

## **Navigating the In's and Out's of Liquidating a Small Business Administration Loan** **By Kelly A. Karstaedt, Esq. and Charles B. Jimerson, Esq.**

The Small Business Administration (“SBA”) has been providing small businesses with loans since its creation in 1953. Its mission statement is “...to aid, counsel, assist and protect the interests of small business concerns, to preserve free competitive enterprise and to maintain and strengthen the overall economy of our nation.” It is clear that the strength of today’s economy is making liquidation of these loans more of a priority than in previous decades. Now, one of the most important pieces of information a bank should know about an SBA loan is how to properly liquidate it.

The SBA provides loans to businesses by backing lender-issued loans and guaranteeing payment of the loan. Guaranteeing the loan means that, should the business default on the loan, the SBA will guaranty the bank recover any outstanding loan funds by “purchasing the guaranty.” In other words, the SBA will pay to the bank the remainder due on the loan. The entire process is referred to as liquidation. By engaging in this process, the lender shifts the risk of loss on the loan to the SBA while still retaining control over loan administration during the time the loan is active.

There are two main types of SBA loans: 7(a) and 504. A 7(a) loan is a lender-issued loan that can be used by a small business for a variety of different purposes. A 504 loan typically involves a senior loan issued by a lender and a junior loan issued by a Certified Development Company (“CDC”) along with some contribution by the Borrower. This type of loan may only be used for major, fixed assets, such as buildings or land. The procedures for liquidating a 7(a) or 504 loan are very similar, but there are a few differences that must be noted. This article will focus on outlining the general steps, but will include any specific differences in procedure for 7(a) versus 504 loans.

### **Classifying a loan as in liquidation status.**

The first step in liquidating any loan is to confirm that it qualifies for liquidation under the SBA. There are eight categories for classifying a loan as in liquidation status:

1. The loan is more than 60 days past due;
2. A foreclosure action has been initiated against collateral securing the loan;
3. A lawsuit has been initiated against a Borrower that may adversely affect ability to repay the loan;
4. A voluntary or involuntary petition for bankruptcy has been filed;
5. The business has been shut down or abandoned and other payment arrangements have not been made;
6. Substantial collateral has been abandoned or in danger of disappearing, losing its value, or being stolen;
7. A receiver has been appointed or some other action has been initiated to liquidate collateral; or

8. Any other circumstances that could adversely affect repayment of the loan.

Once it has been determined that the loan qualifies for liquidation, notice must be sent to the appropriate Commercial Loan Service Center requesting transfer of the loan to liquidation status. Loans originating in the eastern or mid-eastern United States are referred to the service center in Little Rock, Arkansas; loans made in the western or mid-western United States are handled by the service center in Fresno, California. Please refer to the SBA website at [www.sba.gov](http://www.sba.gov) for more information and to obtain the appropriate mailing addresses. Requesting a transfer means the loan will be moved from the Commercial Loan Service Center to the National Guaranty Purchase Center to await further information from the Lender. Transfer into liquidation status does not affect the need to continue reporting the loan on any required monthly or quarterly reports created by the Lender.

#### Conducting a Site Visit

The SBA requires that a site visit be conducted for any loan that has been transferred to liquidation status if the loan is secured, recoverable personal property will be greater than \$2,500 or recoverable real property is valued at more than \$5,000. If a site visit is required, it must be performed within 60 days of an uncured payment default or within 15 days of any adverse event that caused the transfer to liquidation, such as the business shutting down or bankruptcy being filed.

The ability for the Lender to conduct a site visit is typically contained within the default provisions of the Note and/or Security Agreement. The language will require that, upon default, the Borrower must make available all collateral for inspection by the Lender. A site visit should be coordinated between the Lender and the Borrower, or each party's respective counsel. It is likely the situation will arise where a Borrower is either uncooperative or cannot be contacted to schedule a site visit. In such case, the Lender may repossess the collateral without the cooperation of the Borrower so long as the means utilized do not breach the peace. Otherwise, legal action will be required to enforce any contractual default provisions and gain access to the property. A Lender must also consider taking any steps necessary to protect the collateral. If a Borrower is being evasive, the likelihood that the collateral will either disappear or be destroyed greatly increases. The Lender should consider moving for injunctive relief to keep the Borrower from absconding with the collateral or otherwise engaging in any activities that may jeopardize recovery.

