

Realizing on your SBA 7(a) Loan Guaranty – Recovery is not Always Guaranteed

(Navigating the storms of recovering on SBA 7(a) loan guarantees)

This paper was composed by Katie Sanders <Katie.Sanders@law.ua.edu> an extremely bright University of Alabama School of Law J.D. candidate during her clerkship for me in the summer of 2013. She has done an excellent job in compiling and summarizing the voluminous information on this topic. I also owe a debt of gratitude to Sam Renta with Alliance Capital Corporation <srenta@alliancecapitalcorporation.com> for all the information he supplied in making this dissertation a reality. To fully grasp the concepts explored in this paper, the reader needs to have available to him or her various forms produced by the Small Business Administration which can be found on SBA's website (through the hyperlinks contained in this paper).

I hope you will find this information helpful as you travel down the road that hopefully leads you to a realization of your SBA 7(a) Loan Guaranty, keeping in mind that recovery is not always guaranteed.

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I. SBA 7(a) Loan Guaranty Program

A. What is the SBA?

The Small Business Administration (SBA) is a federal agency that was created to assist small businesses and protect the interests of small business concerns in order to preserve free competitive enterprise and strengthen the overall economy.¹ Specifically, SBA strives to help start, build, and grow businesses in order to create jobs and stimulate the economy. SBA is governed by the Small Business Act of 1953, which is codified in 15 U.S.C. § 633. Under this Act, SBA is empowered to deliver loans, guarantee loans made by lenders, assist with government contracts, counsel small businesses, offer entrepreneur development services, and provide other types of assistance for small businesses.²

Among these functions, the SBA is able to make loans³ and guarantee private lender loans to qualified small business concerns under Section 7 of the Small Business Act, which is codified in 15 U.S.C. § 636. Regulations for SBA's loan programs are found in Part 120 of Title 13 in the Code of Federal Regulations (C.F.R.). SBA lending assistance provides benefits to borrowers by making funds available and assisting with long-term financing. These lending opportunities result in improved cash flow, fixed maturity, no balloon payments, and no prepayment penalty for loans with less than 15 year maturity.⁴

¹ 15 U.S.C. § 631

² *Id.*; see U.S. Small Business Administration, "About SBA: What We Do," <http://www.sba.gov/about-sba-services/what-we-do>

³ Although authorized to make direct non-disaster business loans, SBA has not been funded to do so since the mid 1990s.

⁴ U.S. Small Business Administration, "What SBA Offers to Help Small Businesses Grow," <http://www.sba.gov/content/what-sba-offers-help-small-businesses-grow>; see also U.S. Small

B. Lending Programs

SBA currently has three main lending programs: the 7(a) loan program, the 504 loan program⁵ and the disaster loan program.⁶ This paper focuses only on the 7(a) program. Under the 7(a) loan program, the lender is able to finance a loan to a borrower who typically could not obtain credit elsewhere.⁷ In order to qualify, the borrower must be a for profit business, meet SBA size requirements, show good character, credit, management, & ability to repay, and must be an eligible type of business.⁸ If the borrower is eligible as a small business concern, the lender enters into a lender partner relationship with the SBA, whereby the SBA will guarantee a portion of the loan to the participating lender partner.⁹ SBA will guarantee up to 85% for loans up to \$150,000 and up to 75% for loans exceeding that amount up to \$5,000,000.¹⁰ SBA will collect a guaranty fee on the guaranteed portion of the loan, which is charged to lenders but can be

Business Administration, “General Small Business Loans: 7(a),” <http://www.sba.gov/category/navigation-structure/loans-grants/small-business-loans/sba-loan-programs/7a-loan-program>

⁵ The 504 loan program is typically used for long-term financing to attain major assets for business development and expansion. 13 C.F.R. § 120.102. Instead of guaranteeing the loan of a private lender, the SBA uses a Certified Development Company (CDC) as a lender partner to actually finance the loan secured by a 100 percent SBA-guaranteed debenture. A CDC is nonprofit corporation set up to encourage economic development of its community. Of the projected costs for the venture, a private non-CDC lender provides 50% of the financing with senior lien position; the CDC contributes up to 40% of the financing backed by a 100% SBA-guaranteed debenture with junior lien position; and the borrower is expected to provide at least 10% of the financing. *Id.*; see also 13 C.F.R. § 120.801.

⁶ The disaster loan program is a program administered exclusively by the Agency.

⁷ 15 U.S.C. § 636(a)(1); see also 15 U.S.C. § 636(a)(20)

⁸ 13 C.F.R. § 120.100

⁹ 15 U.S.C. § 636

¹⁰ 15 U.S.C. § 636(a)(2)-(3)

collected from borrowers.¹¹ The funds of this fee are designed to reimburse lenders for borrowers who default on repayment.

Through SBA's 7(a) eligible use of proceeds requirement, financing can be guaranteed for a variety of business purposes, such as working capital, inventory, machinery and equipment, leasehold improvements, land and building (for purchase, renovation or new construction), and debt refinancing.¹² The loan maturity will depend on the nature of the loan and the borrower's ability to repay. Typically, it is up to 10 years for working capital & equipment and may be up to 25 years for fixed assets, such as real estate.¹³ To secure the loan, SBA requires the lender to collateralize the loan to the maximum extent possible up to the loan amount, which may include personal assets if business assets do not fully secure the loan.¹⁴ Additionally, the borrower will be required to provide a capital contribution to finance the loan. The lender must verify that the borrower has invested a certain amount of equity into the business to ensure the borrower is committed and indebted to the business.¹⁵

C. SBA 7(a) Loan Process

The process for a 7(a) loan begins when a borrower submits an application for a business loan to a lender. The lender must review the application. Then, the lender must decide if the borrower's application merits a loan or whether there is a weakness involved which would not meet typical underwriting guidelines. If the application has an apparent

¹¹ 15 U.S.C. § 636(a)(18)

¹² 15 U.S.C. § 636(a); 13 C.F.R. § 120.120

¹³ 15 U.S.C. § 636(a)(5); 13 C.F.R. § 120.212

¹⁴ U.S. Small Business Administration, "7(a) Loan Program Terms and Conditions," <http://www.sba.gov/content/7aterms-conditions>

¹⁵ 13 C.F.R. § 120.102

weakness, the lender will likely determine that it needs additional security and can choose to finance the loan contingent on a SBA 7(a) guaranty. SBA will decide whether to accept the loan, in addition to the terms and conditions that will govern the loan. Upon SBA approval, SBA will submit the authorization,¹⁶ and the lender will close the loan. After closing, the borrower will make scheduled payments to the lender, and the lender must provide periodic reports to the SBA on the loan and the business. If the borrower defaults, the lender may request the SBA to purchase the guaranteed portion. If the lender has complied with all applicable requirements, SBA will reimburse the lender up to the guaranty amount, and the borrower will still be obliged to repay the full loan amount.¹⁷

D. Necessity of Lender Compliance

In order to ensure the guaranty, lenders must structure loans according to SBA loan requirements, comply with the SBA loan authorization, and certify that all matters were performed with due diligence.¹⁸ It is imperative for lenders to understand that the SBA authorization is not a contract to make a loan, so there is not an actual “guaranty.”¹⁹ Nor can a potential borrower force a lender to make a loan to a borrower merely because SBA has issued a loan authorization. The making of the loan remains a credit decision of the lender. If a loan is made by a lender under the SBA loan authorization, it is an agreement between SBA, as an agency of the United States Government, and the lender; the borrower is not a party to any loan authorization and the borrower is not a third party

¹⁶ 13 C.F.R. § 120.10 (The authorization is the SBA’s written agreement providing terms and conditions by which SBA will guarantee a loan.)

