Seven Deadly Sins of Loan Documents and How to Level the Playing Field

By Brad Goss, Partner, SmithAmundsen LLC

Loan documents are often described as "standard" or the terms within them routinely referred to by lenders as "boiler plate." Careful review by a borrower is often limited or discouraged as frequently the loan documents are only ready for review on the date of closing. The pressure of getting the deal done and the optimism of starting a new project feeds into the temptation to "just sign and get on with it." And, who wants to spend money on lawyers who are just going to mess up the deal, right? In a rising market and strong sales, the risks seem small, outweighing the expense and potential to alienate the lender, an important relationship in any successful project and a person who will frequently describe himself as a "partner" in the building project.

While the lending relationship is critical to a builder's success, it is not a partnership. The lender does not intend to share in losses of the project and as the lender has capital at risk, the loan documents are written to maximize the remedies of the lender to recover this capital in the event of a default or the loan coming due without any default. The lender owes a duty to its shareholders and depositors to protect deposits and maximize investment by drafting the loan documents in a manner that ensures capital recovery in as swift and comprehensive a manner as possible.

In the most recent downturn, under pressure from state and federal regulators, lenders increasingly refused to renew loans, despite verbal promises to the builder to do so, or would only do so if the builder deposited significant additional capital or pledged additional collateral to the bank. This insistence was particularly startling to builders who had not missed any payments, were not in default and had experienced a relationship in which loan renewals were casually and routinely given.

In light of this backdrop, careful reading of the loan documents and renegotiating certain provisions to level the playing field are essential. So, what's fair and what should builders attempt to change? What might be considered the "seven deadly sins" of unadulterated loan documents? A short list includes cross default and spreader or cross collateralization clauses, overly broad default clauses without notices of default and cure rights, set off clauses in loan documents, misunderstanding the implications of Section 432.047 and certain boiler plate clauses, inadequate loan duration or provisions for loan renewals, guarantees with overreaching terms, improper guarantors and overly expansive scope, and inappropriate loan covenants, including an absence of rebuilding rights and unrealistic performance covenants.

To focus on just a few of these problematic provisions, consider that cross default and cross collateralization clauses pose the risk of a failing project metastasizing into a set of destructive events that place the entire company at risk as the remedies of the lender are no longer confined to the failing project but spread across all of the projects upon which the company is working. Further, failing projects require time to correct and if the loan documents do not provide any opportunity for the builder to correct a default, a lender under pressure to protect its loan may take remedial action that with time the builder could have avoided by curing the default. Similarly, while considering time, a builder must in advance consider the timing of the project's completion in light of the loan term and be certain that an exit strategy is in place either at the time of loan origination or with sufficient time remaining in the loan term to avoid a demand for a loan payoff without funds to satisfy the demand. While carefully considering the business plan, a builder should also carefully consider the company's structure because advance planning may avoid the necessity for certain guarantees that place personal wealth at risk.

In short, careful planning on the front end in the organization of a company, management of the lending relationship, as well as review and negotiation of loan documents may make the difference between working through a failing project versus the failure of the company. Bn