



How to Structure SBA 7(a) and 504 Short Sales

Coleman

a Coleman Webinar
January 10, 2012

How to Ask Questions

- Use Go-to-Meeting's chat function, you can choose to ask question in writing or verbally. If comfortable, give us your first name, name of bank, and city.
- Send an email to bob@colemanreport.com
- Follow www.Twitter.com/bobcoleman #sba and engage in the discussion

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Small Business Lending Industry Discussion



Bob and Charles Show 1:50 - 2:00 PM ET.



We are featuring a complimentary small business lending industry discussion with Bob Coleman, Editor of the Coleman Report and Charles Green, Author of The SBA Loan Book: Bestselling book on SBA-guaranteed financing. This discussion will start at 1:50 PM ET and end at 2:00 PM ET.

Our “How to Structure SBA 7(a) and 504 Short Sales” webinar will begin promptly at 2:00pm ET.

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National Expert Panelist



Mitch Fogel

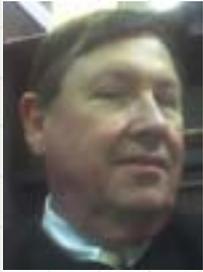
Partner

Fogel Law Group

Licensed to practice law in Florida since 1987, Mr. Fogel founded Mitchell C. Fogel, P.A. in Ft. Lauderdale, Florida in March of 1991. Presently, the law firm is known as the Fogel Law Group (FLG). Formed to provide the highest level of legal services, counseling and professionalism to its clients, FLG has closed numerous loans for its lender clients, including hundreds of SBA 7(a) and 504 loans, earning the firm an excellent reputation nationwide for its expertise in SBA loan transactions. Most recently, FLG has been engaged by many of its lender clients to handle modifications, workouts, foreclosures and liquidations of both SBA 7(a) and 504 loans. Please visit the Areas of Expertise section of the firm's website for more information on how the firm can assist you with your legal needs.

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National Expert Panelist



Timothy Yentsch
Vice President - Underwriting
Independence Bank

Our expert instructor, Tim Yentsch, is the senior credit officer at Independence Bank looking at proposals in many industries including, maritime loans and commercial real estate, gas stations, and government contractors. He heads a condominium association loan program active in New England and NY. Yentsch is also a workout officer with extensive experience in SBA lending including large insolvency cases, investigations, and liquidation of OREO. Yentsch has an MBA in Finance from Cornell University.

Coleman

Moderator



Bob Coleman
Editor

Coleman Report

Bob Coleman is the Author of "Money Money Everywhere And Not a Drop For Main Street". Coleman is the Editor of the Coleman Report, a trade newsletter for small business bankers. He is the nationally recognized expert on small business banking. He has appeared on Fox Business News and CNN and has been quoted by most major financial media outlets including the Wall Street Journal, New York Times and Bloomberg. He has spoken at numerous small business banking events across the United States, including international engagements. Coleman has a B.A. in Medieval History from the University of Southern California and a M.B.A. in Real Estate Finance from the University of Southern California.

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How to Structure SBA 7(a) and 504 Short Sales

I. *Purposes of the Webinar*

- A. To identify what is a short sale.
- B. To address practicalities and myths encountered regarding commercial short sales.
- C. To understand how and under what conditions real property with a lien securing either a loan made pursuant to either the 7(a) Loan Program or the 504 Loan Program of the United States Small Business Administration (SBA) can be sold in a short sale.
 - a. To identify the issues that must be addressed and resolved for a successful short sale involving the lien of an SBA loan.
 - b. To know which parties must be involved in a successful short sale;
 - c. To understand what laws and existing agreements affecting the SBA and its liens, or the liens of 3rd parties, must be complied with and/or overcome :
 - i. State and local laws;
 - ii. Title concerns;
 - iii. Liens and/or possession claims by third parties;
 - iv. the **Authorization (SBA 7(a) Guaranteed Loan)**;
 - v. the **Authorization for Debenture Guarantee (SBA 504 Loan)**; and
 - vi. the documents executed by the Lender of the Loan, such as the **Mortgage and Security Agreement**, the **Third Party Lender Agreement** (SBA Form 2287) or, for closings prior to August 2007, the **Prior Lienholder's Agreement** (SBA Temporary Form 2104)
- D. To learn some strategies that will enable the successful closing of a commercial short sale involving the lien of an SBA loan.
- E. To learn strategies and pitfalls in coordinating short sales and personal OIC (which avoids difficult deficiency issues).

