Understanding When to Use Form Versus Custom Loan Documents

By Michelle R. Jester and Lisa M. Ashley

Form loan documents are a useful and cost-effective tool for lenders to use to document typical, straightforward loan transactions. However, being aware of when and when not to use them, and what they do or do not contain, will also provide a lender with security that the loan is properly documented and enforceable down the road.

If a transaction is complex, contains unique collateral or contains deal specific terms, a custom set of loan documents will more accurately set forth the loan terms and alleviate potential enforceability issues later on. The following are key considerations for adopting form loan document best practices.

When do lenders use "form" loan documents?

Most lenders in Minnesota use form loan documents in what is described as a "typical" loan transaction. A typical loan transaction is a straightforward deal that does not entail unique collateral, loan terms or covenants. Generally speaking, each lender has a threshold loan amount as to when an attorney is retained to prepare customized documents for a loan transaction. The most common dollar threshold amount in Minnesota for using custom loan documents is a loan in excess of the principal balance of $1 million.

Tip #1:

Lenders should use form loan documents in a typical loan transaction that does not include unique collateral, loan terms or covenants.

What are some potential issues with "form" loan documents?

One of the major issues with form loan documents lies in the fact that if you make any changes to the core terms or provisions of the documents, the assurances given by the vendor of the software as to enforceability can be void. Furthermore, each vendor of form loan documents is different in the coverage provided.

Lenders should thoroughly review and become familiar with the provisions contained in any form documentation used in transactions, as well as what coverage and limitations the documents contain. Lenders should also discuss with outside counsel any potential issues of risk or legal limitations in the documents. Not all form documents are equally user friendly, nor do all sets of form documents cover all issues equally comprehensively. Conduct a thorough review and selection process when choosing which vendor's form loan documents to use, so they best fit the lender's overall needs.

Depending on the vendor form utilized, the documents also may not contain the most up-to-date statutory changes that are applicable to Minnesota law. For example, the Minnesota Legislature in 2012 overhauled the receivership statutes; these important changes, which benefit a lender, may not be incorporated or even referenced. Verify that the license agreement provides updates on a consistent basis.

Oftentimes form loan documents are used in a complex transaction with unusual collateral or other atypical issues, and an addendum is included to override the provisions in the form loan documents to attempt to conform to the specifics of the loan. This method can be not only confusing, but also leads to contradictions and enforceability issues later if the loan does not perform as anticipated. For example, a lender may be forced to litigate over what terms apply or don't apply, based on the addendum and the words, or lack thereof, that are used to override the form loan document terms and provisions.

Tip #2:

Understand the terms and limitations of form documents and use custom loan documents where appropriate.

When should a lender use custom loan documents?

Custom loan documents should be used when the lender's threshold loan amount is reached or exceeded. Regardless of the amount of the loan, if a lender is faced with lending to a borrower that has collateral other than real property or common business assets, custom loan documents should be used. Some examples of uncommon collateral include a pledge of membership units, a brokerage account, insurance proceeds, or other third-party pledged security, which can require specifically tailored documentation. The reason additional documentation is necessary is to ensure that the collateral given is properly granted to the lender and make certain the lender has a perfected lien against the granted collateral.

Lenders may also choose to use customized documents when there will be material modifications to the terms of the form documents. These modifications may include changes to a borrower's covenants based upon the unique circumstances of the loan or the borrower or additional financial reporting or loan covenants. In these cases, customized documents will provide the proper forum for a lender to document the precise loan terms without the rigid structure of form documents. Custom loan documents also allow the specific terms to be documented more comprehensively and for the specific terms to be addressed more cohesively from document to document, which can alleviate potential enforceability issues.

If a borrower wants a set of documents prepared to be custom to a specific deal that more precisely documents the agreed upon loan terms, then lenders should discuss these issues with the borrower using customized documentation. In exchange for using customized loan documents, the borrower will pay for not only its attorneys' fees, but also for the lender's fees. The added cost is often offset by having a set of loan documents that more accurately documents the terms of the loan and an opportunity for due diligence and/or loan issues to be more thoroughly reviewed at the time of loan documentation. This generally results in fewer enforceability issues later on in a transaction and allows specific covenants to be documented as part of the loan.