¹⁷ U.S. Small Business Administration, “Steps in SBA Lending: 7(a)Loans,” <http://www.sba.gov/category/lender-navigation/steps-sba-lending/7a-loans>

¹⁸ 13 C.F.R. § 120.410

¹⁹ *Id.*

beneficiary to any loan authorization. SBA has established Standard Operating Procedures (SOPs) as practical requirements for lenders based on sound lending practices for all steps of the loan process. In addition to complying with statutory and regulatory law, lenders must abide by the SOPs to ensure that the borrower is creditworthy, the loan proceeds will be disbursed according to the authorization, so that the guaranty will be realized.²⁰

II. Realizing on the 7(a) Guaranty

A. 7(a) Guaranty Purchase

In order to realize the 7(a) loan guaranty, a lender must make a request to the SBA to purchase the guaranty. SBA will not purchase the guaranteed portion of a loan from a lender unless the lender has submitted a purchase package to SBA. Subsequently, SBA will determine whether the purchase package contains sufficient evidence that the Lender made, closed, serviced, liquidated, and litigated the loan in accordance with loan program requirements and prudent lending practices.²¹ To request purchase of the guaranty, the lender must submit a ten tab purchase package.²² The following are the tabs that need to be completed and important considerations to realize your guaranty:

- 1. The lender must send a demand letter to SBA on SBA's preformatted form.**

²⁰ U.S. Small Business Administration, "Standard Operating Procedures," <http://www.sba.gov/about-sba-services/7481>

²¹ 13 C.F.R. § 120.520

²² 10 Tab Purchase Packages can be found at U.S. Small Business Administration, "7(a) Guaranty Purchase Package Tabs," <http://www.sba.gov/content/7a-guaranty-purchase-package-tabs>

- Before sending the demand letter, the lender should contact the SBA Servicing Center to request for the loan to be placed in liquidation status and transfer the loan to the National Guaranty Purchase Center (NGPC).
- The demand letter should be sent with a memo explaining the reason for the business failure and/or the loan default.
- The lender must liquidate all business personal property before requesting the SBA to honor the guaranty.
 - Business personal property does not have to be liquidated if: (1) the borrower has filed for bankruptcy, or (2) the loan has been sold in the secondary market, and the lender declined to purchase.
 - An explanation should be sent to the SBA if business personal property has not yet been liquidated and does not fall within the above-referenced exceptions.
- A demand for purchase must be submitted within 180 days of maturity of the loan, completion of liquidation, or debt collection litigation in connection with a matured loan.²³
 - SBA will be released from its guaranty if demand for purchase is not made within the guidelines from the maturity date.
 - If it has been more than 180 days since the loan matured, the lender should send a written explanation to the SBA describing why the demand was not made within the required time.

²³ 13 C.F.R. § 120.524(a)(8) (For loans approved after May 14, 2007, the lender has 180 days after maturity or completion of recovery actions to request purchase. For any loans approved before May 14, 2007, the lender must request purchase within 120 days, or SBA will be released from its' guaranty.)

2. The lender must meet the loan requirements in the Loan Authorization.

- The lender should send copies of the Loan Authorization and any amendments to the SBA.
- The Loan Authorization may also require additional documents needed for submission.
- In addition to the Loan Authorization and any amendments, the lender should include any loan modification documents as well as deferments, workout agreements, interest rate adjustments, and payment revisions.
- It is imperative that the lender meets all terms and conditions in the Loan Authorization to realize the SBA Guaranty.
- At this point in the process, the lender should pay particular attention to collateral taken, guarantors, lien positions, and use of proceeds because these items are crucial later in the process.

3. The lender must provide evidence of eligibility.

- The lender should submit the required eligibility checklist.
- If the business was a franchise or dealership, the lender must certify that the business is on the Franchise Registry and provide a Certification of No-Material Change.
 - If the business is not on the Franchise Registry, the lender should provide a copy of the Franchise Agreement to ensure that it was an eligible franchise.

- If the business sold fuel or gasoline, the lender should provide a copy of the Fuel Supply Agreement or Jobber Agreement.

4. The lender must submit all mandatory legal documentation.

- This tab outlines the documentation required for the Legal Review.
- The lender must submit a copy of the original Note ([SBA Form 147](#)) in addition to any Note Modifications, Amendments, Deferments, and Workout Agreements.
- The lender must submit a Statement of Personal History ([Form 912](#)) and a Social Security Number or EIN for each guarantor.
- The lender should review the Loan Authorization and submit the following required documents if applicable:
 - Guaranties ([SBA Form 148](#))
 - Security Agreements ([SBA Form 1059](#), use of the form is optional)
 - UCC Lien Searches with the date of post default UCC Search
 - Title Insurance and Recorded Deeds of Trust/Mortgages
 - Purchase/Sale Agreements
 - Legal Pleadings & Schedules, Bankruptcy Filings and Court Motions
 - Other potentially applicable documents, such as a Certificate of Ownership and/or Certificate of Title of Vehicles or Manufactured Homes, Assignment of CDs or Stock, Assignment of Life Insurance, Landlord's Subordination, and/or the Lease Agreement.

5. The lender must submit a Settlement Sheet ([SBA Form 1050](#)).

- SBA will review the Settlement Sheet to analyze whether the loan proceeds were used in accordance with the Loan Authorization and for eligible business purposes.
- The lender must submit documentary evidence to support proper disbursements. Documentary evidence can include a copy of cleared joint payee checks, paid invoices, and executed contracts.
- SBA requires that [SBA Form 1050](#) be executed by borrower. Many closers use the HUD-1 (Settlement Sheet) in documenting the disbursements of loans. The HUD-1 (Settlement Sheet) can be attached to [SBA Form 1050](#), as evidence of these disbursements; and the borrower can execute [SBA Form 1050](#).

6. The lender must send a Certified Transcript of Account with all required information.

- The Certified Transcript of Account is a document that accounts for disbursement of loan proceeds and applications of payments.
- SBA prefers that lender use [SBA Transcript Form 1149](#), but lenders can use their own transcript if it contains all of the information required by [SBA Transcript Form 1149](#):
 - SBA loan name and 10 digit loan number (SBA loan number, not lender's number);

- Method used for interest computation (360 days or 365 days);
- Date and amount of each disbursement;
- Date and amount of each payment showing principal and interest applications;
- Provide interest paid “from” and “to” dates for all payments;
- Date interest rate changes occurred;
- Next payment due date (“default date”);
- Record of recoveries and expenses;
- Indicate all deferments with dates with principal and interest or interest only;
- Note source of funds if payment was applied to principal;
- Indicate if your ending balance coincides with [1502](#) report; and
- If applicable, provide amount of lender’s successful bid at foreclosure sale.

7. The lender must submit the following information if the loan is in early default.

- A loan is in early default when the default occurred within 18 months of the initial disbursement of proceeds.
 - If the final disbursement occurred more than 6 months after the initial disbursement, the 18 months will begin to run from the date of final disbursement.

- If the borrower cures the default and makes scheduled loan payments for 12 consecutive months after the initial 18-month period (30 months), the loan is not considered to be in early default.
- Early default issues often occur in the following circumstances if the events occur within the required 18 month period:
 - The borrower failed to make one or more scheduled loan payments;
 - The borrower funded the scheduled loan payments from the sale of collateral rather than from business operations;
 - The lender deferred more than three consecutive schedule payments; and/or
 - An issue occurred which required the loan to be liquidated, such as the filing of the bankruptcy petition.
- If the loan is in early default, the lender must provide IRS Income Tax Verification, a Standby Agreement, copy of the business valuation, and evidence of cash equity or asset injection.

8. The lender must send reconciliation of business personal property collateral documentation.

- The lender must itemize all original collateral with a unit value of \$5,000 or more specified in the Loan Authorization. Lender must include a brief description of collateral and serial number if applicable.