II. *Definitions*

- A. The term "short sale" is used to describe a real estate or other asset transaction where:
 - a. The total of all liens and other encumbrances secured by and affecting the property being sold exceeds the value at which the subject property is being sold. The liens and encumbrances are most frequently in the form of mortgages from existing financing, but may also be tax liens, assessment liens, special claims blocking transfer (see below) and/or judgments.
 - b. The holder's of such secured liens agree to release their respective liens on the property even though such holders will receive less than the full amount due on the lien from the proceeds of the sale.
 - c. This mechanism can be used for the disposition of encumbered real estate and/or business assets, for example franchises, professional practices and wholesalers with a customer list being the most suitable.

- B. “7(a) Loan” means a loan made under the SBA 7(a) Loan Program.
- C. “504 Loan” means a loan made under the SBA 504 Loan Program.
- D. “IRS Offer in Compromise” means an agreement made under the Internal Revenue Service’s (IRS) Offer in Compromise (OIC) program which allows qualified individuals with an unpaid tax debt to negotiate a settled amount that is less than the total owed to clear the debt. The SBA offer in compromise program was originally inspired by IRS and there are many similarities. Often similar documentation can be used for both.
 - a. A taxpayer uses the checklist in the Form 656, Offer in Compromise package, to determine if the taxpayer is eligible for the offer in compromise program.
 - b. The objective of the OIC program is to accept a compromise when acceptance is in the best interests of both the taxpayer and the government and promotes voluntary compliance with all future payment and filing requirements.
 - c. A big issue with IRS is uncertainty about how much tax is due- if returns- especially payroll tax reports aren’t filed it can derail a settlement
 - d. The IRS considers the taxpayer’s unique set of facts and circumstances: ability to pay; income; expenses; and asset equity.

III. *General Assumptions and Conditions*

- A. The Seller has determined, for any number of reasons, that selling the subject property is the proper thing to do, but it can not sell the property for a price sufficient to pay off all liens affecting the property (“Liens”) including, but not limited to, mortgage debt, taxes, assessments, and/or judgments. In many cases, the short sale of commercial properties is the only good way out of a bad situation for everyone involved, and for this reason, is a good option to consider if one is in danger of losing his or her company due to increased financial hardship.
- B. The Seller may, or may not, be in default under any of the Liens; but, if not in default, is often feeling like a default is imminent if the property is not sold.
- C. The Seller still holds title to the subject property, even if a foreclosure action has been commenced.
- D. Seller is still authorized to enter into and consummate the contract for the sale of the subject property.
- E. The debtor and the lien holder(s) recognize that the physical property of the debtor can be in jeopardy of foreclosure by the lender if something is not done to stop the debtor’s financial hemorrhaging.
- F. The Seller and Buyer have entered into a bona fide contract for the sale and purchase of the subject property.
- G. In the 504 Loan, the debenture has already been sold.
- H. Best candidates are companies with positive EBITDA and partial DSC where debt is the issue not basic unprofitability. Companies which can function as part of a group (i.e. certain franchises) are also good candidates.

- I. There is a *reasonable* expectation that all competing creditors can be identified and agreements reached. Cases where borrower's RE is in a RE holding company are particularly suitable for this approach. Cases where there are no legal "firewalls", uncooperative junior lienors, or poor business records (and creditors coming "out of the walls") generally require foreclosure, receivership, or insolvency to "sort out".

