COMMERCIAL LOAN BASICS

Most transactional attorneys will encounter deals that involve commercial loans. But what does that mean, exactly, and what are the basics that such attorneys should know, even if they do not have primary responsibility for drafting or reviewing loan documents? This article addresses the basics, including what a commercial loan is, what types of commercial loans are available and the difference between a secured and an unsecured loan.

WHAT IS A COMMERCIAL LOAN?

A commercial loan is debt-based financing, the proceeds of which are used for business purposes such as purchasing real estate or equipment (with funds being disbursed upfront), constructing a project (with funds being disbursed as construction costs are incurred) and/or paying operating expenses (with funds being disbursed either upfront or as needed). In the most basic of terms, a borrower borrows money from a lender and promises to repay such money with interest.

TERM VS. REVOLVING LOANS

Many technical terms are thrown around when discussing commercial loans—one hears of construction loans, permanent loans, bridge loans, mezzanine loans, revolving loans and lines of credit—but commercial loans fall into one of two basic categories: term loans and revolving loans.

TERM LOANS

A term loan is a loan of a lump sum with a regular repayment schedule. Note that "regular" does not necessarily mean equal or "fixed" payments; instead, it means that payments are due according to a regular schedule. That schedule is likely to be monthly, but it is not unusual to see quarterly or semi-annual payments. As the borrower repays the principal amounts of a term loan, those amounts cannot be reborrowed. Borrowers most commonly obtain term loans in connection with large acquisitions (such as real estate or equipment) and/or construction projects. The types of loans identified below all fall within the umbrella of "term loans."

1. **Construction Loans**. Borrowers obtain construction loans for the purpose of constructing projects, and draw the proceeds down as needed to pay construction costs. Construction loans tend to be short-term (usually one to three years), with the full outstanding principal amount and all accrued and unpaid interest being payable at the end of the term (such payment, a "balloon payment"). Borrowers often refinance construction loans with permanent loans or bridge loans, using the proceeds of the refinancing to pay the balloon payment due with respect to the construction loan.

2. **Permanent Loans**. Though a permanent loan is not actually "permanent"—the term does end—most permanent loans have much longer terms (15-30 years) than construction or bridge loans. Construction loans often convert to permanent loans after the expiration of the construction loan term (subject to project completion and no outstanding events of default by the borrower in connection with the construction loan), and borrowers often obtain permanent loans to acquire improved real estate.

3. **Bridge Loans**. A bridge loan acts as a "bridge" carrying a borrower between loans (often a construction loan and a permanent loan). Given such intent, most bridge loans are short-term (usually one to three years). During the term of the bridge loan, the borrower may work to get its project "leased-up," and free rent periods may expire, resulting in a stronger rent roll that allows the borrower to obtain more favorable terms on a permanent loan. During periods when the market for permanent loans is not particularly favorable, a borrower may elect to obtain a bridge loan as short-term financing in the hopes that the permanent loan market will improve during the term of the bridge loan.

4. **Mezzanine Loans**. The term "mezzanine" comes from the architectural world, where a mezzanine is an intermediate level between two floors. In the commercial loan context, "mezzanine" refers to a form of financing that is a hybrid of (or intermediate level between) debt and equity financing. In a real estate transaction, the mezzanine financing is secured not by the real estate, but by a right to an ownership interest in the borrower entity; accordingly, if the borrower defaults, then the lender may take that ownership interest in payment of the loan (convert the debt into equity). Perhaps for this reason, companies often list mezzanine financing as equity, rather than debt, on their balance sheets. Mezzanine loans are subordinate in priority to (paid only after payment of) pure debt, but are senior

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in priority to pure equity and, as a result, can be considered to be more expensive debt (due to having a higher level of risk than pure debt) or less expensive equity. Due to their hybrid nature, mezzanine financing may provide a borrower with access to financing that otherwise would be unavailable.

REVOLVING LOANS

Revolving loans (or revolving credit facilities) are loans of up to a stated maximum principal amount (or credit limit), the proceeds of which can be borrowed and repaid repeatedly so long as, at any given time, no more than the stated maximum principal amount (or credit limit) is outstanding. The primary benefit of a revolving loan is flexibility, not only in that the borrower can borrow, repay and reborrow funds as needed, but also because there are few (if any) restrictions on the use of the funds. Further, at times when no amounts are outstanding, no interest accrues. The drawbacks to revolving loans are higher, and often variable, interest rates and periodic loan maintenance fees. The most common commercial uses of revolving credit are to fund operating and other short-term expenses.

AMORTIZATION PERIOD VS. LOAN TERM

A brief note about the difference between the “term” of a loan and the applicable “amortization period” for that loan. A loan’s “term” is the contract term—the period for which the loan documents remain in effect (absent prepayment or other earlier termination). A loan’s “amortization period” is the amount of time it would take to pay off the loan if the term of the loan extended until the date on which the regularly scheduled payments of principal and interest (the “amortizing payments”) reduce the outstanding loan amount and unpaid interest to $0.00.

If, for a loan, the term and the amortization period are the same, then the loan is said to be “fully amortizing” and there is no balloon payment due at the end of the term.

If the term and the amortization period are different, then the amortizing payments are calculated based on the fiction that the term and the amortization period are the same, but on the final date of the term (the maturity date), there is a balloon payment in the amount of the outstanding principal balance, together with all accrued and unpaid interest.

SECURITY

Most, though not all, term loans (and some revolving loans) are secured. A secured lender assumes less risk than an unsecured lender, which enables it to charge lower interest rates, which in turn reduces the cost of capital to the borrower.

To “secure” a loan, the borrower grants the lender a legal right to take control of certain specified assets if the borrower defaults under the loan documents. The right granted by the borrower is a “security interest,” and the property with respect to which the borrower grants the security interest is the “collateral.” Collateral can be anything in which the borrower can grant a right in favor of the lender; the type and assets of the borrower and the nature and purpose of the loan will influence the type of collateral required.

For questions or additional information on this topic, please contact:

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