- If applicable, the lender must provide proof of perfection of a required security interest on motor vehicles or manufactures homes. The lender should provide a copy of the certificate of ownership and/or any titles on a vehicle.
- Then, the lender must reconcile all original collateral against list of post-default collateral. Any discrepancies between the two lists must be resolved.

9. The lender must submit the required verification of collateral disposition.

- The lender must include a copy of the appraisals of the collateral property at origination and prior to liquidation. The origination appraisal must be dated prior to closing. The post-default appraisal should be less than 120 days old but no more than one year old.
- The lender must perform a site visit within 15 days of an adverse event that causes the loan to be placed into liquidation status or within 60 days of payment default. The lender must put forth every effort to secure and safeguard collateral and provide a post-default Site Visit Report.
- The lender must provide a Report of Sale of collateral or any other disposition activity relating to the collateral. If collateral has been abandoned, lender must document and justify the basis for the decision.

- The lender should submit a Wrap-Up report if the loan is ready for Charge-Off or a Quarterly Status Report which describes the status of liquidation to date.²⁴

10. The lender must submit wire transfer instructions and any other required documentation.

- The lender must submit the SBA’s Wire Transfer Form to ensure prompt and accurate payment.
- This tab should also include any other documents that are required by the Loan Authorization or relevant to the guaranty purchase.
- If applicable, lender should submit Environmental Questionnaire, Phase 1 and 2 Environmental Reports, Assumption Agreements, and Compensation Agreements.

The ten-tab purchase package can be sent by mail in a paper format and electronic format on CD or can be sent electronically by “[Send this File](#).”²⁵ In order to expedite the process and ensure your guarantee, SBA provides helpful purchase tips:

- Submit a complete purchase package with executed tabs, including all required documents and answers to all questions on the tabs;
- Inform the SBA proactively of missing documents and deficiencies; and

²⁴ U.S. Small Business Administration, “Reporting & Site Visit Requirements,” <http://www.sba.gov/content/reporting-site-visit-requirements>

²⁵ U.S. Small Business Administration, “Electronically Submit Your Package,” <http://www.sba.gov/content/electronically-submit-your-package>

- Build your loan file using the ten tab system from the origination to ensure all documents are present at origination.²⁶

Once the ten tab package has been received, an SBA official will review the package. There are four major components of a guaranty purchase review, which are origination, closing, servicing, liquidation and litigation. SBA will determine that the loan was originated in accordance with 120 of Title 13 of the C.F.R. and the SOPs. Then, SBA will analyze whether the loan was closed in the manner required by the Loan Authorization. Next, SBA will evaluate whether the lender's servicing of the loan complied with the Loan Authorization, the regulatory requirements, and prudent lending practices. Another inquiry into the servicing facet is whether the actions by the lender caused harm to the SBA. Finally, SBA will review whether the liquidation and collection of the defaulted loan followed all program guidelines and was handled prudently.

Once the purchase request has been reviewed, the recommending SBA official must make a recommendation. Then, another SBA official must approve the recommendation. SBA also requires an attorney to review each purchase request. Once the guaranty purchase review is complete, SBA's general policy is to reach a fair decision based on the review of the lender's purchase request and the materiality and harm caused by any adverse event.²⁷ If the lender has been deficient in any aspect of handling the SBA loan, there can be a monetary adjustment of the guaranty, often referred to as a "repair",

²⁶U.S. Small Business Administration, "Regular 7(a) Guaranty Purchase Package Tabs," <http://www.sba.gov/sites/default/files/regular-7a-guaranty-purchase-package-tabs.pdf>

²⁷ U.S. Small Business Administration, "Denials of Liability & Repairs," <http://www.sba.gov/content/denials-liability-repairs>

or an outright denial of payment on the guaranty.²⁸ SBA's outright denial of the payment on the guaranty is extremely rare, but that option is available to SBA. The lender has the option to cancel the guaranty or withdraw from the request for purchase if more time is needed to collect appropriate documentation. Ideally, once the purchase request is complete, a decision to honor the guaranty will be made as soon as possible.

B. Secondary Market Loans

A lender may sell the guaranteed portion of the loan on the secondary market.²⁹ Typically, lenders sell on the secondary market to increase liquidity or earn a profit.³⁰ The Fiscal Transfer Agent (FTA) of SBA administers the secondary market loans. First, a lender must agree to sell the guaranteed portion of the loan to a purchaser, referred to as the sale of a certificate.³¹ The FTA will manage the closing of the sale. At closing, the purchaser receives a SBA Guaranteed Interest Certificate. After the sale of the guaranteed portion, the lender is still responsible for all servicing actions for the loans.³² Also, the lender is responsible for collecting the payment and forwarding the guaranteed portion to the FTA. Then, the FTA handles the administration and disbursement of the payment to the purchaser.³³

Once the loan is 60 days past due, the guaranty must be purchased from the secondary market to avoid excessive interest charges. When the borrower defaults, SBA

²⁸ *Id.*

²⁹ 13 C.F.R. § 120.601

³⁰ SOP 50 50 4, Chapter 8, Paragraph 4

³¹ 13 C.F.R. § 120.600-601 ("Certificate" is the document that FTA issues, which represents a beneficial fractional undivided interest in a Pool, an aggregation of SBA guaranteed portions made by lenders, or a fractional undivided interest in a portion or all of the guaranteed portion of an individual 7(a) loan.)

³² SOP 50 50 4, Chapter 8, Paragraph 8

³³ U.S. Small Business Administration, "SBA Secondary Market Program Guide," http://www.colsonservices.com/main/forms/secguide_table_of_contents.pdf

strongly encourages lenders to re-purchase the defaulted loans directly from the secondary market holder. If the lender re-purchases from the secondary market and subsequently request an SBA purchase, the lender must follow the same instructions for pre-purchase submission. If the lender refuses to purchase, SBA will purchase from the secondary market holder once it receives all required documentation.³⁴ For secondary market loans that SBA purchases, the lender must submit a loan status report within 15 business days of the SBA's purchase.³⁵ The loan status report must address the status of the borrower, guarantors, collateral, workout or restructuring plans, and liquidation activities including sale of collateral, foreclosures and litigation. The report must be accompanied by sufficient documentation for SBA to conduct a post-purchase review. If the lender does not provide adequate documentation, the SBA may initiate a recovery action for the disbursement if there are any repairs and restrict the lender's future participation in the secondary market.³⁶

³⁴ The documentation for secondary market purchase by SBA includes the following:

- Written notice and request for transcripts: The lender must advise SBA in writing that it will not purchase from the secondary market. SBA will then notify the FTA and the lender that SBA will purchase the guaranteed portion. The lender must send any future loan collections to SBA's Denver Finance Center using [SBA Form 172](#).
- Transcript of Account: It is strongly suggested the primary lender use [SBA Transcript Form 1149](#). Failure to provide all of the required transcript information may result in a delay of the purchase and an invoice to the primary lender for the interest expense associated with that delay.
- Executed Copy of the Loan Authorization
- Executed Copies of all Payment Modifications: Enclose copies of all deferment and other payment/terms modifications.
- Investor Approval of all Payment/Term Modifications: As required, (refer to the 1086 and applicable SOP).