IV. *Short Sale Issues and Considerations*

- A. **Purchase and Sale Agreement (PSA).** The PSA must be a bona fide agreement. It must include as a term that the closing is contingent upon the approval of the deal by the lien holders and the agreement of such lien holders to accept a full payoff of an amount *less* than the applicable lien, which may be found in a short sale addendum. Be conscious of the following issues:

- Dilatory buyers (waiting for the Bank to own so they can get a bargain)
- Buyer friendly P&S with overly generous walk away provisions
- Buyers without financing- the P&S is only as strong as the buyer
- Unrealistic listing prices and broker warehousing
- There has to be a built in sunset on sale efforts
- Your neighbor is often your best buyer
- The present use of the property may not fetch the highest price

- B. **Title matters.** It is critical that a title search be performed once the PSA is executed (perhaps even beforehand) so that Seller and Buyer can determine what lien holders and other parties need to be contacted regarding the proposed short sale. The title search will help to identify and provide information regarding mortgages, tax delinquencies, judgments, municipal and association assessment liens, and code violations and fines. As the Buyer (and its lender) will require that clear and marketable title to the property be conveyed at the closing of the short sale, it is best to update the title search frequently during the short sale process as other liens may appear that were not on the original title search. It is possible that each lien holder will require separate negotiation if the proceeds of the short sale are insufficient to fully pay the lien holder the amount of its lien, so it is best to know this title information as early as possible. Also, the title search will provide information as to whether any of the liens affecting the property are with regard to a 7(a) loan or a 504 loan, either of which invoke other regulations with which compliance is required in order to close the short sale (as discussed below).

C. **Liens**

- a. *Mortgages:* Most often the largest lien affecting the property and therefore one of the most challenging and time consuming. A request from a debtor to approve a short sale should be analyzed in the same manner as any other request for release of lien for consideration. The decision to approve the short sale is whether (a) the dollar amount offered as consideration in

exchange for release of the lien in the short sale meets or exceeds (b) the dollar amount which the lender would reasonably expect to receive if the lender were to foreclose on the property, carry it until disposition, and sell it. Obtaining approval for a short sale may require considerable negotiation and time, and may also need the approval of a specific lender committee or party, so sufficient time must be allocated for this effort. The lender will require, at a minimum, that the following documents be submitted for its review and analysis in making its determination of whether to approve the proposed short sale:

- The Real Estate Listing Agreement;
 - The PSA (including all Addenda such as a Short Sale Addendum);
 - If possible, a draft PSA or terms sheet may be of use at inception of sale efforts
 - A current title report (updated as needed);
 - Draft and final Settlement Statement;
 - Particularly when a business is being short sold, the Settlement (or Closing) Statement is often a *moving target*, which may require or make most sense the use of holdbacks and an escrow agent to administer such holdbacks
 - Written consent and approval from any other lien holder whose agreement is required to complete the short sale;
 - An appraisal of the subject property; and
 - Approval letter from the purchaser's lender, if any.
- b. *Real Estate and Personal Property Taxes:* In general, real estate taxes owed on the subject property have the highest priority and become a lien on January 1st of each year, even if such taxes are not due and payable until later that calendar year. It is not likely that these taxes can be reduced by negotiation, so they will need to be fully paid at the closing, and perhaps even beforehand as an advanced expense which is recovered at closing, which will then reduce the amount available to pay the other lien holders.
- c. *Judgments:* Depending on state law, a judgment against the Seller may become a lien on property held in title by the Seller. If this is the case, then (1) then the judgment holder is a lien holder and (2) depending on priority, the judgment may need to be addressed so that Seller can convey clear and marketable title to the property at the closing of the short sale.
- d. *Assessments:*
- Municipal Assessments
 - Assessments by cities and counties, including special assessments, are commonly a lien against ALL property

owned by the seller and located in the county in which the code violations exist (check local laws).

- Penalties on unpaid charges often accumulate daily and can grow to be a VERY large part of the lien.
- These can often be negotiated to reduce the amount of the penalty but NOT the underlying assessment.
- Association Assessments
 - If the subject property is located in a PUD or other form of organization (e.g., an office park, an office condominium) which has common interests (such as landscaping, security, paving, electric, and water), then there will likely be a recorded Declaration or other instrument which provides for each owner within the organization to pay assessments to cover the expenses incurred regarding the common interests. The Declaration (and even some state laws) will likely provide that such assessments are a lien against the owner's property and may also confer priority of such lien over the lien of a mortgage (check local laws).
 - There will often be other charges included in such lien for the association's efforts to enforce the lien, such as attorney's fees and costs, which will cause the lien to grow significantly.

