

Negotiating the Loan Assumption Agreement: A Roadmap for Sellers and Buyers

John R. Cauble, Jr.

Key issues need to be addressed to avoid pitfalls with the lender's form of loan assumption agreement.

When an owner is selling real property subject to an existing loan to be assumed by the buyer, even if the transfer itself is permitted under the existing loan documents, certain issues commonly arise from the seller's and the buyer's perspectives with the lender's form of loan assumption agreement. This article provides a roadmap for the issues most commonly faced by the seller and the buyer in negotiating the typical loan assumption agreement with the lender.

John R. Cauble, Jr. is Of Counsel with Pircher, Nichols & Meeks, a real estate law firm with offices in Los Angeles and Chicago. He may be reached at jcauble@pircher.com.

Preliminary Considerations

Review the Existing Loan Documents. The buyer should of course review all of the existing loan documents for a loan it will be assuming to assess its position as prospective borrower. In addition, both the seller and the buyer should carefully review the existing loan documents to evaluate potential issues with the loan assumption.

Lender's Discretion. The assignment and assumption provisions in the loan documents should be carefully reviewed at an early stage. Is assignment and assumption a right or subject to the lender's consent? If consent is required, is the lender required to be reasonable? If the lender is re-

quired to be reasonable, what does this mean under applicable state law? Is the lender entitled to modify the loan documentation or demand other consideration as a condition to giving consent? The extent of the lender's discretion under the assumption provisions of the existing loan documents (and applicable state law) to disapprove the transfer, impose additional conditions and control the forms of the assumption documentation will affect the relative bargaining strengths of the parties in negotiating the form of the loan assumption agreement.

Recourse Provisions. Is the loan recourse or nonrecourse? If nonrecourse, are there any recourse

carve-outs or springing recourse provisions?

Guaranties and Indemnities. Are there any third party guaranties or any environmental or other indemnities? Is there a right to substitute new parties to have the original parties released from personal liability?

Assumption Fee. It is critical to understand what the amount of the assumption fee will be, as this will most likely be the single largest cash outlay in connection with the consummation of the loan assumption.

Complete List of Loan Documents. It is important to compile a complete list of the existing loan documents and to obtain accurate legible copies of all of the loan documents.

Renegotiation of Loan Documents. The buyer typically will not have the ability to renegotiate the terms of the existing loan documents, and therefore the buyer should review and conclude that the existing loan documents are acceptable before undertaking the time and expense of the loan assumption process. Similarly, the seller should insist that buyer complete its review and approval of the existing loan documents within a specified time frame.

Prior Loan Assumption. If the loan has been previously assumed, a review of the prior loan assumption agreement may give a preview of what form the lender will expect. However, a lender's forms often change over time, especially if in the interim the loan has been sold or securitized or if the lender has changed its law firm or loan servicer. In addition, the seller should review all documents executed in connection with its prior assumption to assess the extent of its recourse personal liability for which it will be seeking release.

Financing Alternatives to the Assumption. Financing alternatives to the loan assumption should be assessed, and in this connection the prepayment and any defeasance provisions in the existing loan documents should be reviewed. The viability of alternative modes of acquisition financing may affect the lender's flexibility on the loan assumption issues.

Buyer's Exit Strategy. The buyer also will need to consider its own exit strategy in connection with such review; for example, is only a one-time assumption permitted, is there a lock-out on early prepayment, is only defeasance permitted?

Identity of Lender and Loan Servicer. The buyer should investigate the reputations of the lender and its loan servicer. Are they reasonable or difficult to deal with? Responsive or bureaucratic? If this is a conduit loan, then the responsiveness of the loan servicer may depend on its share (if any) of the as-

sumption fee. Do either the seller or the buyer have relationships with the lender or its loan servicer that may help in expediting the process?

Timing. Time is usually the friend of the lender. The lender is often not motivated to move faster than its own deliberate pace to go through its internal procedures (and, in the case of conduit loans above a certain size, the approval procedures of the rating agencies), and once the draft of the loan assumption agreement is finally generated the seller and the buyer often are so eager to finalize it that the lender frequently can prevail on material issues by simply giving its attorney and front line business person little authority to concede anything material. Thus the seller and the buyer must be willing to endure further delay to further pursue these issues. The purchase and sale agreement also should address the issue of timing; for example, the seller may want a relatively short contingency period to finalize the loan assumption documentation but the buyer may want a longer period so that it does not lose the deal merely because of lender delays.