See U.S. Small Business Administration, "Secondary Market Purchase,"

<http://www.sba.gov/content/secondary-market-purchase>

³⁵ 13 C.F.R. § 120.520 (c)

³⁶ *Id.*

C. 120 Day Rule

After the first unresolved payment default for 60 days, SBA is liable for the interest rate on the loan minus 1% for the guaranteed portion to the lender for a period of up to 120 days.³⁷ Therefore, it is advisable for the lender to submit the purchase request within 120 days to take advantage of the rule. Specifically, if the SBA receives the package within 120 days of default, all interest is payable to the date of purchase payment.³⁸ This includes interest during the period of time that SBA was processing the purchase and from the interest-paid-to-date until the date of default. If the SBA does not receive the package within 120 days of default, the interest will still be payable for only 120 days.³⁹ If the lender has already liquidated the loan, a lender may deduct 120 days of accrued interest from liquidation proceeds.⁴⁰

D. Servicing and Liquidation Actions

All lender actions must comply with SBA loan program requirements.⁴¹ While the lender is servicing or liquidating a loan, there are many actions which require prior SBA approval or notification.⁴² The Office of Financial Program Operations (OFPO) has developed a [Servicing and Liquidation Actions 7\(a\) Lender Matrix](#) to ensure SBA lenders are able to find and comply with Agency Loan Program Requirements.⁴³ While servicing a loan, the lender is responsible for actions necessary to support the growth of the

³⁷ 13 C.F.R. § 120.522

³⁸ *Id.*

³⁹ *Id.*

⁴⁰ SOP 50 50 4A, Chapter 9

⁴¹ See SOP 50 10 5, Subpart B and SOP 50 57; 13 C.F.R. § 120.535; 13 C.F.R. § 120.536

⁴² 13 C.F.R. § 120.536

⁴³ U.S. Small Business Administration, “7(a) Servicing and Liquidation Actions Matrix,” [http://www.sba.gov/sites/default/files/Unilateral%20Action%20Matrix%20for%207\(a\)%20Loan%20Servicing-Liquidation%2020130430.5.pdf](http://www.sba.gov/sites/default/files/Unilateral%20Action%20Matrix%20for%207(a)%20Loan%20Servicing-Liquidation%2020130430.5.pdf)

business, as well as evaluating and responding to problems which may arise.⁴⁴ There are red flags indicating potential problems that must be addressed when servicing loans, including: payment default notices; requests for relief in loan terms or conditions; cash flow problems; adverse changes; cancellation of life or hazard insurance policies; death or illness of a principal; tax problems; substantive changes in management or control of the business; fire or loss of collateral due to natural disasters; legal actions; loss of contracts; borrower's failure to submit financial statements timely; and/or loan delinquencies in excess of 60 days.⁴⁵ The lender's handling of the abovementioned situations in the servicing process is crucial to the final review of the guaranty purchase.

E. Lender Documentation & Reporting

During the purchase process, the SBA is concerned with materiality and harm.⁴⁶ The lender should proactively approach any issues because early identification could lead to possible solutions to ensure the guaranty. Therefore, the lender should ensure all actions are properly documented and prudent to minimize the effect of an adverse action on SBA's decision to purchase.⁴⁷ Lender's actions will be reviewed to determine if they were prudent, lawful and commercially reasonable, and consistent with lender's practice on its non-SBA loans.⁴⁸ Therefore, documentation is crucial to evidence justifications for decisions.

⁴⁴ SOP 50 50 4A

⁴⁵ *Id.*

⁴⁶ SOP 50 57, Chapter 24, Subpart B

⁴⁷ U.S. Small Business Administration, "Sale-Release of Collateral," <http://www.sba.gov/content/sale-release-collateral>

⁴⁸ 13 C.F.R. § 120.535

In addition to documenting all actions, all SBA loans must be reported on the [SBA 1502](#) report to the Fiscal and Transfer Agent (FTA) once a month.⁴⁹ After submitting the guaranty purchase package, the lender must submit a Quarterly Status Report. This report should address the status of the borrower, guarantors, collateral, workout or restructuring plans, and liquidation activities, including sale of collateral, foreclosures and litigation.⁵⁰ Additionally, the lender must submit a Site Visit Report after every visit to the borrower’s business premise.⁵¹ Once all the requirements for collection and liquidation are satisfied, the lender must submit a Wrap-Up Report for each loan.⁵² Before sending a Wrap-Up Report, the lender must be reasonably aware that the loan is ready for charge off because loans cannot be sent to Treasury for further collection if the lender is still servicing the loan.⁵³ A lender must comply with all reporting requirements to realize the guaranty.

⁴⁹ SOP 50 57, Chapter 3, Subpart F; U.S. Small Business Administration, “Lender Reporting,” <http://www.sba.gov/category/lender-navigation/lender-reporting>

⁵⁰ SOP 50 57, Chapter 3, Subpart F

⁵¹ *Id.*

⁵² SOP 50 57, Chapter 26

⁵³ *Id.*

III. Grounds for Denial

SBA does not have to honor a guaranty purchase request in full or in part on a 7(a) loan if the lender failed to comply materially with a loan program requirement; failed to make, close, service, liquidate or litigate the loan in a prudent manner; placed SBA at risk through improper action or inaction; failed to disclose a material fact to SBA in a timely manner; or misrepresented a material fact to SBA regarding the loan.⁵⁴ The following are the common reasons cited by the SBA in which a guaranty is repaired or denied:

Expiration after Maturity Issue

If the lender does not request purchase within 180 days after loan maturity, SBA is not obligated to purchase the guaranty.

Lien and Collateral Issues

Lien and collateral issues may result in a missed recovery. Examples of lien and collateral issues that may arise are as follows:

- Failure to obtain required lien position;
- Failure to properly perfect security interest; and/or
- Failure to fully collateralize loan at origination when additional collateral was unavailable.

Unauthorized Use of Proceeds Issues

⁵⁴ 13 C.F.R. § 120.524(a)

Recovery can be repaired or denied when proceeds are disbursed for purposes inconsistent with the loan authorization or subsequent modifications without a business justification. Typically, if proceeds are distributed in a manner not consistent with authorization, the guaranteed amount may be repaired. However, a complete denial will result when early default and improper use of the proceeds cause the failure of the business.

Liquidation Deficiency Issues

Liquidation deficiency will generally result in a repair. However, a denial may occur when harm is the full value of the outstanding balance. The following situations are examples of liquidation deficiencies:

- Failure to conduct a “Site Visit” which resulted in a missed recovery;
- Improper safeguarding or disposition of collateral which resulted in missed recoveries; and/or
- Misapplication of recoveries to lender’s loan when SBA-guaranteed loan has lien priority.

Undocumented Servicing Actions Issues

An undocumented servicing action will generally result in a repair of recovery under the following situations:

- Liens not properly renewed during servicing on worthwhile collateral;
- Release or subordination of collateral without documented business justification;

- Allowing hazard insurance to lapse on major collateral when collateral is subsequently destroyed; and/or
- Failure to maintain life insurance on principal when principal subsequently dies.

Early Default Issues

Early default can result in a denial if it is determined to be the reason for business failure under the following circumstances:

- Missing or unsupported verification of required equity injection, which will include verification of source in certain cases; and/or
- Missing or unsupported documentation of verification of borrower financial information with IRS when financial information was relied on in lender's credit analysis.