e. *Other liens:*

- Municipal Liens
 - Charges for utilities and water are frequently a lien against ALL property owned by the seller and located in the county in which the code violations exist (check local laws).
 - Penalties on unpaid charges often accumulate daily and can grow to be a VERY large part of the lien.
 - These can often be negotiated to reduce the amount of the penalty but NOT the underlying charges.
- Code Violations
 - Fines for code violations are frequently a lien against ALL property owned by the seller and located in the county in which the code violations exist (check local laws). These may preclude use of facility for a particular purpose, critical industries-septic fields –particularly restaurants, gas stations. Be aware that a “grandfathered” property use may EXPIRE after a year of vacancy.
 - These often accumulate daily and can grow to be VERY large liens.
 - Municipality will often negotiate to reduce the amount of the lien under certain conditions; but ONLY as to real property which is NOT the property on which the code

violation existed and NOT at all if the code violations remain uncured (e.g., gas stations).

- Special taxes
 - In many cities and counties, there exist special tax districts and special taxes (e.g., for hospitality, restaurants, hotels) (check local laws).
 - Penalties on unpaid taxes often accumulate daily and can grow to be a VERY large part of the lien.
 - These can often be negotiated to reduce the amount of the penalty but NOT the underlying tax.

f. *SBA*:

- When a loan is made pursuant to the SBA 7(a) or 504 loan programs, additional laws and regulations become applicable to the disposition of the loan, including in the case of short sales, and the SBA is entitled to participate in the decision making process of the short sale.
- SBA had recently tightened its position on Purchase Money Note Receivable Financing (within an existing SBA loans).

D. Communication and Negotiation

- a. One of the most important steps in beginning the short sale process for commercial properties is to first contact the lien holder(s) and make a proposal. This proposal will ideally include a breakdown of the potential foreclosure costs as they compare with the difference between the short sale amount and the net worth of the property. Other important pieces of documentation to include are estimates of projected improvements needed in order to make the commercial property desirable, as well as a letter of hardship to the lien holder explaining both the current and prospective financial situation of the company. Having these documents on file with the lien holder will help secure a speedy decision on their part, and therefore, financial peace of mind on the part of the property owner.
- b. Generally, because the sales proceeds belong to the secured creditor(s), and not the debtor/seller, the secured creditor(s) can negotiate the amount of closing costs paid from the proceeds of a short sale, such as real estate commissions. Such negotiations can be very intense, particularly when it comes to (i) satisfaction of junior liens and (ii) closing costs, particularly brokers' commissions. Best practice is to get the junior lien holder to agree to terms in writing as early as possible. If there is no PSA yet, but the short sale process has commenced, to give the junior lien holder(s) some incentive, perhaps offer a small fixed amount PLUS some portion over a fixed amount that the senior lien holder receives, which incentivizes all parties (See Excel Tool included with this Webinar).

- c. As the short sale moves towards the closing, there will be multiple negotiations proceeding concurrently with the lien holders, the Seller, the Buyer, the Brokers and other parties, each of whom will have some degree of leverage in getting the deal to close. Of course, as discussed below, when the subject property is under the lien of a 7(a) loan or a 504 loan, then there will be additional regulations that must be complied with for the short sale to be consummated. Moreover, even if ALL of the lien holders agree on the closing figures and distribution of sales proceeds, a short sale can be delayed, and even cancelled, if the SBA does not also agree to such terms. Accordingly, it is very important to identify the existence of the SBA in the short sale process and to initiate communication with the SBA regarding the short sale as soon as possible.

E. Other Considerations

- a. *Going concern:* Frequently, the highest sale value will be obtained if the debtor's real property and its business are sold as a "going concern" rather than as an empty building.
1. Permitting the debtor to maintain its business gives the debtor something to sell and keeps the debtor engaged in the process, thus the debtor is more likely to maintain the property...thus benefitting the lender (i.e., less carrying costs). Lender can make such conduct a condition of its short sale approval.
 2. The more that the property and business are sold for, the less any deficiency the debtor and/or guarantors are liable for....which often keeps the debtor engaged in the process and acting to maximize the sale price.
 3. A Forbearance Agreement, with a "sunset provision" and a confession of judgment in favor of lien holder, may be necessary during this pre-sale period.
 4. Note the following regarding SBA policy concerning going concern sales:
 - While SOP appears to ease restrictions on going business compromises, SBA still views this as an exception to policy and will approve only the most compelling cases (i.e., save the "town").
 - A sale not completely arms length will be viewed as a going business compromise if the owner settles with the lender and SBA at the same time.

