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Fundamentals of Loan Contracts: A Look At SOME Important Provisions

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Perusing a loan agreement could be burdensome and seem unfathomable. Fine prints and rather multiple long provisions with rarefied jargon could be a nightmare for the unsophisticated and unprofessional. As such, it might make sense to look at some of the provisions which could pose the most imminent potent perils to the borrower. In this article, we attempt to explore SOME of the salient provisions of a loan document in some detail.

1. ALLOCATION OF PAYMENTS PROVISION

It is often customary and really hard to change the provision discussing allocation of payments. Such provision often provides that loan payments are allocated based on the following formula: First, the loan payment is applied to the interest due and then the remaining is applied to the principal.

This provision is extremely important since the more principal remains the more interest accrues. In other words, if the loan payment would first apply to principal, the amount of principal would go down and as a consequence the less interest will be paid over time. But, in most usual circumstances, as reiterated above, the loan payment will first reduce the interest to the amount agreed to by the parties on an APR basis and then, if any, the loan payment applies to the principal and reduces the principal. Undoubtedly, this sequence of allocation is favorable to the lender and not the borrower.

2. LATE CHARGES PROVISION

There are a few salient points with respect to late charges provision in a loan agreement:

1. **Late Charges Applied To Any Unpaid Portion:** It is often the case that if borrower by a certain date does not pay the ENTIRE loan payment due, the borrower incurres a late charge. Thus, the late charge might apply if borrower did not pay the entire amount due or

hypothetically a dollar less. This rather draconian measure could be mitigated through negotiation and compromise.

2. **Administrative Costs Could Be Tacked to Late Charges:** On top of Late Charges, there could be usually Administrative Costs related to collecting AND accounting for that particular installment.

3. INTEREST ON UNPAID INTEREST

One of the other draconian provisions of a loan agreement pertains to the interest charged on the interest portion of the loan payment already due and delinquent. Often, the loan agreement provides that the interest on this amount is higher than the rate charged to calculate loan installments. It is possible that if the interest portion of the installment has not adequately been paid, a larger interest has to be paid through compounding of the interest i.e. the higher interest rate is charged on both the principal and the accrued interest thus resulting in a much higher loan payment.

4. ACCELERATION CLAUSE

Often, loan payments provide for Acceleration clauses. Acceleration clauses are synonymous with their function. If the borrower DEFAULTS on the installment payment, then the entire loan payment PLUS interest become DUE immediately (accelerated) at lender's option.

5. BALLOON PAYMENT

Balloon payments are synonymous with the name i.e. a loan payment arrangement in which the borrower makes relatively smaller amounts during the term of the loan mostly interest payments and then when the loan is due - unless it is refinanced - the borrower has to make one huge payment (balloon payment). Such loan arrangements could be devastating to the Borrower unless the Borrower could secure financing prior to the end of the loan term. If financing is not secured and the due date arrives, then the Borrower will be in serious trouble.

Nonetheless, there could be some other arrangements negotiated to mitigate such eventuality.

DISCLAIMER

This article NEITHER supplants NOR supplements the breadth and depth of such rarefied topic. In fact, this article ONLY provides a rather rudimentary synopsis of such esoteric subject matter.

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