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Negotiating and drafting commercial loan documents in the current lending environment

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I have very intelligent developer clients. My clients have, over the years, pointed out to me important points to negotiate involving commercial loan documents. In this article, I will discuss the important points to be negotiated in a commercial loan transaction. I want to show that there are only a small number (less than a dozen) of issues that need to be addressed in the loan documents.

The Nervous Lender Clause

A common clause in a commercial promissory note allows a lender to call the loan if the lender feels uncomfortable about the loan. I call it the Nervous Lender Clause. Many commercial lenders have experienced difficulties. Therefore, I cannot think of a lender who is not nervous at times.

The clause usually reads as follows: "The occurrence of any materially adverse event or circumstance with respect to the borrower and any guarantor such that the bank deems itself insecure." The lender lists this as an "Event of Default."

Some lenders will agree to delete this clause. Others will only modify the clause to read as follows: "There shall have occurred any significant and material adverse change in the business, operations, properties or condition (financial or otherwise) of mortgagor or any guarantor, which, in the reasonable opinion of the lender acting in good faith, impairs its security or increases its risk."

Obviously, deleting the nervous lender clause is better for the borrower than merely modifying it.

In any event, the nervous lender clause must be addressed in every commercial loan closing.

Bad Boy Carve Outs

Often the monetary and non-monetary obligations of a borrower under the loan documents are personally guaranteed by the principal of the borrowing entity. The lender will want the guaranty to be unlimited. If the borrower has leverage, he can limit his personal exposure to instances where he has violated what we call "Bad Boy" provisions. "Bad Boy" carve outs are fraud, diversion of funds, malfeasance and waste. Lately I have noticed that the list of bad boy carve outs seems to get longer and longer. The list of fundamental wrongs committed by a guarantor whereby they should lose their protection from liability should be limited to fraud, diversion of funds, malfeasance and waste.

Unlimited Guaranty v. Limited Guaranty

One problem is that the limited guaranty may not be clearly drafted to limit personal liability. Very often a limited guaranty will provide for a limitation of liability in one clause, and then completely take away the limitation in another clause. It is my job to protect my developer clients and to ensure that a limited guaranty is a limited guaranty. I have reviewed a set of documents for construction to permanent financing loan, in which the guaranty was unlimited up until the point of completion of construction. At that point, the loan would convert into a standard commercial loan, and the unlimited guaranty would become a limited guaranty except for the "Bad Boy" carve-outs. The problem was that the documents stated that after the completion of construction, the guaranty would

be limited, unless there was an event of default, in which case the guaranty would resume its unlimited status. The documents gave a limited guaranty and then took the limitation away. I do not see the need for convoluted loan documents, but I find myself reviewing them on a regular basis.

There are other issues involving a guaranty. For example, a guaranty could be limited to a dollar amount. Also, when there are more than one guarantor, the liability could be joint but not several so that each guarantor's liability is limited to his pro-rata share of the debt based on his pro-rata share of the deal. Finally, the lender could be obligated to look to the property first and then, in the event of a deficiency, the lender could look to the guarantors.

Grace and Cure Periods

The borrower needs notice and a period of time to cure defaults. With respect to monthly payments, only a cure period is necessary because the borrower knows when the monthly payment is due. As to all other defaults, written notice and a cure period is necessary. Usually, the notice is a 30 day written notice and period to cure. Often the cure period is longer, provided the developer starts to cure the default immediately and proceeds diligently. There may or may not be an outside cure date, such as 90 days after the notice of default.

Leasing

The borrower needs flexibility on leasing. Of course the lender is entitled to copies of all signed leases and amendments to the leases. The borrower should have the freedom to lease the mortgaged property as long as the rent is at or about market and the lease is a standard form and has been entered into in the ordinary course of business. A borrower and a lender might agree on a form lease. The borrower shall then be able to enter into lease agreements with tenants without the consent of the lender, provided the form is used and has not been materially altered and the rent is market rent.

Alternatively, the borrower and lender might agree that lender's approval might only be required for the larger leases of the mortgaged property (e.g., the anchor tenants in a shopping center), where there are a number of smaller tenants but only one or a very few larger tenants.

The Deposit Relationship

Lenders will usually require that borrowers keep operating accounts with the lender. The borrower should be aware that the loan documents will allow the lender to reach these funds in the event of a default by the borrower. Borrowers need to be careful not to keep all of their liquid funds with one lender given the broad rights of set off in loan documents.

Relationship Lending

Often lenders are relying on the business acumen of an individual borrower. The real estate may be secondary. Therefore, the personal guaranty becomes critical to the transaction. In such a situation, the borrower must carefully present his entire financial picture to the lender at the beginning of discussions for a loan. The lender will want the right to call the loan in the event of the death of the individual guarantor. The loan documents should give the estate of the individual borrower a period of time to provide an alternative guarantor - usually the spouse or adult children of the deceased guarantor. As long as a reasonable alternative guarantor is provided, the lender should not be allowed to call the loan in the event the guarantor dies.

Cross-Collateralization, Cross-Default and Dragnet Clauses

Borrower's counsel should try to eliminate each of the following from the commercial loan documents:

"Cross-collateralization: The process of tying two or more mortgages together so that the security of

one note stands as security for the other note(s).

Cross-defaulting clause: A provisions in many mortgages that a default in any mortgage on the property, or any loan by the same lender to the same borrower, will constitute a default in the one containing the clause, even if all note payments are current on that particular mortgage.

Dragnet clause: A clause in a mortgage loan that spreads a dragnet, which, in fishing, is a large net dragged across an area in order to capture everything it encounters... In addition, a dragnet clause can provide that default in any other loans will constitute a default in the mortgage loan, even if the mortgage payments are current."

Evans, Denise L. and O. William Evans, The Complete Real Estate Encyclopedia: From AAA Tenant to Zoning Variances and Everything in Between, McGraw-Hill 2007.

While I am not always successful in eliminating these clauses, I need to try. In any event, I have to advise my clients about them.

Fire and Other Casualty

A lender should not be able to control insurance proceeds for a casualty where the damage falls below a certain threshold. I typically argue that my client should have full control over insurance proceeds for claims that are less than $100,000.

Conclusion

I cannot presume to know what a loan officer experiences while supervising and enforcing provisions in loan documents. However, I do wonder if a loan officer wants to spend his time on provisions like the nervous lender provision, bad boy carve-outs that are too extensive, the requirement of lender's consent to even small, standard lease agreements, and lender's control over small insurance claims. A win-win situation for borrowers and lenders would be to get back to clear, consistent and practical loan documents.

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