- If the owner of the business that is being short sold remains in management, SBA will scrutinize such owner's employment terms and contract.
 - They can and will consider coordinated sale/OIC arrangements but do not want to give the appearance that the debtor "held the collateral hostage" to get a better deal.
 - Classic cases:
 - franchise, dealership or professional practice that must stay open.
 - collateral that requires continued time, attention and care (e.g., golf course, agriculture).
 - A business with considerable consumer A/R, customer deposits, or customer list
- b. *Evictions:* There may be a need to evict any or all parties in possession, or claiming a right of possession, so that Seller can convey clear and marketable title to the property at the closing of the short sale. This can be expensive and take a considerable amount of time....which can lead a lender who has priority over these claims to decide that a foreclosure is the desired path.
- c. *Foreclosures:* Some states, including Florida, require foreclosure through a judicial process, while other states have a non-judicial foreclosure process. The type of foreclosure process is critical because, among other things, it has a major impact on the speed in which a foreclosure and liquidation will progress and can be completed, which in turn affects the timing of certain actions under the Loan documents and the SBA Loan documents.
- d. *Special Claims Blocking Transfer:* Franchise terms (per UFOC and Franchise Agreements); other tax claims; timber liens; liquor licenses and taxes; state lottery regulations; fuel agreements (i.e., gas stations); maritime necessities on a fishing vessel; and agricultural liens.
- e. *Appraisal:* An appraisal by a qualified and experienced appraisal company is highly recommended and, for most lender short sales and all SBA-affected short sales, will be necessary under any circumstance.
- f. *Right of First Refusal:* Note that an association, a tenant, or some other third party may have a right of first refusal that will need to be waived for the short sale to close successfully.
- g. *SBA Matters:* There will be regulations to address and satisfy regarding the 7(a) Loan or the 504 Loan.

- h. *Motivations:* As short sales can be very complicated and have many players, it is critical to keep the parties interested and motivated to accomplish the short sale. Motivations include: Debtor's and Guarantor's desire to avoid deficiency; senior lender's maximizing of returns of loan principal, etc.; broker's earning a commission; junior lien holders receiving any portion of their lien and not being foreclosed by a senior lien; keeping a business a going concern for the sake of the employees, customers, community; the carrying expense of the business or property; the timing of the closing; payment of taxes and other municipal charges; the condition of the real or personal property.

F. **Closing and Disbursement.** Once all parties have agreed on the final negotiated terms of the short sale (including all closing expenses, all lien holder payoffs, and final purchase price), the short sale can close and the closing agent will disburse funds in accordance with the Closing Statement *approved in writing* by all applicable parties.

V. *Considerations regarding 7(a) loans and 504 loans*

A. **7(a) Loans:**

a. *The Authorization (SBA 7(a) Guaranteed Loan).*

- i. The Authorization provides the SBA's terms and conditions for approving the application for the SBA to guarantee a specific percentage (usually 75%) of the subject loan.
- ii. If all of these terms and conditions are not fully complied with, then the lender may not have access to the SBA guarantee, which the lender relied upon when it determined to make the subject loan.
- iii. The Authorization requires that all lien instruments including Mortgages, Deeds of Trust, and Security Agreements include the following language:

United States Small Business Administration. The Loan secured by this lien was made under a United States Small Business Administration (SBA) nationwide program which uses tax dollars to assist small business owners. If the United States is seeking to enforce this document, then under SBA regulations:

- (a) **When SBA is the holder of the Note, this document and all documents evidencing or securing this Loan will be construed in accordance with federal law.**
- (b) **SBA may use local or state procedures for purposes such as filing papers, recording documents, giving notice, foreclosing liens, and other purposes.**

By using these procedures, SBA does not waive any federal immunity from local or state control, penalty, tax or liability. No Borrower or Guarantor may claim or assert against SBA any local or state law to deny any obligation of Borrower, or defeat any claim of SBA with respect to this Loan.