Different Interests of Seller and Buyer. The interests of the seller and the buyer are not identical vis a vis the lender. The seller and the buyer each will be concerned that the other will unnecessarily delay the process or run up legal fees to pursue issues that the other is more concerned with. The purchase and sale agreement often will provide that the seller and the buyer must be "reasonable," but beyond this it should attempt to identify core issues that a party is entitled to insist upon such as, for example, that the seller will be released from future liability under the loan. The seller and the buyer also may want to address in a side letter any known issues that they initially will raise with the lender but concede if not resolved within a specified time period. The seller and the buyer also may want to agree between themselves on when or if either will be entitled to threaten or pursue litigation against the lender if the lender in effect prevents the assumption by imposing unreasonable requirements or delays.

Allocation of Fees and Costs between Seller and Buyer. The loan assumption agreement typically will provide that the seller and the buyer are jointly responsible for paying the lender's fees and costs. It therefore is important for the understanding between the seller and the buyer as to allocation of fees and costs to be expressly documented in a signed agreement. This agreement also should clarify whether the seller needs the buyer's written consent

before initiating the various stages in a loan assumption and whether the same allocation applies regardless of whether the sale is consummated. If the purchase and sale transaction fails to close, the allocation provided between the seller and the buyer may differ depending upon the reason for such failure. Any agreement by the buyer to bear these costs should not be subject to the liquidated damages provision in the sale agreement and should be guaranteed by a creditworthy guarantor if the buyer is a single purpose entity formed for the acquisition.

Discover Lender Issues Early. The lender may impose additional requirements that result in greater costs and greater liabilities. These even could include new indemnities or guaranties not included in the existing loan, and could result in termination of the sale transaction if the seller and the buyer do not agree to these additional requirements. It therefore is important to try to discover these additional requirements as early in the process as possible. The tradeoff is that because the lender will not even start consideration of the assumption until the borrower signs a letter agreeing to reimburse all of the lender's costs (including attorney's fees), the seller and the buyer may prefer to delay starting the loan assumption process until the due diligence period under the purchase agreement has expired.

MUTUAL SELLER/BUYER ISSUES

Conditional Effectiveness. The lender's form may contain conditions to the effectiveness of the lender's consent to transfer and to other provisions contained in the loan assumption agreement. From the seller's and the buyer's perspectives there are two concerns with this approach: First, the provisions of the loan assumption agreement benefiting the lender should not become effective until the entire loan assumption agreement becomes unconditionally effective. Second, the sale of the property should not be consummated before the entire loan assumption agreement becomes effective.

These concerns can be addressed by providing in the loan assumption agreement that the conditions are deemed satisfied or waived upon the entering into of the loan assumption agreement, and then putting the loan assumption agreement into escrow so that it is not released until the lender in fact has satisfied itself that all of the conditions have been satisfied. Fallback positions include accepting a lender's certificate or a letter from the lender's attorney stating that the conditions all have been satisfied or waived, and then making the receipt of such

certificate or letter a condition for release of the executed loan assumption agreement from escrow. Release of the executed loan assumption agreement from escrow and the closing of the sale transaction should be mutually conditioned upon each other so that they occur simultaneously or not at all.

Lender's Costs and Fees. Unfortunately, it is not unusual for lenders and loan servicing agents to attempt to collect costs and fees to which they are not entitled under the loan documents. The essential first step is to carefully review the applicable loan document provisions as to:

1. what fees and costs are required to be paid by borrower in an assumption context,
2. whether the lender's consent is required and whether the lender is required to be reasonable in exercising its consent, and
3. the loan prepayment and defeasance provisions to assess the alternatives to an assignment and assumption of the loan.

The parties' should then carefully monitor what fees and costs the lender (or its servicing agent) is attempting to charge the borrower. The borrower should resist any fees that are not expressly provided for in the existing loan documents. Costs should be limited to itemized actual out-of-pocket costs. A potential issue is whether the lender can charge as a cost any fees of the loan servicer, on the theory that such fee would be a cost to the lender.

Release of Lender. The lender's form will typically contain a release of any claims against the lender, and often go further to provide that the seller and the buyer agree to indemnify the lender for any lawsuits brought by the seller or the buyer or their affiliates for released claims.

Why Release the Lender? The first question is why should the lender even receive a release? If under the existing loan documents there is an express right of the borrower to transfer and the provisions do not provide the lender with leeway to stall or impose conditions, then the seller and the buyer might decide to challenge the appropriateness of this provision. Because lenders commonly insert this provision in their forms, however, the lender may feel that this concept has become customary and resist any attempt to eliminate this provision. The lender also may argue for mutuality: if the seller is not clearly entitled to be released upon assumption, then the re-

lease of the lender can be viewed as consideration for the release of the seller; similarly, if the buyer is not clearly entitled to exclude pre-closing matters from the scope of its assumption, then its release of the lender can be viewed as the price for the exclusion for the buyer's benefit.

