

Considerations in Foreclosing SBA 504 Mortgages

By: Charles B. Jimerson, Esq.

Overview of typical SBA 504 transactions

Banks and other lending institutions offer a number of US Small Business Administration (“SBA”) guaranteed loan programs to assist the development of small businesses. While the SBA itself does not make loans, it does guarantee loans made to small businesses by private and other institutions. Specifically, the US SBA 504 loan or Certified Development Company (“CDC”) program is designed to provide financing for the purchase of fixed assets, which usually means real estate, buildings and machinery, at below market rates. The 504 Program cannot be used for working capital or inventory, consolidating or repaying debt, or refinancing. The SBA 504 program works by distributing the loan among three parties. Typically, a 504 project includes:

- A loan secured from a private sector lender with a senior lien covering up to 50 percent of the project cost;
- A loan secured from a CDC (backed by a 100 percent SBA-guaranteed debenture with a junior lien) covering up to 40 percent of the total cost;
- A contribution from the borrower of at least 10 percent equity.ⁱ

Generally, the project assets being financed are used as collateral. Personal guaranties of the principal owners are also required.

Actions upon 504 loan default

In the event of default, the priority lienor, the SBA and the CDC agree to cooperate in liquidating and/or selling the common collateral. Any liquidation of the loan must occur in a prudent and commercially reasonable manner. The SBA considers it to be a commercially reasonable practice for lenders to purchase or maintain hazard insurance on worthwhile collateral after a loan has gone into default, as well as public liability coverage. Lenders may request that SBA share in the premium expense. Site visits to inspect collateral after defaults are typically required. Lenders should prepare a comprehensive listing/inventory of collateral at default along with an assessment of the collateral condition based upon the site visit. Lenders can substitute third party inspection reports from inspection or appraisal services firms as long as the costs are reasonable and customary and the services are provided within the specified SBA timeframes. The SBA encourages the lender to consider workouts wherever possible prior to liquidation. If a workout agreement is reached, the Lender must notify SBA in writing of the existence and terms of the agreement.

Typically, most Third Party Lender Agreements on SBA 504 loans contain Notice of Default provisions which require the priority lien holder to give the CDC and SBA written notice of borrower default within thirty (30) days after the event of default and sixty (60) days notice of foreclosure upon

the common collateral. As you can imagine, this notice requirement is not often built in to the action plans of lenders looking to expedite the liquidation of a troubled asset and remove the liabilities from its books. Therefore, it is prudent for the lender or lender's counsel to ensure the proper noticing guidelines are followed contemporaneously with or shortly after mortgage default and acceleration. It is also worthwhile to reach out to the CDC and the local SBA litigation counsel to obtain a waiver of this notice requirement that will enable the lender to initiate foreclosure at a sooner date. For additional general pre-foreclosure considerations, please visit our Banking Law and Commercial Foreclosure FAQ's at <http://www.jimersoncobb.com/html/bankingfaqs.html>.

SBA defenses in foreclosure action

Because the loan documents clearly specify that the lien or security interest held by the CDC or SBA will be junior and subordinate to the lien or security interest held by the priority lender unless otherwise agreed upon in writing, it is atypical to receive any Answer from the U.S. Attorney on behalf of the SBA that raises defenses other than the customary defenses. Conventional defenses include:

- Reservation of one year right of redemption;
- 30 days to deliver a treasury check in the event of successful bid at sale;
- The US is not bound by the sixty day time period imposed by *Fla. Stat.* §45.032 for distribution of surplus proceeds;
- SBA's lien is not subordinate to any Default Provision Fees (per language of SBA standard Third Party Lender Agreements), which characteristically include prepayment fees, default interest rates, monetary borrower penalties and late payment fees and charges; and
- Lenders are precluded from recovery on future advances except for those expenditures to collect on the loan or maintain the collateral.