Any and all information obtained from a site visit should be documented in a report that will be provided to the SBA at a later time. Some items to consider when conducting a site visit include taking a full inventory of all collateral, identifying any occupants if real property is collateral, reviewing any environmental risks that may need to be dealt with and reviewing the Borrower's books for proper usage of the loan funds.

It is important when conducting a site visit to carefully catalog all collateral that remains in the Borrower's possession and come up with a plan for preserving same. If this is not done, there may be issues when reporting the site visit to the SBA, such as undervaluing or failing to

properly care for or prevent theft of collateral. Any such issues may delay, or even hinder, a Lender's ability to recover the outstanding balance of the loan under the guaranty.

#### Requesting Reassignment of a 504 Loan and Purchasing the Debenture

If a CDC is the party responsible for collecting on the loan, the loan must be reassigned from the SBA to the CDC. The CDC must make this request prior to taking any liquidation or litigation actions. The request must include the reason for the reassignment, the loan documents to be reassigned and a litigation plan if litigation is contemplated. Any time after reassignment, and at its sole discretion, the SBA may reassign loan documents back to the SBA and take over liquidating the loan. Under these circumstances, the CDC is required to return all reassigned loan documents back to the SBA.

The debenture, or bond guaranteeing the debt, should also be purchased by the SBA before engaging in any collection methods. The CDC must submit a written request to the SBA for the purchase to be made. After purchase, the SBA will notify the CDC that purchase has been completed to allow the CDC to proceed with liquidation and/or litigation. For additional information, please see the bLAWg article entitled *Considerations in Foreclosing SBA 504 Mortgages* at <http://jimersoncobb.com/blawg/2010/08/30/considerations-in-foreclosing-sba-504-mortgages/>.

#### Liquidating Assets

In many cases, before a Lender is able to liquidate collateral, a liquidation plan must be created and submitted to the SBA for approval. Such cases include where the loan was authorized under a Certified Lender Program, the collateral is being sold to associates of the Lender or a sale to associates of the Borrower. In any other case, a liquidation plan is recommended for internal use by the Lender to organize the process, but one is not required for submission to the SBA. The liquidation plan should be created immediately after a site visit is conducted and, if so required for submission to the SBA, submitted as quickly as possible. In the case of a 504 loan, a liquidation plan must be completed and submitted for approval in all cases within 30 days of purchase of the debenture.

Once a liquidation plan is created, and approved if necessary, liquidation of any collateral should commence at once to avoid any further depreciation in value or the risk of losing the collateral to a nefarious Borrower. The Lender must take possession and arrange for liquidation by any "commercially reasonable" means. I also suggest cost effective because expenses incurred for preserving and liquidating collateral may be recoverable from the SBA. Logic would seem to suggest that only reasonable expenses will be paid so do not get extravagant when conducting appraisals and preserving collateral or you may not see a return of your costs.

What if the Borrower denies the Lender access to collateral for repossession and liquidation? UCC § 9-609 requires taking possession of collateral without judicial process by means that do not constitute a breach of the peace. Therefore, all precautionary steps must be taken to ensure that liquidation proceeds in the most reasonable, and peaceable, of manners. In the case of a Borrower blocking the Lender's ability to repossess, judicial means will be necessary, such as an action for replevin.

### Litigation as a Method of Recovery

A Lender may also file a civil action against the Borrower to recover under the loan, such as an action for monetary damages on the note or a foreclosure action on any real property securing the loan. If litigation is contemplated, the SBA requires a litigation plan be created and submitted for approval if the litigation is anticipated to be non-routine or if legal fees will likely exceed \$10,000. In all other cases, a litigation plan is not required but may be helpful for internal use by the Lender and/or its legal counsel.

During the course of any litigation, copies of any significant pleadings must be submitted to the SBA. Significant pleadings include counterclaims, final judgments, etc. All other pleadings should not be submitted. Also, if any material changes take place during the pendency of the case that were not addressed in the original litigation plan, or if fees increase by 15% or more, an amended litigation plan must be submitted to the SBA for approval before continuing with the case.