Indemnity Liability of Seller and Buyer Should be "Several" Only. If the release of lender provision is not eliminated, then any provision obligating the seller and the buyer jointly to indemnify the lender against any later claims violating the release should be changed so that it is "several" only and not joint, in order that the seller is not liable for later lawsuits brought by the buyer or its affiliates, and vice versa.

SELLER'S ISSUES

Release of Seller and Guarantors. The seller (and any guarantors or indemnitors) should be released from all liability arising at or after the moment of transfer. Even if the loan is nonrecourse, it will probably contain recourse carve-out provisions creating recourse liability for specified "bad boy" acts and environmental matters, and it may contain a "springing recourse" provision making the entire loan recourse for certain prohibited acts such as unpermitted transfers or failure to comply with the single purpose entity requirements. It would be unfair for the seller (or its guarantors or indemnitors) to have personal liability because of defaults by the buyer under the loan documents on or after the closing date.

Closing Date. The lender's form may provide that the seller is only released from liability arising after the closing date. This exposes the seller to liability for breaches by the buyer on the closing date. The seller should ask to be released from all liability arising on or after the moment of closing. If agreement cannot be reached on this point, then the recourse provisions of the existing loan documents should be carefully reviewed to assess exactly what recourse liability could possibly be triggered upon the acquisition by the buyer. If the recourse provisions are limited to affirmative acts by the borrower, then an acceptable fallback compromise might be to expressly provide that the seller will not be liable for any acts by the buyer. However, if the recourse provisions could be triggered by the buyer's misrepresentations or failure to comply with special purpose entity requirements, then the fallback compromise would also need to exclude these from the seller's potential recourse liability.

Definition of Loan Documents. The seller should make sure that the release covers all of the relevant

documents. For example, the lender's form may define "Loan Documents" as only the original promissory note and specified security instruments, in which event the release would fail to release the prior loan assumption agreement (if the seller itself was not the original borrower) and any guaranties or indemnities.

Seller's Recourse Liability. Once the transfer to the buyer is consummated, the seller will, of course, no longer have an interest in the property, and accordingly the loan assumption agreement may not contain an exculpation provision for the seller, even if the loan itself is completely non-recourse. The seller should therefore realize that it will have recourse personal liability for all of its covenants, representations and warranties contained in the loan assumption agreement and negotiate them accordingly.

Seller's Representations to Lender of Non-Default. Some lenders attempt to require that the seller represent and warrant that it is not in default under the existing loan. If the underlying loan is non-recourse as to any outstanding defaults that may happen to exist, this could lead to the ironic result that the seller has no recourse liability under the loan itself, but once the seller sells then it would have recourse liability for violating its no-default representation in the loan assumption agreement. To avoid this unfair result, the seller should try to eliminate any such representations or limit its liability to the net proceeds from the sale, add a survival limitation, or limit any such representation in the loan assumption agreement to the seller's actual knowledge.

Seller's Representations to Buyer of Non-Default. Some lender's forms provide that the seller's representations also run to the benefit of the buyer. From the seller's point of view this is entirely inappropriate: the extent of the seller's representations to the buyer should already have been negotiated in the purchase agreement, and even if a seller is forced to give certain representations to the lender this does not mean that the buyer is therefore entitled to receive the same representations. For example, in negotiating the purchase agreement the seller may have successfully resisted giving any representation that it is not in default under the loan, arguing that because loan documents typically contain much broader representations and covenants than those in a purchase agreement this would indirectly give the buyer much broader representations than it would be entitled to. In addition, the purchase agreement may contain survival and liability limits more favorable to the seller than such limits (if any) contained in the loan assumption agreement, such as, for exam-

ple, limiting the scope to the actual knowledge of specified individuals, excluding breaches known to the buyer prior to expiration of the due diligence period, excluding consequential damages, a minimum claim floor and maximum liability cap, and survival for only a limited time period.

BUYER'S ISSUES

Exculpation. Except for the obligation to reimburse the lender's costs and fees, the buyer's assumption and the other liability of the buyer under the loan assumption agreement should be subject to the same limitations on liability set forth in the loan documents being assumed.

Limit "Borrower" to Buyer. The lender should agree in the loan assumption agreement that from and after the closing the definition of "borrower" is changed to refer solely to the buyer. Otherwise, the buyer runs the risk that the lender could later argue that events at or after the closing relating to the seller trigger default provisions relating to the status or actions of the "borrower."

Estoppel Information. The buyer should ask the lender to provide information typically provided in estoppel letters, such as the loan balance, reserve balances, complete list of loan documents and a statement that the lender is not aware of any outstanding defaults.

