity when holders of the ownership interests have the right to buy out the controlling ownership interest holders.

Defaults and cure periods

Many loan applications address borrower defaults in very general terms. For example, the application may contain a statement that "borrower defaults will be as described in the loan documents governing the transaction." Unless the loan application contains specific notice and cure periods for borrower defaults, or the borrower is particularly sensitive to default cure periods, the borrower's counsel should consider deferring the negotiation of default and related cure period provisions until the actual negotiation of the loan documents.

Casualty and condemnation provisions

As part of the loan application process the borrower's counsel may have an opportunity to negotiate the conditions under which casualty and condemnation proceeds will be made available to the borrower for use in restoring the collateral property. If the loan application form does not address these issues, then this may be another topic that the borrower can defer until the actual negotiation of the loan documents.

Lenders often use the yield on a specified U.S. Treasury security plus some basis point spread to determine fixed rate loan pricing.

Other deal-specific requirements

The loan application should contain any other deal-specific provisions that the lender will need to incorporate into its loan underwriting and approval processes and/or the actual loan documents. Deal-specific requirements that should be set forth in both the loan application and the loan documents include:

- Any DSC or LTV tests that will be applicable to the loan collateral following the loan closing.
- Any post-closing requirements or restrictions relating to future leasing activity at the property.
- Any prohibitions on or permitted secondary financing.
- Any repair or replacement reserve, real estate tax and insurance escrow or other escrow requirements.

Examples of requirements that, while important for loan application purposes, will not be placed in the loan documents include:

- The lender's agreement to use loan documents from a prior loan as the template documents for the contemplated loan.
- The lender's agreement to use specific legal counsel for the transaction.
- Any pre-closing property-related requirements (e.g., minimum occupancy levels).
- The borrower's request that the lender waive certain closing requirements (e.g., the lender agreeing to accept certificates evidencing insurance coverage rather than actual insurance policies).

LENDER'S DUE DILIGENCE AND CLOSING REQUIREMENTS

The loan application should list all of the due diligence items and other submissions and requirements that must be satisfied by the borrower as a condition to the lender evaluating the application, completing due diligence, issuing the loan commitment and closing the transaction.

Borrower formation requirements

Depending on the lender and the type of loan, the lender may specify in the loan application that:

- The borrower must own only the loan collateral and cannot own any other assets.
- The borrower have a certain organizational structure (e.g., a Delaware limited liability company that has one or more independent members for bankruptcy-remoteness purposes).
- The borrower's organizational documents contain a number of "special purpose entity" provisions that are intended to keep the assets of the borrower from being consolidated with the assets of the borrower's parent in the event of the bankruptcy of the parent.

The borrower's counsel must incorporate the lender's requirements into the borrower's organizational documents, either at the time of entity formation or by amendment to existing organizational documents.

Borrower and guarantor formation, due authorization and loan document enforceability opinions from the borrower's counsel are customary loan closing requirements.

The borrower's counsel should attempt to negotiate cure periods in connection with all termination events.

Underwriting deliveries

Appendix 2 to this article contains a sample list of the types of documents that the lender may require from the borrower in connection with the lender's loan underwriting process. In addition to the items listed in Appendix 2, the loan application delivery list should include copies of the borrower's organizational documents (to the extent existing at the time of the loan application) and of any guarantor of the loan.

Title and survey requirements

The lender should include its title insurance and survey requirements in the loan application. Title insurance requirements may include:

- A list of title insurance companies that are acceptable to the lender.
- Identifying the form of mortgagee title insurance policy (e.g., a 2006 American Land Title Association policy) that the lender must receive at closing.
- A description of any endorsements to the title insurance policy required by the lender.
- If applicable, the lender's title reinsurance guidelines.

Most lenders require a current ALTA/ACSM (*i.e.*, American Land Title Association/American College on Surveying and Mapping) survey of the property. Lenders also will specify what additional matters (the so-called Table A items) must be depicted on the survey. The lender must include its survey guidelines and any required form of survey certification as exhibits to the loan application (See Appendix 3 to this article for examples of lender survey guidelines and a survey certification).

Legal opinions and other closing deliveries

The loan application should contain a description of the legal opinions and any special requirements or deliveries that must be satisfied or provided by the borrower (or the borrower's counsel) as a condition to loan closing. Borrower and guarantor formation, due authorization and loan document enforceability opinions from the borrower's counsel (or local counsel, if necessary) are customary loan closing requirements. Lenders also may require a non-consolidation opinion letter under certain circumstances (for example, large loans and/or commercial mortgage-backed securities loans). The borrower's counsel may have to provide a tax opinion in a bond financing or a low-income housing tax credit transaction. Some loan applications even attach a suggested form of borrower's counsel opinion letter as an exhibit.