SBA Loan Eligibility Issues

If there is an issue with the borrower's eligibility under the loan eligibility requirements, the lender may be denied recovery on the guaranty if it did not investigate and monitor with due diligence. The following are common examples, but all SBA loan eligibility requirements must be complied with:

- Ineligible franchise;
- Ineligible loan purpose; and/or
- Ineligible loan recipient (i.e. loan to an associate of lender).⁵⁵

⁵⁵ U.S. Small Business Administration, "Top Reasons for Repair and Denial,"

IV. Putting It All Together

Now that you know the nuts and bolts of the SBA 7(a) loan, it is time to put the pieces to work. Below is a checklist of items to ensure that you are following the SBA requirements as you go through the 7(a) loan process:

Application: Eligibility, Credit & Use of Proceeds Requirements

- Met SBA Eligibility Requirements
 - Business is a for-profit domestic operation
 - Size determinations were correct and analyzed according to SBA policy
 - Written evidence that credit was not available on reasonable terms
 - No prior loss to the Government
 - Principal(s) are eligible citizens or have eligible non-citizen status
 - Proceeds fund sound business purposes
 - No actual or apparent conflicts of borrower and/or lender exist
- Met SBA eligibility requirements for franchise (if applicable)
- Engaged in a satisfactory credit analysis
- Verified equity injection prior to disbursement through supporting documentation
- Pledged sufficient collateral
- Provided all required content in the business loan application

www.sba.gov/content/top-reasons-repair-denial; see 13 C.F.R. § 120.524; see also SOP 50 50 4A, Chapters 9 & 10 and SOP 50 51 2A, Chapter 13

Authorization, Closing, & Disbursement

- Complied all required terms for the loan
- Paid guaranty fee on time
- Verified loan proceeds were used for purposes defined in the Loan Authorization
- Verified all collateral lien positions
- Received personal and/or corporate guaranty
- Obtained and reviewed IRS tax transcripts
- Received SBA approval of environmental questionnaire
- Verified that property is not in a flood area or required flood insurance
- Verified that borrower had or obtained hazard insurance

If applicable:

- Verified borrower has a life insurance policy
- Executed and perfected a Collateral Assignment of Life Insurance
- Obtained and executed a Stand-By Agreement

Servicing, Liquidation, Litigation, & Guaranty Purchase

- Paid fees on time in accordance with the Authorization
- Monitored continued creditworthiness
- Provided evidence that a site visit was performed
- Received prior written SBA approval for servicing or liquidation actions in the SOP
- Gave SBA notice upon classification of the loan into liquidation
- Prepared a written liquidation plan
- Secured collateral by site visits and reasonable steps after loan is placed in liquidation

- ___Used current appraisals to evaluate liquidation collateral
- ___Forwarded all recoveries on repurchased loans within 15 days of receipt
- ___Requested purchase at least 180 days before loan maturity
- ___Sent all required items for 10-tab guaranty purchase package
- ___Completed certified transcript of account
- ___Complied with all reporting requirements

SBA Eligibility Requirements

A lender should be sure to verify that the loan is eligible under the SBA requirements. Loan eligibility is a material requirement, so ineligibility would result in a full denial of the guaranty. The key factors for eligibility are based on what the business does to receive its income, the character of its ownership and where the business operates. In general, the businesses must meet the following criteria to be eligible for SBA assistance: be a business operating for-profit; be located, engaged, or propose to do business in the United States; qualify as a small business under SBA size requirements; be able to demonstrate the need for the loan proceeds; have reasonable invested equity; attempt to use alternative financial resources before seeking financial assistance from SBA; have a plan to use the funds for a sound business purpose; and not be delinquent on any existing debt obligation to the United States.⁵⁶ Additionally, there must be no apparent conflict of interest between the borrower and the lender.

As mentioned above, one of the eligibility requirements is that the borrower must be a “small business concern.” The lender must verify that the borrower is a small business by that size standards defined under the North American Industry Classification

⁵⁶ 13 C.F.R. § 120.100-101

System (NAICS).⁵⁷ The Small Business Act defines a small business as a business that is owned and operated and not dominant in its field of operation.⁵⁸ The size standards vary from industry to industry and are developed considering the economic characteristics comprising the structure of an average firm size, start-up costs, entry barriers, and distribution of firms by size.⁵⁹ Additional considerations include technological changes, competition from other industries, growth trends, historical activity within an industry, unique factors occurring in the industry which may distinguish small firms from other firms, and objectives of the business' programs and the impact on those programs of different size standard levels.⁶⁰

Certain businesses are automatically ineligible to receive a SBA loan. The following businesses are ineligible:

- Non-profit businesses (a for-profit subsidiary will be eligible);
- Financial businesses primarily engaged in the business of lending (such as banks and finance companies);
- Passive businesses owned by developers and landlords that do not actively use or occupy the assets acquired or improved with loan proceeds (other than eligible passive companies defined in 13 C.F.R. § 120.111);
- Life insurance companies;
- Businesses located in a foreign country (a U.S. business owned by aliens may qualify);
- Pyramid sale distribution plans;

⁵⁷ 13 C.F.R. § 121.101; The codes can be found at North American Industry Classification System, "Introduction to NAICS," <http://www.census.gov/eos/www/naics/>.

⁵⁸ 15 U.S.C. § 632

⁵⁹ 13 C.F.R. § 121.102

⁶⁰ *Id.*

- Businesses deriving more than one-third (1/3) of gross annual revenue from legal gambling activities;
- Businesses that are involved in any illegal activity;
- Private businesses that limit the number of memberships for reasons other than capacity;
- Government-owned entities;
- Businesses principally engaged in teaching, instructing, counseling or indoctrinating religious beliefs;
- Consumer and marketing cooperatives (producer cooperatives are eligible);
- Loan packagers earning more than 1/3 of their gross annual revenue from packaging SBA loans;
- Businesses with an associate who is in jail, on probation, on parole, or has been indicted for a felony or a crime of moral turpitude;
- Businesses where the lender, CDC, or any of its associates own an equity interest;
- Businesses which present live performances of a prurient sexual nature or derive, directly or indirectly, more than de minimis gross revenue through the sale of products, services, or presentation of a prurient sexual nature;
- Businesses that have previously defaulted on any federal loan or federally assisted financing (unless waived by the SBA for good cause);
- Businesses engaged primarily in political or lobbying activities; and/or
- Speculative businesses (such as oil wildcatting per the SBA example).⁶¹

⁶¹ 13 C.F.R. § 120.110

Franchise Eligibility

If the business is a franchise, it will be eligible unless the franchiser retains power to control operations to the extent that it is equivalent to an employment contract. To be eligible, the franchisee must have the right to profit from labors proportionate with ownership.⁶² SBA has compiled a list of eligibility issue for franchises, called the Franchise Findings, to determine common requirements found in franchise agreements that would cause the business to be ineligible.⁶³ The lender is responsible for ensuring the franchise meets the eligibility requirements in accordance with SBA policies in effect at the time the application was filed. The lender should make sure the agreement is located on the Franchise Registry and obtain a Certification of Non-Material Change from the franchisor that states the agreement under consideration is the same as the one approved by the registry.⁶⁴

Credit Analysis

In order to qualify for an SBA 7(a) loan, a borrower must be creditworthy, contribute a small portion of the equity, and provide a reasonable assurance of repayment. Lenders are required to assess the applicant's credit factors to determine that the borrower is able to reasonably assure repayment. The most important factor in assuring repayment is the cash flow of the business, not the liquidation of collateral.⁶⁵ A

⁶² U.S. Small Business Administration, "7(a) Loan Program Eligibility," <http://www.sba.gov/content/7a-loan-program-eligibility>

⁶³ U.S. Small Business Administration, "Franchise Findings," <http://www.sba.gov/content/franchise-findings>

⁶⁴ *Id.*

⁶⁵ SOP 50 10 5C

lender must review the following to adequately evaluate the borrower's creditworthiness: character, reputation, and credit history; experience and depth of management; strength of business; past earnings, projected cash flow, and future prospects; ability to repay the loan with earnings from the business; sufficient invested equity to operate on a sound financial basis; potential for long-term success; nature and value of collateral; and any affiliates' effect on the applicant's repayment ability.⁶⁶

Use of Proceeds

Borrowers may use 7(a) loan proceeds for a variety of sound business purposes, including starting a new business or assisting in the operating, acquisition, or expansion of an existing business. The following are the specific uses that the borrower may use loan proceeds for:

