

## An Ounce of Prevention...and Ways to Cure: Avoiding the Pitfalls of SBA-guaranteed Loans

Lenders can encounter many situations that place an SBA loan guaranty in jeopardy. How one copes with these challenges may determine whether the SBA will honor (i.e., purchase) the guaranty in the event of a borrower default.

### Collateral and lien issues

One of the most obvious issues for a lender to be mindful of is ensuring that it obtains a valid, perfected security interest on all agreed-upon collateral for the loan. If a security interest has not been properly perfected, if the lender's security interest is of lower priority than the SBA expects, or if only some of the agreed-upon loan collateral is covered by the lender's lien, the SBA may deny the lender's request to purchase the loan guaranty. Generally, these types of lien issues can be resolved (i.e., "repaired") by counsel, either through corrective or additional lien filings.

### Shortfalls when collateral is liquidated

Lenders need to carefully follow SBA guidelines when liquidating loan collateral. One step that is often skipped, at the lender's risk, is the site visit. When a site visit is conducted, the lender needs to be vigilant in accounting for, and appraising, all the existing collateral. Failing to conduct a site visit and failing to account for and appraise collateral following a borrower default are common reasons the SBA uses to justify denying guaranty purchase requests.

In many instances, these issues can be repaired by taking corrective action (which can be costly and time-consuming). The safer and better course is for a lender to engage experienced counsel to guide it through the site visit process so that critical steps are not missed. Once a liquidation is conducted, the lender should take care to monitor and safeguard all collateral. Lost or damaged collateral can result in an SBA denial of a purchase request.

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### 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](mailto:LRiley@ShapiroSher.com) or Mr. Foley at [SWF@ShapiroSher.com](mailto:SWF@ShapiroSher.com).

## **Servicing issues**

Another critical duty of the lender is to document its servicing of the SBA loans. This includes renewing liens on collateral before they lapse, keeping records to justify any releases or subordination of liens, making sure that the borrower (or the lender, if necessary) maintains adequate hazard insurance on the collateral, and ensuring that key man life insurance (when required by the loan documents) is kept in place. It is vital that the lender diligently monitor and track, among other things, lien and insurance premium deadlines so that lapses do not endanger the SBA guaranty.

## **Denials due to early default or unauthorized use of proceeds**

Common reasons for the SBA's refusal to honor a guaranty are early default by a borrower and the borrower's unauthorized use of loan proceeds. In the case of early default (i.e., default within 18 months of final disbursement) the SBA will usually deny a guaranty purchase request if the lender's actions contributed to the failure of the borrower's business.

The best way for a lender to avoid this situation is to maintain adequate documentation for the loan, including proof that the borrower's principals made any equity injections required by the loan documents, as well as proof that the borrower's financial condition is supported by its tax filings. With regard to unauthorized use of proceeds, the initial loan authorization agreed to by the lender, the SBA, and the borrower almost always dictates, in precise terms, the permissible use of the loan proceeds. Therefore, releasing loan proceeds to a borrower must be viewed not as the end of the lender's oversight, but the first step in ensuring that the loan proceeds are being used by the borrower as agreed. As always, documentation is essential. Monitoring the borrower's use of proceeds is crucial, but documenting the lender's monitoring efforts and observations is at least as important, perhaps even more so.

## **Making timely purchase requests**

One pitfall that can be easily avoided by lenders is making timely requests that the SBA purchase a loan guaranty. The SBA is not obligated to purchase a guaranty if the purchase request is made more than 120 days after the borrower defaults. While determining the date of default is not generally problematic, counsel can be helpful in guiding a lender through the purchase request to ensure that it is filed in a proper and timely fashion.

## **Avoiding denials based on borrower ineligibility**

The SBA will often deny a purchase request if it determines that the lender made a loan to an ineligible franchise, for an ineligible purpose, or to an ineligible loan recipient. Unfortunately, this is not a situation that can be easily (if ever) repaired. Given the stakes, therefore, a lender should carefully review these aspects of a loan with counsel during the loan origination process. Once the loan proceeds have been disbursed, it is usually too late to repair this problem, and the SBA guaranty will prove useless.

## **Final thought**

While the SBA endeavors to be fair in reaching equitable solutions with lenders on troubled loans, an ounce of prevention really is worth a pound of cure. Proper due diligence, documentation and monitoring, along with the assistance of experienced counsel, often allow lenders to identify and correct potential problems, including those discussed above, before they endanger the SBA guaranty.