

LOAN DOCUMENTATION: REQUIREMENTS AND SOLUTIONS IN A CHANGING REGULATORY ENVIRONMENT

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As a result of the economic downturn and the recently-passed financial overhaul legislation, banks of all sizes are being subjected to regulatory scrutiny on an unprecedented scale. While much attention is being given to large financial institutions and complex financial instruments, the enhancement of oversight and enforcement powers of the various federal regulatory authorities is also likely to have a significant impact on community banks. Likewise, in surviving the current crisis and continuing to push towards stability in a turbulent market, financial institutions are conducting aggressive reviews of their current policies and practices to minimize risk and increase shareholder value. Borne out of all of this regulatory reform is a growing awareness among community bankers that sound loan documentation practices are critical to mitigating risk.

Complex lending transactions that are inadequately or improperly documented can cause unnecessary credit exposure and give rise to a host of regulatory compliance issues. To begin with, the FDIC, OCC and Federal Reserve have all demonstrated an increased willingness to take action against financial institutions that do not adequately document lending transactions. Additionally, banks that properly document complex credit transactions significantly reduce the inherent risk of nonpayment and eliminate concerns about enforceability in bankruptcy or workout situations, difficulty in selling participations, and potential litigation resulting from intercreditor disagreements.

Interagency Guidelines Establishing Standards for Safety and Soundness require financial institutions to establish and maintain loan documentation practices that (i) enable informed lending decisions and risk assessment on an ongoing basis, (ii) identify sources of repayment and assess the ability of borrowers to timely repay the indebtedness, (iii) ensure all potential claims against borrowers are legally enforceable, (iv) demonstrate appropriate administration and monitoring of loans, and (v) adequately address the size and complexity loans.¹ In the current economic climate, regulators have become much more aggressive in reviewing, and in many instances criticizing, financial institutions' loan documentation policies and practices. In testimony before the House Committee on Financial Services last year, the Comptroller of Currency, John C. Dugan, cited loan documentation as specifically having an impact on a bank's safety and soundness, stating that "[t]he list of OCC enforcement actions in recent years illustrates the OCC's ability and willingness to take formal actions when warranted to require correction of unsafe or unsound banking practices."² While the Comptroller noted that loan documentation deficiencies are typically addressed through informal actions, he stated that in addressing more serious cases, "the OCC can and will take formal enforcement actions, as [its] track record clearly demonstrates."³

¹ Interagency Guidelines for Establishing Standards for Safety and Soundness, 12 C.F.R. pt. 30, app. A (2010).

² John C. Dugan, Comptroller of Currency, Testimony Before the Committee on Financial Services of the U.S. House of Representatives 7 (March 20, 2009), *available at* <http://www.occ.treas.gov/ftp/release/2009-26a.pdf>.

³ *Id.* at 5.

In addition to facing formal and informal actions by regulators, inadequate loan documentation increases the risk of banks experiencing enforceability issues if a borrower defaults. As the number of borrowers facing bankruptcy or workout scenarios has drastically increased in recent years, borrowers or their trustees (if in bankruptcy) increasingly look to exploit holes or weaknesses in documentation to reduce liabilities. In addition, courts have become more willing to dismiss foreclosure proceedings because of inadequate loan documentation.⁴ Indeed, banks that attempt to cut expenses up front through the use of standard, boilerplate forms may open themselves up to far more significant costs on the back-end.

While inadequate loan documentation can increase a bank's risk exposure in respect of its loan portfolio, deficient documents can also hinder a lender's ability to sell participations in its loans. Federal banking regulations specify that purchasing loans and loan participations may result in a finding of unsafe or unsound banking practices in the absence of the necessary documentation providing controls over risk.⁵ Prudent purchases of loan participations are governed by the credit principles and procedures embodied in the purchasing bank's lending policy, which should include a comprehensive analysis of the credit quality of the obligations to be assumed, an analysis of the value and lien status of the collateral and proper documentation detailing and securing the purchasing bank's interests.⁶ Banks are likely to refuse to purchase participations in loans backed by sub-standard documentation and risk loss of their investment and potential action by regulators.