Tip #3:

Custom loan documents should be used in loan transactions over a certain dollar amount or where the transaction contains unique collateral, covenants or terms.

Form Loan Documents continued on page 26

CLASSIFIEDS

Modular Bank Buildings

Looking to branch? Opening a new Charter? Disaster Planning? Need a temporary facility while remodeling? Call North American Buildings 888-800-8866. We have temporary/permanent modular bank facilities new and used. Fully equipped with office furniture and bank equipment. North American Buildings, 888-800-8866, www.NorthAmericanBuildings.com.

Index of Advertisements

Anastasi Jellum	11
Beisel & Dunlevy	7
Bell State Bank & Trust	25
Diebold	20
EO Johnson Business Technologies	5
Emergent Networks	2
Gislason & Hunter, LLP	15
Graduate School of Banking	23
Lindquist & Vennum	13
Manheim	28
North American Buildings	26
PULSE	27
Stein & Moore	18

Advertisements

The contents of advertisements that appear in the *MBA News* are solely the responsibility of the advertisers. Appearance of an advertisement in the *MBA News* does not constitute a recommendation or endorsement by the association or the *MBA News* of the goods or services offered. Publication of any advertisement may be subject to review by the *MBA News* Policy Board. For more information on advertising in *MBA News*, contact Terry Tiller at terryt@minnbankers.com.

Articles

MBA News regularly publishes a variety of by-lined columns authored by individuals whom we consider to be knowledgeable in their respective fields and who have a valuable message to share with Minnesota's banking community. Opinions in these columns, however, are those of the authors and do not necessarily represent the opinions of the Board of Directors, members, or staff of the Minnesota Bankers Association.

MBA News is printed on 30% recycled content paper.

Enterprise Risk Management continued from page 13

control implementation up to each department or responsible person to execute, instead of assessing a mile deep and only an inch wide.

This concept of a consistent framework will allow institutions to realistically compare areas of the institution and their associated risk. Trying to compare the output of individual risk assessments such as IT and Lending is more difficult than comparing apples and oranges; one really isn't even a fruit. The ERM processes can sit on top of these existing processes and provide a consistent framework of measurement. Again, not replacing those control activities or risk management practices, just measuring and reporting on them. This is empowering institutions to leverage all their existing controls in a new framework, taking credit and communicating risk management efforts. Work should not be duplicated with this new process, as it only measures controls and enables planning and management of risk.

When searching for the right solution to help your financial institution navigate its Enterprise Risk issues, keep these key points in mind. ERM does not need to be a mammoth process, it can and may be more quick and easy of an assessment than previously expected, which can then provide clear understanding of risk and drive decisions within your institution. ERM is a mile wide and inch deep process that provides continuous process improvement and value in the institution. Caution for those who venture a mile deep, ensure you have a broad enough process to truly encompass all areas of risk. ■

Chad Knutson, CISSP, CRISC, CISA
VP Research & Development
Secure Banking Solutions
Chad.knutson@protectmybank.com

Form Loan Documents continued from page 8

Every lender should establish a set of policies for when to use form loan documents and when custom documents will provide more accurate documentation and ensure loan enforceability. Using these policies consistently throughout the bank's lending groups will support not only loan integrity, but also enhance more effective communication with borrowers at the beginning of a transaction. Lenders should consult with legal counsel familiar with representing lenders in loan transactions if there is a concern about the contents of its form loan documents or what policies to use with respect to form and custom loan documents. ■

Michelle R. Jester, attorney in the Banking & Finance Group of Messerli & Kramer P.A., representing clients in real estate financing as well as representation of lenders in origination of loans, workouts, and foreclosures. mjester@messerlikramer.com,612.672.3600; www.messerlikramer.com.

Lisa M. Ashley, attorney in the Banking & Finance Group of Messerli & Kramer P.A., practicing in banking and real estate law to represent lenders, developers, landlords and investors. Her experience includes loan origination and workouts. lashley@messerlikramer.com, 612.672.3600; www.messerlikramer.com.

Michelle R. Jester
Attorney
Messerli & Kramer P.A.
mjester@messerlikramer.com

Lisa M. Ashley
Attorney
Messerli & Kramer P.A.
lashley@messerlikramer.com