- Acquiring land by purchase or lease;
- Improving a site (such as grading, streets, parking lots, and landscaping), including up to 5% for community improvements;
- Purchasing one or more existing buildings;
- Converting, expanding, or renovating one or more existing buildings;
- Constructing one or more new buildings;
- Acquiring by purchase or lease and installing fixed assets;
- Purchasing inventory, supplies, or raw materials;
- Financing working capital; and/or

⁶⁶ 13 C.F.R. § 120.150

- Refinancing certain existing debts.⁶⁷

Borrowers are prohibited from using proceeds for certain items. If loan proceeds are used for the following purposes, there may be a denial of the guaranty:

- Effecting a partial change of business ownership or a change that will not benefit the business;
- Permitting the payments, distributions or loans to be paid to associates of the applicant (except for ordinary compensation for services rendered);
- Investing in real or personal property acquired and held primarily for sale, lease, or investment;
- Refinancing existing debt when the lender is in a position to sustain a loss, and SBA would take over the loss by refinancing;
- Repaying delinquent state or federal withholding taxes or any other funds that should be held in trust or escrow; and/or
- Paying for a non-sound business purpose.⁶⁸

Equity Injection

Lenders are required to verify the borrower's equity injection before disbursing loan proceeds. The lender should maintain evidence of this verification in their loan files. Lenders must use every reasonable and prudent effort to verify that equity is injected and will be used in accordance with its intended purpose.⁶⁹ If there is a cash injection, verification should include documentation such as a copy of a check along with evidence

⁶⁷ 15 U.S.C. §636(a); 13 C.F.R. §120.120

⁶⁸ 13 C.F.R. § 120.130

⁶⁹ 13 C.F.R. § 120.102; SOP 50 51 2B, Chapter 13, Paragraph 24

that the check was processed.⁷⁰ For example, the lender could show one bank account statement dated before the disbursement showing that the funds were available and deposited into the borrower's account. Also, the lender could use a copy of an escrow settlement, as well as a bank statement showing the injection of equity into the business prior to disbursement. Generally, a promissory note or financial statement is not sufficient evidence of cash injection. If the equity injection is funded by assets, the lender has a duty to carefully determine the value of non-cash assets.⁷¹

Additionally, the lender must determine if the equity injection is "material" to the borrower's operation. For this purpose, "material" means any equity injection that is greater than 1/3 of the amount of the loan or \$200,000. If the cash equity injection is material, the lender must verify the existence of the injection, as described above, in addition to the source of the cash equity injection. The purpose of verifying the source of the injection is to ensure that the funds will be used for the intended business purpose. Specifically, the lender must present evidence demonstrating that the borrower did not use the proceeds of the loan to fund the equity injection.⁷²

Contents of Application

SBA requires an application for a business loan to contain the following forms and documentation for approval of the guaranty application:

- [SBA Form 4](#), Application for Loan
- [SBA Form 4, Schedule A](#), Schedule of Collateral (lender can use their own document to list collateral and attach it as "Exhibit A");

⁷⁰ *Id.*

⁷¹ SOP 50 10 4, Subpart A, Chapter 4

⁷² SOP 50 51 2B, Chapter 13, Paragraph 24

- [SBA Form 912](#), Statement of Personal History (required for all principals, officers, directors and owners of 20% or more of the borrower);
- [7\(a\) Eligibility Questionnaire](#);
- Personal Financial Statement, dated within 90 days of submission to the SBA, with all owners of 20% or more and any proposed guarantors (lenders may use their own form or [SBA Form 413](#));
- Business Financial Statements dated within 90 days of submission (must consist of year-end balance sheets for the last 3 years, year-end profit and loss statements for the least three years, reconciliation of net worth, interim balance sheet, interim profit and loss statements, affiliate and subsidiary financial statement requirements, and cash flow projection);
- Description of the business, list of principals, and the copy of the lease if applicable;
- Detailed list of all machinery and equipment to be purchased with loan proceeds and cost quotes;
- Equity Injection Form explaining type and source of applicant's equity injection;
- [SBA Form 159](#), Fee Disclosure and Compensation Agreement (must be completed for each agent compensated by the borrower or lender);
- Copy of [IRS Form 4506-T](#), Request for Copy of Tax Return;
- [SBA Form 4-1](#), Lender's Application for Guaranty (includes pro forma balance sheet, explanation of use of proceeds and benefits of loan, lender's

internal credit memorandum, justification for new business, and business valuation for existing business or change of ownership);

- [SBA Form 1846](#), Statement Regarding Lobbying; and
- [SBA National 7\(a\) Authorization Boilerplate](#) language must be complete; and if applicable:
 - If real property is to be purchased with loan, need appraisal, lender's environmental questionnaire, cost breakdown, and copy of purchase agreement;
 - If an existing business is being purchased, need a copy of buy-sell agreement, copy of business valuation, pro forma balance sheet for the business being purchased as of the date of the transfer, copy of seller's financial statements for the last three complete fiscal years or for the number of years in business if less than three years, interim statements no older than 90 days, and an alternate source of verifying revenue if seller's financial statements are not available; or
 - If business is a franchise, complete Franchise Form (need either a Certification of No Change or Non-Material Change if listed on the Franchise Registry, or a copy of the Franchise Agreement and Federal Trade Commission Disclosure Report of Franchisor if not listed on the registry).⁷³

Terms of the Loan

⁷³ 13 C.F.R. § 120.191; *see also* SOP 50 10 5(E)

The lender must comply with the Authorization, which lists the required conditions for SBA to guaranty the loan. In addition to the conditions in the Authorization, there are restrictions on all 7(a) loans for the guaranty percentage, loan maturity, interest rate, and total loan amount. The maximum guaranty percentage cannot be more than 85% for loans up to \$150,000 and cannot exceed 75% for loans over \$150,000.⁷⁴ Therefore when requesting a guaranty, the percentage must remain within the defined parameters. The requested loan amount cannot exceed \$5 million, which yields a guaranty of up to \$3.75 million.⁷⁵

While the Authorization lists the required conditions that must be met, it does not specify the actions that the lender should take to meet those conditions. A lender is expected to be able to carry out the necessary actions to meet the conditions in the Authorization, including:

- Preparing all required loan documents and executing the documents properly;
- Perfecting all security interests in any collateral specified in the Authorization;
- Obtaining evidence that lender actually obtained the necessary lien position; against all required collateral, by means of title insurance or UCC lien searches;
- Disbursing loan proceeds for the uses prescribed in the Authorization; and
- Retaining documentation of the manner by which the lender complied with the conditions set forth in the Authorization.⁷⁶

⁷⁴ 15 U.S.C. § 636(a)(2)-(3)

⁷⁵ *Id.*

⁷⁶ U.S. Small Business Administration, “7(a) Terms & Conditions” <http://www.sba.gov/content/7aterms-conditions>

As far as disbursing the loan, the lender can establish its own disbursement schedule, but all proceeds must be disbursed within 48 months after the date of the approval.⁷⁷ Also, the lender has the option of calculating the loan maturity date from either the date of the note or the date of the initial disbursement. However, a lender must abide by the maximum maturity dates, which are 25 years for real estate and up to 10 years for equipment, machinery, and inventory loans.⁷⁸

The repayment terms must contain the exact boilerplate language for the conditions in the Authorization.⁷⁹ The lender has no option to enter its own specific language for the repayment terms, without approval from the SBA. Generally, 7(a) term loans are repaid on a monthly basis with principal and interest from the loan. For variable rate loans, the lender can require different payment amounts as the interest increases; whereas, a fixed-rate loan will require the same payment throughout the life of the loan because the interest rate is constant. If the maturity is less than 15 years, the lender may not charge the borrower if the loan is paid off before maturity. The lender must be sure that it abides by these conditions when structuring the terms of the loan.