Recently the American Bankers Association called attention to the "lax credit administration and complacency" issues which were causing loan participation investments to become a neglected element of a bank's loan portfolio.⁷ A March 2010 ABA Banking Journal article stressed that the failure to apply safe and sound credit practices to all aspects of loan participations could subject banking institutions and their directors and officers to legal liability, unintended legal lending limit violations and penalties, and regulatory enforcement actions.⁸ Noting that "[m]any very large deals have been documented with boilerplate contracts that may not be appropriate or well understood by the participants," the article emphasized that regulators were beginning to focus on this area as a result of the "significant legal, financial, regulatory accounting, and financial reporting issues [which had] arisen as a result of participant, servicer, and borrower defaults and bankruptcies."⁹

Fortunately, given the severe consequences of inadequate or unsuitable loan documentation, the potential solutions are fairly straightforward and easy to implement. First, in determining the loan documentation necessary for a certain credit transaction, lenders should create a term sheet that lays out the details of the proposed transaction with as much specificity as possible. Term

⁴ See BAC Funding Consortium Inc. ISAOA/ATIMA v. Jean-Jacques, 28 So.3d 936, 939 (Fla. Dist. Ct. App. 2d Dist. 2010); Countrywide Home Loans, Inc. v. Taylor, 17 Misc. 3d 595 (Sup. Ct. 2007).

⁵ OFFICE OF THE COMPTROLLER OF CURRENCY, BANKING CIRCULAR NO. 181 (REV.): PURCHASES OF LOANS IN WHOLE OR IN PART-PARTICIPATIONS 1 (1984).

⁶ See *id.* at 2.

⁷ Dave Weir & Curt Peterson, *Haunted by the Ghost of Loan Participations Past and Present?* ABA BANKING JOURNAL, Mar. 12, 2010.

⁸ *Id.*

⁹ *Id.*

sheets should include not only the details with respect to pricing, principal amounts and maturity, but a complete description of the proposed collateral, any financial or other covenants, conditions to their making of the loan and any necessary representations and warranties. In going through this exercise, banks will be forced to address not only the more straightforward risks with respect to cash flow and debt service coverage, but other issues such as the ability of a borrower to move cash out of the borrowing entity or enter into other transactions that may increase the risk to the lender. Creation of a term sheet will also provide insight into whether standard form loan documentation is suitable (*i.e.*, the loan is a run-of-the-mill transaction with little nuance or complexity) or whether legal counsel should be engaged to draft custom documentation. Particularly in the case of the latter situation, a term sheet will also serve as a road map to the borrower and lender and force the parties to agree to virtually all of the most contested points up front. This will drastically decrease the need to re-negotiate and make repeated substantive changes to the actual documentation, thereby reducing legal fees and other transaction costs.

Assuming a credit transaction contains the potential complexity that necessitates customized loan documentation, the lending institution should discuss the desired structure of the transaction with its counsel. Experienced counsel will provide advice with respect to (i) the documentation required, (ii) potential risks to the lending institution and steps to mitigate those risks through specific provisions in the documentation, (iii) types and amounts of collateral, (iv) the borrower information necessary for the lending institution to adequately reduce the transactional risk, (v) ongoing reporting requirements that will provide the lending institution with early warning of any financial trouble of the borrower, (vi) issues with current and future security interest holders and potential intercreditor issues, and (vii) typical market practices regarding pricing, documentation and covenants. Counsel should also be able to manage the transaction, negotiate with borrower's counsel or counsel for participating creditors and facilitate signing and closing.

It is important to note that while custom documentation will result in higher legal fees than the use of standard forms, those costs are mitigated by the significant reduction in risk to the lending institution, the avoidance of formal and informal penalties from banking regulators for unsafe or unsound practices and the enhanced ability of the lending institution to sell participations in the credit facility. Additionally, the bulk of legal fees and expenses are typically passed on to the borrower and are not borne by the lending institution itself.

While standard documentation may still be suitable for routine, small-dollar loans to individuals, most complex financial transactions with commercial entities require custom loan documentation to adequately protect a lending institution against foreseeable transactional risk. Additionally, the level of oversight and scrutiny of loan documentation policies and practices by regulators will undoubtedly increase as a result of the recent financial reform legislation. Customized loan documentation will in many cases prevent any safety and soundness concerns that might otherwise arise from the use of standard form documents.

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