There is no requirement by the SBA to engage in litigation to collect on the loan. If litigation is included in the plan for recovery, the SBA requires that the litigation be necessary, reasonable and customary for the locality as well as cost effective. If a judgment is obtained, the SBA requires that any non-exempt assets be executed on within 90 days of entry of the judgment, if possible, and the judgment be recorded in any state the Borrower has assets. Even though litigation is not a requirement, it may be the best method for collecting on the note if liquidation is not feasible to recover a significant portion of the debt owed. Filing suit on the note, especially when there is a personal guaranty involved, can push the Borrower into making payments. Also, if payments are not forthcoming, it can expand the avenue for recovery by opening up the ability to collect on the guarantor's personal assets.

In the situation where a bankruptcy action is pending against the Borrower or any guarantors, the Lender has the responsibility of keeping up-to-date on the bankruptcy action and intervening where necessary to protect its investment. This includes filing a proof of claim and participating in the litigation as necessary to avoid discharge of the debt.

### Purchasing a 7(a) Guaranty

In the case of 7(a) loan, the SBA will guaranty that the entire loan, or a portion of the loan, will be assumed and repaid by the SBA upon Borrower's default. The Lender is required to request the SBA purchase the guaranteed portion of the loan, thereby being paid for whatever remains outstanding on the loan balance after all other avenues of recovery have been exhausted. A request for purchase of the guaranty should not be made until after all collateral has been liquidated and litigation and collection efforts have ceased. There is no requirement that a judgment be obtained or all possible collection avenues taken, but the SBA will review the purchase package for such items if litigation was performed. Failing to take reasonable and cost effective avenues of recovery may delay, or even permit a denial of the request, until such steps are taken. It would be wise to exhaust all potential collection methods, such as discovery and garnishment, before requesting an SBA guaranty purchase. A request for purchase can be made by using the SBA's Tab System, which can be found on the SBA website at <http://www.sba.gov/content/regular-7a-guaranty-purchase-package-tabs>.

If a Lender sold the loan to an investor on the secondary market, the SBA will often request that the Lender purchase back the guaranteed portion of the loan. Alternatively, the Lender can submit a request to have the SBA purchase the guaranteed portion of the loan directly from the secondary market investor. If the SBA is the direct purchaser, the Lender must submit a loan status report to the SBA within 15 days after the guaranty is purchased and the standard purchase package within 45 days of the purchase. Therefore, whether the SBA purchases the guaranty from the Lender or a secondary market investor, the Lender must still submit a purchase package to the SBA for review and entry into their files.

### Recovering Expenses

The SBA provides a means and method of recovering expenses incurred in the liquidation of collateral or during litigation. Some items that can be recovered include appraisal fees, any measures taken to preserve collateral and litigation expenses, such as costs and attorney's fees. Expenses can be recovered by either deducting the expenses from any money recovered from the Borrower or by submitting a request for reimbursement to the SBA. In the case of a 504 loan, the CDC may also submit a request to the SBA for it to directly pay a vendor for services rendered.

A request for reimbursement must be submitted to the appropriate SBA Loan Center using the Tab System for a 7(a) loan. A 504 loan request may be a simple letter but must include the CDC contact information, a summary of expenses, itemized invoices and any supporting documentation. Expenses that are less than \$5,000 should be compiled and submitted quarterly or whenever the aggregate reaches greater than \$5,000. Any individual expense that exceeds \$5,000 may be submitted at any time.

### Wrapping Up Liquidation

Once liquidation and litigation have been concluded, the guaranty has been purchased and all available methods for collecting on the loan from the Borrower have been completed, it is time for the final wrap-up report. The Lender must create and submit to the SBA a report detailing all efforts made and outcomes achieved through the liquidation process. This report must be submitted within 90 days of completing all reasonable and cost-effective measures. Also, if more than \$600 was charged-off, the Lender must issue a 1099-C to the Borrower and the IRS. Once the SBA approves the wrap-up report, a Lender or CDC may close its file and keep it in accordance with applicable record retention policies. The time necessary to liquidate an SBA loan varies in each case. Some loans may only require a few months from the time of default to exhaust all liquidation avenues and close out the loan. Others, in situations where the debtors are unresponsive or evasive and/or litigation is contested, could take years to fully complete.

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