Banking & Financial Services Report

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SBA Loans Pose Hidden Risks for Unwary Lenders

SBA loan programs give lenders the flexibility they need to finance small businesses that might not otherwise qualify for loans. Generally, SBA loans spread a borrower's credit risk between the lender and the government, which acts as either a guarantor or second-tier lender, thereby increasing the likelihood of the lender recovering on its loan in the event of a default.

While the government's involvement is reassuring, it does not guarantee a favorable outcome for the lender. Many technical underwriting and due diligence requirements must be complied with, or the Small Business Administration could seek to avoid its obligations to the lender. Below is a primer on how to avoid the hazards that too often foil lenders in connection with SBA loans.

Maintaining Proper Documentation

An SBA loan applicant must meet and certify that it conforms to certain size and control requirements. Size and control determinations are based on several factors relating to the entity and its affiliates. Not surprisingly, many of these factors are subjective and open to interpretation. Thus, it is important to ensure that the application is clear, precise, and thorough in documenting that the business does satisfy the stated requirements.

Small business applicants must also demonstrate the need for the SBA to guaranty the loan. Ultimately, however, the lender is responsible for making this determination – by documenting the factors that prevent financing without SBA support, and by certifying that credit is not otherwise available. The lender *must* retain this explanation in the applicant's file. A lender's failure to adequately support its need determination and maintain supporting documentation may provide the SBA with grounds to void its guaranty in the event of a default.

Avoid These Two Common Mistakes

Lenders risk adverse consequences when they fail to adequately monitor a borrower's use of SBA-guaranteed loan funds. In order to qualify for most SBA loan guaranty programs, a borrower must submit a proposal or project description showing that the funds will be used for an eligible purpose (for example, renovation, construction, or purchase of land and building). A lender's failure to monitor the borrower's use of funds can, in some cases, provide the SBA with a basis for avoiding its guaranty obligations.

In addition, lenders should be vigilant about timely paying the SBA loan guaranty fee. Failure to pay the fee within 90 days of SBA approval will lead to cancellation of the guaranty agreement. [*continued on reverse*]

About the Firm

In 2011 Shapiro Sher Guinot & Sandler was named the top medium-size law firm in Maryland for "Business & Transactions" by Super Lawyers, a division of Thomson Reuters. The firm represents clients in numerous practice areas, including banking, bankruptcy, corporate, real estate, tax, and commercial litigation.

The firm's banking lawyers provide experienced counsel in connection with all aspects of commercial loans. Co-chaired by **K. Lee Riley, Jr.** and **Scott W. Foley**, the firm's **Banking & Financial Services Group** represents regional and community banks, credit unions, finance companies, pension funds, and other financial institutions in Maryland and throughout the Mid Atlantic.

Mr. Riley advises financial institutions in commercial lending transactions; Mr. Foley advocates for financial institutions in commercial loan workouts, restructurings, and bankruptcy proceedings. Because the group has extensive experience in the origination of loans and in workout situations, it is prepared to provide efficient representation at every stage in the commercial lending process. With over thirty years of experience in the banking industry between them, Mr. Riley and Mr. Foley appreciate the potential hazards facing clients in the commercial loan process, and strive to protect lenders' interests throughout the lifecycle of the loan.

For more information about the Banking & Financial Services Group, contact Mr. Riley at LRiley@ShapiroSher.com or Mr. Foley at SWF@ShapiroSher.com.

Submitting Demands for the SBA to Honor its Guaranty

Under certain circumstances, a lender may demand in writing that the SBA honor its guaranty if the borrower is in default on any installment for more than 60 calendar days (or less if the SBA agrees) and the default has not been cured. If a borrower cures a default before a lender requests purchase by SBA, the lender's right to request purchase on that default lapses. Also, the lender cannot make a purchase demand on the SBA more than 120 days after the maturity of a loan.

A purchase demand to the SBA must include a written demand letter, a certified transcript of the account (using SBA Form 1149 is recommended), and copies of all loan-closing instruments. Before submitting such a demand and accompanying documents, lenders should be sure to review them thoroughly with counsel.

Litigating SBA Claims Against Lenders

When a lender submits a demand that the SBA purchase a loan guaranty, the government will sometimes refuse to honor its guaranty on the ground that the lender materially breached the guaranty agreement. These types of claims have spawned countless lawsuits. In determining whether a lender's breach was material, courts generally look to: (1) whether the breach operated to defeat the bargained-for objective of the parties; (2) whether the breach caused disproportionate prejudice to the SBA; (3) whether custom and usage considers such a breach to be material; and/or (4) whether the allowance of reciprocal non-performance will result in the accrual of an unreasonable and unfair advantage.

It does not take an attorney to know that you do not want to put these broad and subjective questions in the hands of the court. By putting forth the additional time and effort up front to identify and ensure compliance with necessary regulations, lenders and their borrowers can avoid litigation and benefit from SBA loan programs. The importance of maintaining proper loan documentation and following proper administrative procedures cannot be overstated.

Bills Propose Increase on Credit Union Commercial Lending

Under the Credit Union Membership Access Act of 1998, the amount that credit unions can lend to businesses is capped at 12.25 percent of a credit union's assets. Currently pending Senate Bill 2231 and a companion bill in the House of Representatives (H.R. 1418) would allow well-capitalized credit unions to increase this amount to 27.5 percent of assets. This is a bipartisan effort. The Senate bill is sponsored by a Democrat; the House bill is sponsored by a Republican.

The Credit Union National Association and its members favor the legislation. According to the Maryland/DC Credit Union Association, the bill would "greatly increase the ability of credit unions to make fiscally-sound loans to small businesses in desperate need of new avenues to capital." The trade group estimates that passage of the bill would lead to $13 billion being lent to small businesses nationwide, $130 million of which would be lent in Maryland.

The Maryland Bankers Association (MBA) and other banking associations, however, oppose legislation increasing the cap on business lending by credit unions. Kathleen M. Murphy, president and CEO of MBA, described SB 2231 as "a lending grab by a very small number of aggressive, growth-oriented credit unions to expand into an area well beyond their congressionally mandated mission in a manner that jeopardizes their safety and soundness."

You can read the text of the Senate bill at http://thomas.loc.gov/cgi-bin/query/z?c112:S.2231. Votes on both the House and Senate bills are possible later this year.

Pulver Joins Shapiro Sher's Growing Banking Practice

Shapiro Sher's banking group welcomes Joseph A. Pulver, a 2008 graduate of the University of Baltimore Law School who also holds an M.B.A. from the University of Baltimore's Merrick School of Business. Prior to joining Shapiro Sher, he practiced for four years with another Maryland firm, primarily providing legal services to financial institutions and capital finance companies. His experience includes representing lenders in commercial loan workouts, restructurings, and loan originations. The hiring of Mr. Pulver is part of an overall expansion of the banking practice at the firm.