The most substantive of the standard defenses asserted by the SBA is the reservation of the right of redemption pursuant to *28 U.S.C. 2410 (c)* within one year from the date of the foreclosure sale. Fundamentally, the right of redemption occurs when a party pays off a superior mortgage to protect its interests from being extinguished. In actions in which the United States has a lien and is joined as party – as actions where the U.S. Small Business Administration is a party – its redemption period is one year from the date of foreclosure sale. *See 28 USC Sec 2410*. With federal liens, redemption requires the amount to be paid for such property shall be the sum of—

(1) the actual amount paid by the purchaser at such sale (which, in the case of a purchaser who is the holder of the lien being foreclosed, shall include the amount of the obligation secured by such lien to the extent satisfied by reason of such sale),

(2) interest on the amount paid at 6 percent per annum from the date of such sale, and

(3) the amount (if any) equal to the excess of

(A) the expenses necessarily incurred in connection with such property, over

(B) the income from such property plus (to the extent such property is used by the purchaser) a reasonable rental value of such property.

Managing or eliminating the SBA's one year right of redemption at and after Foreclosure Sale

It is my opinion that 28 U.S.C. 2410 governing the amount paid at sale is a poorly written and nebulous guide post. Because the redemption amount is "the actual amount paid at sale (which, in the case of a purchaser who is the holder of the lien being foreclosed, shall include the amount of the obligation secured by such lien to the extent satisfied by reason of such sale)," the amount of the judgment and the effects of the right of redemption affects the amount bid at sale. Where a nominal bid is advisably made to save on documentary stamp taxes, considerations in bidding should be given to ensure that the SBA redeemer would have to bid full judgment amount to redeem the property.

After the sale the U.S. SBA will have a one year redemption right from the date of the foreclosure sale to redeem its subordinate lien. The SBA's one year period of redemption constitutes a cloud on title to the property which limits the marketability of the property and may have detrimental effect on achieving maximum value through a sale. A situation in which the SBA may exercise its right of redemption could occur if the foreclosing lender bids up to or receives credit for its judgment value, but does not satisfy the SBA's lien and the SBA believes the property is worth more than the foreclosure sale proceeds and thus exercises the right by satisfying the judgment/bid amount. It is prudent to speak with the U.S. Attorney, CDC and if applicable the local SBA litigation counsel in advance of the sale to ascertain their intentions in this regard.

In these economic times, absent a large amount of equity in the property, it is unlikely that the US SBA will exercise their redemption right at sale or anytime thereafter. If they do, however, it is likely a good thing for the priority lienor since the SBA will satisfy the judgment (or fair market value of property) + post-judgment statutory interest + expenses incurred during the time period in which the foreclosing lender holds the property. Under this circumstance, the only way redemption could have negative implications is if the foreclosing lender has a buyer on the hook and this lingering redemption right scares the putative buyer away, or the SBA exercises the right and the foreclosing lender loses a lucrative turnaround deal. Again, it is unlikely that either of those things will occur in this marketplace.

The more realistic situation is one in which the foreclosing lender finds a buyer and seeks a waiver from the SBA of their redemption rights. Absent a written, recordable waiver of the SBA's right of redemption, the foreclosed property cannot be conveyed with clear title until one year after the foreclosure sale. My experience is that this is achievable in exchange for minimal consideration. The U.S. Attorney often forwards such requests to the local SBA litigation counsel, who in turn works with the CDC and Commercial Loan Department in Little Rock, AR.

In facilitating this release, the SBA frequently requires a written communication documenting terms of existing offers made by potential buyers (including brokerage commission breakdowns), a breakdown of known equity, a copy of the judgment and certificate of title, a current appraisal and an offer of cash consideration for release of the right. Once this information is received, the SBA is then able to sign off on the release. In dealing with the SBA through this process, it is important to

communicate that time is of the essence if a potential qualified buyer is “on the hook.” It is quite possible to get lost in SBA bureaucracy if a sense of urgency is not conveyed. A 45-60 day post-foreclosure resale closing seems to be the norm, as it usually takes that long to obtain and record a Certificate of Title and a Release of Right of Redemption.

Once the property has sold or is set for resale, at that point it is prudent to assess and begin the process of seeking deficiency judgment. The process differs depending on whether the foreclosing lender can sell the property expeditiously or not. The measure of damages in deficiency is the difference between the judgment amount and the value of the mortgaged property as of the date of the sale, and deficiency proceedings often come down to a battle of the adverse real estate appraisers.

SBA 504 loans are a veritable briar patch waiting to snag lenders tromping down the commercial foreclosure pathway. As such, it is advisable to retain competent legal counsel at the onset to advise in issues minor and major to protect the lender’s rights.

ⁱ US SBA- <http://www.sba.gov/financialassistance/borrowers/guaranteed/CDC504lp/index.html>