If the loan collateral consists of office or other commercial property, then the borrower may be required to provide tenant estoppel letters and/or subordination, non-disturbance and attornment agreements, or SNDAs, from certain tenants as a condition to loan closing. In negotiating these requirements with the lender, the borrower's counsel should consider:

- Attaching the forms of estoppel letter and SNDA as exhibits to the loan application.
- Having the lender agree in the loan application that the lender will accept, in satisfaction of any loan closing requirements, the forms of estoppel letter and SNDA, if any, that the tenants are required to deliver under the terms of the relevant leases.

In the event that estoppel letters furnished by tenants are deemed by the lender to be unacceptable and the borrower wants the ability to provide the lender with landlord estoppel letters instead, the borrower should negotiate this condition as part of the loan application process.

Some lenders, particularly insurance companies, require their borrowers to execute and deliver at loan closing certifications and representations relating to matters under the Employee Retirement Income Security Act. Because of the highly technical nature of the ERISA laws and the severity of the consequences for both the lender and the borrower if the borrower violates an ERISA certification or breaches a representation, the parties must review and include in the loan application any required ERISA certifications and representations that the borrower must execute at loan closing.

FEES AND EXPENSES

The loan application should list:

- All fees and reimbursements payable by the borrower to the lender and third parties engaged by or on the lender's behalf.
- The method the lender uses to calculate all fees, if applicable.
- The timing of the borrower's payment of those fees and reimbursements.
- The circumstances under which all or a portion of any fees may be waived or refunded to the borrower.

Fees may include those for a loan application, a due diligence review, a loan commitment, an early rate lock, legal fees (if the lender has agreed to cap legal fees or to pay a fixed legal fee, then the application should contain the capped or fixed fee amount) and an interest rate standby fee (sometimes also referred to as a forward commitment fee or a good-faith deposit). The loan application also should identify all fees that will be payable by the borrower in connection with any permitted collateral substitutions or releases, any transfers of the collateral or any transfers of interests in the borrower.

TERMINATION OF LOAN APPLICATION

The lender will want the right to terminate the loan application upon the occurrence of any of the following events (referred to here as "termination events"):

- The borrower's failure to satisfy any of the conditions set forth in the loan application (this would also include inaccurate due diligence information received from the borrower).
- The borrower, any guarantor or any key tenant becoming insolvent or filing bankruptcy, or a material adverse change in the financial condition of any of those parties or the loan collateral.
- Material damage to or destruction of the loan collateral.
- A material default by a key tenant under its lease.
- Any event that would constitute an event of default by the borrower or any guarantor under the loan documents (the default to be determined as if such documents were in effect before closing).

The borrower's counsel should attempt to negotiate cure periods in connection with all termination events. The loan application must describe what the borrower's financial obligations to the lender will be following the occurrence of a termination event. Preferably, the borrower would, at most, forfeit any loan application fee paid to the lender and also be responsible for

Borrower and guarantor formation, due authorization and loan document enforceability opinions from the borrower's counsel are customary loan closing requirements.

As part of the loan application process the borrower's counsel may have an opportunity to negotiate the conditions under which casualty and condemnation proceeds will be made available.

payment of the lender's third-party transactions costs (for example, reasonable attorneys' fees and costs and the actual costs of third party reports) as liquidated damages. If the borrower locks the interest rate and paid an early rate lock fee before a termination event, then the lender also may want to retain the early rate lock fee as compensation for any loss incurred in locking the interest rate before closing. The loan application should provide that all fees not retained by the lender following a termination event in accordance with the terms of the loan application will be promptly returned to the borrower.

If the lender should elect for any reason (other than the occurrence of a termination event) not to make the loan, then, at a minimum, the loan application should specify that the lender will promptly return all amounts previously paid to the lender by the borrower in connection with the loan application process.

SOME OTHER USEFUL LOAN APPLICATION PROVISIONS

The borrower's counsel may want to include several other useful provisions in the loan application, such as representations and indemnities from both the borrower and the lender identifying:

- Any third-party loan brokers that are to be paid in connection with the loan.
- The party that is responsible for making those payments.
- A timeline for the lender's expected review of the due diligence materials, loan committee consideration and approval of the loan, issuance of a binding loan commitment letter, and preferred and outside closing date (the last date that closing can occur before the lender's commitment to fund expires).

These factors might be helpful in keeping the parties focused on accomplishing the tasks necessary to close the loan.

CONCLUSION

A comprehensive, well-drafted and negotiated loan application will greatly simplify the lender's due diligence, underwriting, loan commitment and loan documentation processes. Ideally, the loan commitment letter can be relatively short and can attach the executed loan application as an exhibit and incorporate that document into the commitment letter by reference.



Everett S. Ward, a partner in **Quarles & Brady** in its Chicago office, has significant experience across a wide range of real estate transactions. He represents corporate, commercial and not-for-profit clients in the acquisition, disposition, development, financing and leasing of commercial, industrial and residential real property. He also represents clients in the formation and financing of real estate joint ventures on both stabilized assets and development projects. He can be reached at everett.ward@quarles.com.

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