Guaranty & Servicing Fee Payments

To counteract the costs of the loan program, SBA charges the lender a guaranty fee and a servicing fee for each loan. The guaranty fee is a one-time charge that the lender is obligated to pay the SBA. If the loan has a maturity of less than twelve months, the guaranty fee must be submitted with the application, and the fee will be 0.25 percent

⁷⁷ SOP 50 10 5(E), Subpart B, Chapter 7, Paragraph III

⁷⁸ 15 U.S.C. § 636(a)(5); 13 C.F.R. § 120.212

⁷⁹ U.S. Small Business Administration, “7(a) Loan Repayment Terms,” <http://www.sba.gov/content/7a-loan-repayment-terms>

of the guaranteed portion of the loan. For loans with a maturity greater than one year, the guaranty fee can be anywhere between 2 percent to 3.75 percent depending on the amount of the guaranteed portion of the loan, and the fee must be paid within 90 days of the loan's approval.⁸⁰ The lender can charge this fee to the borrower once the SBA gives a loan approval. If the lender does not pay the guaranty fee in a timely manner, SBA can terminate the guaranty.⁸¹

Unlike the one-time charge for the guaranty fee, the servicing fee is an annual on-going charge. This fee will be a percent of the outstanding balance of the guaranteed portion of the loan. The servicing fee will remain in effect for the life of the loan. Contrary to the guaranty fee, the lender may not charge the borrower for this fee.⁸²

Verification of Use of Proceeds

Lenders are responsible for verifying that loan proceeds are being used in accordance with its authorized purpose. [SBA Form 1050](#) Settlement Sheet requires lenders to document disbursement of loan proceeds through the issuance of joint payee checks. If the lender does not use joint payee checks to evidence use of loan proceeds, the lender should provide copies of paid receipts, paid invoices or other supporting documentation clearly showing that the proceeds were used in accordance with the loan authorization. Prudent lending standards mandate that the lender take reasonable measures to verify the use of loan proceeds.⁸³

⁸⁰ 15 U.S.C. § 636(a)(18); 13 C.F.R. § 120.220(a)-(b)

⁸¹ 13 C.F.R. § 120.220(e)

⁸² 13 C.F.R. § 120.220(f)

⁸³ SOP 50 51 2B, Chapter 13, Paragraph 22

Collateral/Lien Position

The lender must obtain proper lien position on collateral. The lender should collateralize the loan to the maximum extent possible. If business assets do not fully secure the loan, the lender should take require available personal assets to be used as collateral. Typically, the lender should create a list of significant collateral securing the loan. The list of collateral should be kept with a UCC financing statement to ensure that the lender will be able to establish priority of its secured position on the specified collateral.⁸⁴ Additionally, the collateral list with the UCC financing statement will greatly assist the process in the event of default and consequent liquidation of the collateral.

Guaranties

The lender must obtain at least one individual or corporate guaranty for each loan.⁸⁵ If there is any entity that owns at least 20% of the borrower entity, this entity must provide an unlimited guaranty. If an individual owns 20% or more of the borrower entity, the lender must obtain an unlimited full personal guaranty from this individual. Additionally, the spouse of the personal guarantor must sign a guaranty on any interest that he or she has in the collateral. In order to determine the assets available to support the guaranty, the lender must obtain financial statements from all necessary individuals and entities.⁸⁶

⁸⁴ SOP 50 51 2B, Chapter 13, Paragraph 27

⁸⁵ SOP 50 10 5(E), Subpart B, Chapter 4

⁸⁶ *Id.*

IRS Tax Transcripts

Lenders must verify the financial information submitted with a loan application using [IRS Form 4506](#).⁸⁷ IRS Form 4506 can be downloaded from IRS website at [IRS.gov](#). However, the IRS will require a fee for processing IRS Form 4506. [IRS Form 4506-T](#) can be downloaded from the SBA website at [SBA.gov](#) and the processing fee will be waived. Even if this requirement is not specified in the Authorization, the lender must check the financial information to be sent to the SBA against the information sent to the IRS to ensure there are no discrepancies. Also, it is important to ensure the borrower is up to date on taxes because the borrower is prohibited from using any of the loan proceeds to pay past-due taxes.⁸⁸

Environmental Investigation

The lender is required to get an environmental investigation on all commercial property, which has a security interest offered as security for the loan. The lender must check the NAICS to ensure that the property is not in an environmentally sensitive area. Once the lender determines that it is not likely that the property has environmental contamination, the lender must submit an environmental questionnaire to SBA with recommendations and request SBA to send an environmental approval.⁸⁹ If there is evidence of contamination, the lender must get a Phase I and/or Phase II Environmental Site Assessment (ESA) and take necessary actions depending on the assessment results.⁹⁰

⁸⁷ SOP 50 50 4A, Chapter 9, Paragraph 4(b)

⁸⁸ 13 C.F.R. § 120.160

⁸⁹ SOP 50 10 5(E), Subpart B, Chapter 4, Paragraph III

⁹⁰ *Id.*; see SOP 50 10 5(E), Subpart B, Chapter 4, Paragraph III (E-G)

Insurance

The Loan Authorization will contain the insurance requirements from origination of the loan. The Authorization will always require hazard insurance to insure the collateral.⁹¹ Also, the lender should always get a title commitment (and associated policy of title insurance) on the property to insure the required lien on the property.⁹²

Additionally, the lender must get a Standard Flood Hazard Determination ([FEMA Form 81-93](#)) done on the property.⁹³ If it is determined that the property is in a special flood hazard area, the lender should require the borrower to get flood insurance through the National Flood Insurance Program (NFIP).

As opposed to insuring the collateral with hazard and flood insurance, life insurance is actually considered collateral. When the viability of the business and repayment ability is directly attached to one individual, the lender should require an assignment of life insurance. If the loan is fully collateralized otherwise, life insurance may not be necessary, but it should be obtained if possible to protect the lender's interest in a key individual of the entity. In addition to the common insurance requirements mentioned above, the lender may also need to require other insurance suitable to the loan, such as liability insurance, disability insurance, and worker's compensation insurance.⁹⁴

It is crucial that the lender monitor the status of the insurance. If the insurance lapses and the property is destroyed or the insured dies, the lender will be accountable for the loss. As soon as the lender becomes aware of a lapse in the insurance, the lender must determine what action is considered prudent and reasonable. In some instances, the

⁹¹ 13 C.F.R. § 120.160(C)

⁹² SOP 50 57, Chapter 9, Paragraph B

⁹³ 13 C.F.R. § 120.170

⁹⁴ SOP 50 10 5(E), Subpart B, Chapter 5, Paragraph II

prudent and reasonable action may be to force the insured to guarantee that the lender and SBA are protected under the insurance policy, either by reinstating the insurance or signing a new policy.⁹⁵

Standby Agreements

A lender must obtain a Standby Agreement ([SBA Form 155](#)) if there are other creditors involved in the secured property. The standby creditor must agree to subordinate any lien rights in collateral securing the loan to the lender's rights in the collateral, or if applicable subordinate, in full or in part, any payment rights due standby creditor to lender's rights to payment. The creditor must also agree not to take any action against the borrower or any collateral without lender's consent.⁹⁶ This agreement is essential to ensure that the lender obtains the necessary lien and debt position.

