

## COMMERCIAL REAL ESTATE



# Understand loan commitments and avoid costly litigation later

Loan commitments map or outline the leading portion of a real estate transaction. Since litigation involving disputed loan commitments is extremely expensive and time consuming, an understanding of the loan commitment is essential for both borrowers and lenders.

A loan commitment is an agreement between a borrower and a lender who agrees to lend to the borrower a specific amount of money, at a certain interest rate, to be funded within a specific period of time and to be used for a specific purpose. It identifies the parties and details their relationship, spells out how each is to perform and includes loan documentation, default provisions and remedies.

There are three main types of loan commitments — binding, contingent and non-binding.

In Texas, the majority of loan commitments originally took the form of binding loan commitments — enforceable contracts, which could be breached by either the lender or the borrower. Analogous to an enforceable contract, the binding

loan commitments could give rise to actual damages in case of a breach by either party.

Over time, however, both lenders and borrowers became wary of litigation and court costs associated with disputed binding loan commitments. They began modifying the binding commitment by adding provisions that set up contingencies and conditions to the obligations of either the borrower or the lender.

## BINDING LOAN COMMITMENT

Because they establish a binding contractual relationship between the borrower and the lender, binding loan commitments are detailed and comprehensive. They have consideration, generally come without conditions or contingencies, are complete and have all of the necessary elements of a contract.

They should also contain a provision that sets forth the remedies of each party in the event of a default. From the borrower's perspective, the remedy provision should provide that the payment of the application/commitment fee that was paid at the time of execution of the binding loan commitment is the sole and exclusive remedy of the lender in the event of a breach by the borrower.

The binding loan commitment should also set forth the specific loan documentation that will be required and all of the material provisions of the loan.

Typical language included in the binding loan commitment includes statements such as:

- "This loan commitment is meant to be binding."
- "This proposal is a binding commitment by the lender to lend funds to the

borrower."

## CONTINGENT LOAN COMMITMENT

A contingent loan commitment is a contract between the borrower and the lender and consists of many of the material loan provisions in a binding loan commitment. The contingent loan commitment, however, will provide that the obligation to fund the loan will be contingent upon the lender's approval of many contingencies or conditions such as:

- The loan documentation.
- Financial information of the borrower or guarantor.
- Security or collateral for the loan.
- Appraisals.

Those contingencies have been interpreted differently by lenders and borrowers. Borrowers who have submitted documentation to previous lenders and obtained loans often believe that the current lender's contingencies will be satisfied if that same documentation is

provided to the current lender. However, different lenders have different loan requirements. The current lender may reject the borrower's deliveries of information and its contents even though such deliveries and contents may have been accepted by a previous lender.

The borrower may assert that "it had a deal" with the lender and file a

lawsuit to try and enforce what it perceives was a valid commitment for a loan. Consequently, disputes over contingent loan commitments have been the source of many lawsuits in Texas.

## NON-BINDING LOAN COMMITMENT

The purpose of the non-binding loan commitment is to outline the planned loan terms, where the intention of the lender and the borrower is not to form a binding contract or a binding loan commitment.

Lenders and borrowers often use this type of loan commitment to determine if they are close to an agreement in principle so that both parties are assured that it will be worth their time and money to begin the negotiation of specific loan documents.

A non-binding loan commitment will explicitly state that it is non-binding, yet in many instances a lender will require a payment of some amount of money, usually to cover expenses and not as a commitment or application fee.

Typical language included in the non-binding commitment includes:

- "This is a non-binding loan commitment."
- "This term sheet is not a commitment to lend."
- "Proposal letter only — this is not a commitment to lend."

Lenders and borrowers alike should be prudent when executing loan commitments so that each party understands the ramifications of executing the loan commitment and the failure to abide by its terms. ■

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