Recourse Liability for Pre-Closing Defaults or Recourse Events. The buyer will not want to assume recourse liability for pre-existing recourse defaults or events giving rise to recourse liability. This issue may not be quite as simple as it first appears, because the lender may resist a broad formulation such as that the buyer (and any substitute guarantors or indemnitors) shall have no recourse liability on account of any default (including for this purpose any event that would be a default but for the expiring of notice or cure periods) or event giving rise to recourse liability under the loan documents occurring prior to the closing.

Identify and Review Recourse Provisions. The buyer should first identify and review all of the recourse provisions in the loan documents in order to assess what the potential pre-existing recourse liabilities could be. In a typical real estate loan which is generally non-recourse, common recourse provisions to check for include:

1. recourse carve-outs for the borrower's bad acts,
2. springing recourse liability where the entire loan becomes recourse for certain of the borrower's acts such as prohibited transfers,
3. environmental indemnities, and
4. limited guaranties.

Status of Borrower. The buyer should not be required to assume recourse liability with respect to pre-existing defaults or events relating to the status of the borrower, such as its special purpose entity covenants and its representations as to organization and financial statements. The reason is that these are no longer relevant once the buyer becomes the new borrower. The buyer may want to go even further and argue that any such defaults should not enable the lender to accelerate the loan.

Unpermitted Transfers. Prior unpermitted transfers or liens may give rise to springing recourse liability under the loan documents. As with the status of the borrower issues discussed above, transfers of interests within the prior borrower should no longer be relevant.

Springing Recourse. More generally, because recourse liability for the entire loan amount is at issue, the buyer may insist that it will not assume the risk of having recourse liability for the entire loan because of a pre-existing default under the springing recourse provisions.

Ongoing Defaults. The buyer would prefer that the lender only require assumption on a recourse basis for defaults or events first arising or accruing after the closing. However, the lender may not find this satisfactory, because if a default is ongoing in nature then the lender will expect its current borrower to address the issue. The buyer's counterargument is that the purpose of recourse carveouts is to deter specified bad acts by the borrower, and therefore the deterrence function is not appropriate for pre-existing defaults. One approach to resolving this question is to analyze each recourse carveout separately as to whether it would be appropriate for the buyer to have recourse liability if there were a pre-existing default.

Scope of Exculpation. The assumption provision should be phrased to make it clear that the buyer receives the benefit of the exculpation provisions in

the existing loan documents. Further, the buyer should consider arguing for the incorporation by reference into the loan assumption agreement of the existing exculpation provisions in the loan documents but redefining "borrower" to mean only the buyer, as a means of excluding recourse liability for the seller's defaults or status.

Environmental Indemnity. The lender is likely to insist that if there is a recourse environmental indemnity then this must be assumed by a related party of the buyer with substantial net worth. Further, if any environmental problem exists after the closing of the loan assumption then from the lender's perspective recourse liability should not be defeated if the environmental problem also existed before the closing.

Seller's Indemnity. If the buyer concludes that there is a material risk of pre-existing recourse defaults or recourse events and cannot fully resolve this with the lender, then the buyer may ask the seller for an indemnity on these issues, arguing that the seller already has recourse liability to the lender for such issues (if any).

Distinguish Accelerability from Recourse Liability. The buyer should remain aware that merely because it does not assume a pre-existing default, this does not address the issue of the lender's ability to accelerate the loan because of a pre-existing default.

Representations of Non-Default. The buyer should also consider the extent to which it has been able to obtain representations from the seller and lender that there are no pre-existing defaults or recourse events.

Form Upon Subsequent Sale. Ideally, the lender would agree that upon any subsequent sale of the property by the buyer for which loan assumption is permitted, the form of the loan assumption agreement will be in substantially the same form, except (in the case of conduit loans) for changes required by the applicable rating agencies. However, this can be difficult to obtain unless the lender is especially motivated to be cooperative. In this connection, the buyer should review the existing loan documents regarding the standards for loan assumption documentation, in particular whether the lender is required to be reasonable and not impose additional conditions and not modify the loan terms, and to the extent there is no such requirement then the buyer should try to negotiate at least a reasonableness requirement. Otherwise, even if the loan assumption agreement entered into by the buyer upon purchase is acceptable, by the time of subsequent resale of the property the lender may have changed its requirements to a much more onerous form of loan assumption agreement.

CONCLUSION

Before undertaking the loan assumption process, the seller and the buyer should each review the existing loan documents and agree between themselves on how to handle cost allocations and the other issues discussed here. They should view the lender's form of loan assumption agreement only as an initial draft to be carefully reviewed and negotiated, keeping in mind relevant factors in the overall transaction such as how much discretion the lender has under the assumption provisions in the existing loan documents (and under applicable state law) and how much time pressure there is to close the sale transaction. ■