Monitoring Creditworthiness

The lender is required to continually monitor the borrower's creditworthiness. The lender is responsible for ensuring the borrower maintain a steady financial and operational condition. The lender can monitor credit by requiring the borrower to submit financial statements, maintaining constant contact with the borrower on the status of the business, and reviewing credit reports, credit scores, or tax information when needed to verify the borrower is still creditworthy.⁹⁷

⁹⁵ U.S. Small Business Administration, "Helpful Hints for Navigating the National Guaranty Purchase Center," http://www.sba.gov/sites/default/files/Helpful_Hints_Guide_20120504.pdf

⁹⁶ SOP 50 10 5(E), Subpart B, Chapter 5, Paragraph IV

⁹⁷ SOP 50 57, Chapter 3, Paragraph E

Site Visits & Safeguarding Collateral

All lenders are required to make timely site visits to assess the value of the property. Additionally, lenders must take inventory of loan collateral to assess workout possibilities and develop a significant liquidation plan. A site visit is generally considered timely within 15 calendar days of the occurrence of an event that would cause the loan to be placed in liquidation, such as abandonment of the business, bankruptcy of the borrower when loan is in default and substantial collateral exists, litigation against the borrower that may have a substantial adverse effect on the lender's interest, or foreclosure by a prior lien holder on substantial collateral. If there is significant collateral that could be removed or the value could be depleted, the site visit should be made as soon as possible. A current appraisal or third party inspection is acceptable to assess the current collateral value.⁹⁸

Servicing & Liquidation Approval

As mentioned earlier, the lender should refer to the Servicing and Liquidation Action [7\(a\) Lender Matrix](#) before any action to determine whether it requires prior SBA approval or notification.⁹⁹ Generally, the lender will need written approval from the SBA for the following types of servicing activities:

- Altering substantially the terms or conditions of any loan (including an increase in principal amount or change in interest rate);
- Releasing collateral having a cumulative value in excess of 20 percent of the original loan amount;

⁹⁸ SOP 50 51 2B, Chapter 13, Paragraph 28

⁹⁹ U.S. Small Business Administration, "7(a) Servicing and Liquidation Actions Matrix," www.sba.gov/content/7a-servicing-and-liquidation-actions-matrix

- Accelerating the maturity of the note;
- Bringing a suit upon any loan;
- Compromising or waiving a claim against any borrower, guarantor, obligor, or creditor arising out of the loan; and/or
- Increasing the amount of any prior lien by the lender on collateral securing the loan.¹⁰⁰

If any servicing or liquidation action does not require prior approval, lenders should document all justifications for their decisions with supporting documentation in their file.

Liquidation & Litigation Plans

All Lenders are expected to liquidate and conduct debt collection litigation for 7(a) loans in their portfolio no less diligently than for their non-SBA portfolio. This includes liquidating in a prompt, cost-effective, and commercially reasonable manner, consistent with prudent lending standards, and in accordance with Loan Program Requirements. All collateral should be liquidated and all worthwhile avenues of collection should be pursued until loans can be charged off. Lenders must take precaution in liquidation actions to ensure that no actual or apparent conflict of interest will result from the lender's actions. For instance, if the lender has any loans that are not guaranteed by SBA, the lender may not take any action which confers a preference to the lender over recovery on the SBA loan.¹⁰¹

¹⁰⁰ 13 C.F.R. § 120.513

¹⁰¹ U.S. Small Business Administration, "Helpful Hints for Navigating the National Guaranty Purchase Center," http://www.sba.gov/sites/default/files/Helpful_Hints_Guide_20120504.pdf

Lenders should prepare a liquidation plan based on the facts known and reasonable assumptions. This practice is considered prudent and commercially reasonable to maximize recovery. [SBA Form 1979](#) can be used to properly prepare your liquidation plan.¹⁰² Further, lenders must liquidate all business personal property that secures the loan before the lender submits a purchase package to the SBA, unless the borrower has filed for bankruptcy.¹⁰³

In addition to a liquidation plan, lenders should prepare a litigation plan to include any work to be performed and fees to be charged. Depending on the anticipated cost and the nature of the work, lenders must obtain SBA's prior approval of a litigation plan before entering into any non-routine litigation. Non-routine litigation includes factual or legal issues in dispute that require resolution through adjudication; legal fees that are estimated to exceed \$10,000; lender has a potential or actual conflict of interest with the SBA; or lender has made a separate loan to the borrower, which was not a loan by SBA.¹⁰⁴

Practice Tip: If a lender engages in non-routine litigation, incurs legal expenses, and then submits its litigation plan and invoices for legal work already performed, these legal expenses could be challenged and might be disallowed.

Secondary Market Purchase

Once the loan is 60 days past due, SBA advises the lender to repurchase the defaulted loan from the secondary market holder. If the lender repurchases the defaulted

¹⁰² U.S. Small Business Administration, "SBA Form 1979, Liquidation Plan Format," www.sba.gov/sites/default/files/bank_sba1979.pdf

¹⁰³ 13 C.F.R. § 120.520(a)

¹⁰⁴ U.S. Small Business Administration, "Litigation Plans," www.sba.gov/content/litigation-plan

loan, all recoveries on repurchased loans must be forwarded to the SBA within 15 days of receipt. If SBA purchases the loan from the secondary market, the lender must submit a loan status report within 15 days of the purchase.¹⁰⁵ The lender's report should include a status report on the borrower and the condition of the collateral, plans for any type of loan workout or restructuring, any current or further liquidation activities, and/or the status of any ongoing or potential foreclosure proceedings. The lender is still responsible for servicing and liquidation activities after SBA purchases the loan so it should keep adequate documentation of all actions to submit to SBA with the loan report.¹⁰⁶

Maturity

The lender must send a demand for purchase within 180 days of maturity of the loan, completion of the liquidation, or debt collection litigation in connection with the loan.¹⁰⁷ If the demand letter is sent later than 180 days after maturity, SBA will be released from its guaranty. If the lender needs to extend the maturity, SBA approval is required and must be requested prior to stated maturity of the loan.

Certified Transcript of Account

A lender should document all transactions to the borrower's account. If the loan is in default, the lender must submit a certified transcript of account to SBA when the lender requests guaranty purchase.¹⁰⁸ The transcript must adequately reflect all transactions on the borrower's account. Specifically, the lender must include the payment

¹⁰⁵ 13 C.F.R. § 120.520(c)

¹⁰⁶ 13 C.F.R. § 120.524

¹⁰⁷ 13 C.F.R. § 120.524(a)(8)

¹⁰⁸ SOP 50 50 4D

receipt dates, next due date, interest rates in effect throughout loan's term, application of payments and sale of collateral proceeds, and the interest paid to date.¹⁰⁹ The lender must carefully document all information because the lender has to certify that it is a true and accurate reflection of the account.

Reporting

The lender must report the status on all 7(a) loans on [SBA's 1502 report](#) to the FTA on a monthly basis.¹¹⁰ When the loan is transferred into liquidation status, the lender must change the status code on the monthly 1502 report to "5" for liquidation status. After purchase of the guaranty, quarterly liquidation reports must be submitted to SBA at sbchargeoff@sba.gov.¹¹¹ Once the lender becomes reasonably aware that the loan is ready for charge off, the Wrap-Up report should be sent, but only after the lender has made a final determination that the loan will not be fully repaid after all worthwhile collateral has been liquidated and no further recoveries are anticipated within a reasonable time.¹¹²

¹⁰⁹ *Id.*

¹¹⁰ SOP 50 57, Chapter 3, Subpart F; U.S. Small Business Administration, "Lender Reporting," <http://www.sba.gov/category/lender-navigatgion/lender-reporting>

¹¹¹ *Id.*

¹¹² SOP 50 57, Chapter 26

V. Conclusion

All lenders choose the SBA 7(a) loan program for the government guaranty. Therefore, a lender must do everything in its power to protect and realize the guaranty. The most crucial step along the process is documenting all your actions to justify that you acted as a prudent lender in accordance with the Authorization and SBA loan requirements. A lender should not wait until a loan goes into default to attempt to remedy an issue. If an issue arises along the journey, a lender must proactively work with the SBA to resolve the issue once it arises. As a lender, protect yourself at every stage, and you will ultimately be on the road to realizing your SBA 7(a) guaranty.