A Borrower's Top 10 List

How to Protect Your Interests with Lenders

[by Joshua Stein]

Before you sign a commitment letter or loan application, think about negotiating at least 10 important points, even at this early stage of the transaction. This assumes you've already confirmed that all the basic "deal terms" are right.

If your commitment letter or loan application deals favorably with these 10 points, you will be on your way to a simpler, faster and less expensive loan closing, and a more attractive loan.

Every transaction raises a range of issues and has its own dynamics. Your leverage — including, above all, whether you are negotiating with other lenders simultaneously — will determine whether you can successfully score on these or any other points.

A lender's flexibility will often drop if the lender intends to securitize your loan and must worry about complying with rating agency requirements. But these requirements are sometimes in flux and not absolutely clear. The consequences of noncompliance may or may not be grievous for the lender. If a securitized lender wants to make a deal badly enough, you may still find some flexibility.

1. Handle Problems in Advance: If you know your project suffers from a problem that any lender's due diligence will inevitably reveal, put it on the table when you start negotiating your loan. Lenders can be far more accommodating and flexible before you've paid a commitment fee.

2. Refund of Fees: Beware of nonrefundable fees, especially if the transaction dies because the lender disapproves something about the loan. Require the lender to refund as much of the fee as possible, even though the lender will typically insist on covering its third-party costs first.

3. Controlling Due Diligence and Closing Costs: Get the lender to identify its consultants in the commitment letter. Try to cap the consultants' fees. Do the same for legal fees if you can. Lenders often believe, though, that such a cap is inconsistent with receiving the best representation. Among the many other techniques available to control legal fees, one of the best is to raise and resolve in the commitment letter the issues described here.

4. Opinions of Counsel: Driven partly by the rating agencies, lenders have learned to love opinions of counsel more and more over the years. But, opinions can be expensive. Some of the more exotic new opinion requirements would probably flunk any rational cost-benefit test. If you ask to cut back the opinion requirements early on, you may be able to do so.

Keep the opinions as narrow and plain vanilla as possible. Above all, try to avoid the dreaded substantive nonconsolidation opinion. And, if you foresee any possible issue, make sure the lender will accept an opinion issued by the counsel you want to use.

5. Single-Purpose Entities: If the lender wants you to form a new single-purpose entity to hold the property, make sure this will not create tax problems or raise any other issues. Try to avoid any requirement for an independent director. If you anticipate the need to borrow from the principals for capital projects or to cover cash shortfalls, make sure the required single-purpose entity can still do it.

6. Tax and Insurance Escrows: More loans than ever require monthly escrows for taxes and insurance — a procedure that creates extra work, extra potential for mistakes and negative arbitrage for the borrower, all premised on doubt that the borrower will pay the most basic costs of ownership when due.

You may be able to persuade a lender to drop these escrows. You might offer, for example, a limited personal guaranty that the borrower will apply any cash flow first to pay taxes and insurance when due. On the other hand, many borrowers refuse to provide any personal guaranty of anything under any circumstances.

7. Insurance: If the commitment letter and the loan documents will require more or better insurance than you typically expect to provide, this will impose an extra cost of the financing. Try to identify the lender's specific insurance requirements and have your insurance broker compare them against your regular practices.

Some common battlegrounds: the

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minimum required rating for the insurance carrier, limitations on the deductible amount, extra coverage for rental interruption, flood insurance beyond the federal flood insurance program, earthquake coverage, excessive amounts of liability coverage and requirements to deliver a certified copy of the policy.

If the building burns down or some other loss occurs, get the right to use insurance money to rebuild. Lenders have become more accommodating on this issue. You can, at any stage in loan negotiations, go into as much detail as you want about how the reconstruction process will work. This is, however, probably one area where a broad-brush approach will suffice — something less than absolute precision and certainty — even in the final loan documents themselves. Just make sure you don't have to deliver a bond or a personal guaranty.

8. Transfers: Do you want the right to sell the property, subject to the mortgage, to a reasonable purchaser that satisfies certain criteria? If so, raise the question at the commitment letter stage. Negotiate the lender's assumption fee and other fees up front. These issues become particularly important if the loan doesn't permit prepayment.

If you want flexibility in transferring partnership or limited liability company interests in the borrower, ask up front. If the borrower's organizational documents provide for a buy-sell or a forced sale under any circumstances, perhaps the loan documents should expressly allow such a transaction. Otherwise, whatever the organizational documents provided for becomes almost illusory. Different principals of the borrower may, of course, have different views. Whoever anticipates being the victim of one of these involuntary transfers may like the idea that the loan documents prohibit it.

9. Nonrecourse/Personal Liability: For routine nonrecourse financing, don't settle for a reference to the customary carveouts. Define exactly what they are. Make crystal clear that even for those carveouts, no one has any liability except the actual borrower. Try to attach the actual text of the nonrecourse carveouts to the commitment letter or application.

Avoid recourse liability for vaguely defined concepts like fraud or waste.

10. Lender Discretion: Both during the closing process and under the final loan documents, limit the areas where the lender can exercise unrestricted discretion in approving or disapproving anything. The more discretion a lender has, the more easily the lender can prevent you from taking actions that make sound business sense down the road.

By following these 10 points, you'll probably save yourself some money ... and aggravation.

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