Any clause in this document requiring arbitration is not enforceable when SBA is the holder of the Note secured by this instrument.

b. *The Mortgage and Security Agreement*

- i. The Loan documentation will usually provide under what circumstances, and how, Lender must provide written Notice to Borrower
 1. non-monetary defaults;
 2. monetary defaults;
 3. Borrower may have opportunity to cure some or all default(s)
- ii. Lender can't commence an effective foreclosure against Borrower and junior lien holders unless and until Loan's notice requirements have been satisfied, and make sure that all state debtor protection laws are fully satisfied.
- iii. See special required language provided in Section V.A.a.iii. above.

c. *The Security Agreement (Chattel Mortgage)*

- i. The Loan documentation will usually provide under what circumstances, and how, Lender must provide written Notice to Borrower:
 1. non-monetary defaults;
 2. monetary defaults;
 3. Borrower may have opportunity to cure some or all default(s)
- ii. Lender can't commence an effective foreclosure against Borrower and junior lien holders unless and until Loan's notice requirements have been satisfied.
- iii. See special required language provided in Section V.A. a.iii. above.

d. *SBA SOP Requirements*

- vii. **Protect the Collateral** – Lender must take all reasonable measures to protect the Collateral (including agreeing to the short sale, paying real estate taxes or insurance premiums, etc.)
- viii. **SBA Guaranty Sold in Secondary Market** - Bank or SBA to repurchase guaranty
- ix. **Liquidation of Assets** - SBA requires that lender take all reasonable measures to liquidate assets prior to exercising on the SBA Guaranty

- x. **Litigation Plan** – SOP requires that the Lender prepare a litigation plan with your Guaranty claim
- xi. **10-Tab** - SOP requires that application for SBA Guaranty be accompanied by a fully prepared 10-Tab file

e. *Other considerations*

- i. Deficiency claims and judgments.
 - a. When a lien holder, particularly a lender, agrees to accept less than the outstanding balance of the lien, the lien holder may seek a deficiency judgment against the debtor and/or guarantors. In a short sale situation, the measure of the deficiency is the difference between the amount of money received by the lien holder from the short sale and the amount of money (including costs of collection) owed to the lien holder. Of course, the debtor and guarantors will fight any such deficiency claim and this will often be a highly negotiated term.
- ii. Insolvency and Bankruptcy
 - 1. Borrower - will often file or threaten bankruptcy in the course of a short sale negotiation to leverage itself out of a deficiency claim.
 - 2. Guarantor - will often file or threaten bankruptcy in the course of a short sale negotiation to leverage itself out of a deficiency claim.
- iii. Offer in Compromise - CDC and SBA will pursue an Offer in Compromise to recover a deficiency from the debtor and/or guarantors and also has the right to proceed to its Administrative Wage Garnishment (AWG) Rights (discussed below).

B. **504 loans:**

- a. *The Authorization for Debenture Guarantee (SBA 504 Loan).*
 - i. The Authorization provides the SBA's terms and conditions under which the SBA will guarantee the subject Debenture issued by the CDC and used to fund a specific 504 Loan.
 - ii. If all of these terms and conditions are not fully complied with, then the SBA's guarantee may be at risk, which the lender and CDC relied upon when it determined to make the subject loan and Debenture.
 - iii. The Authorization requires that all lien instruments including Mortgages, Deeds of Trust, and Security Agreements include the following language:

United States Small Business Administration. The Loan secured by this lien was made under a United States Small Business Administration (SBA) nationwide program which uses tax dollars to assist small business owners. If the United States is seeking to enforce this document, then under SBA regulations:

- (a) When SBA is the holder of the Note, this document and all documents evidencing or securing this Loan will be construed in accordance with federal law.
- (b) SBA may use local or state procedures for purposes such as filing papers, recording documents, giving notice, foreclosing liens, and other purposes. By using these procedures, SBA does not waive any federal immunity from local or state control, penalty, tax or liability. No Borrower or Guarantor may claim or assert against SBA any local or state law to deny any obligation of Borrower, or defeat any claim of SBA with respect to this Loan.

Any clause in this document requiring arbitration is not enforceable when SBA is the holder of the Note secured by this instrument.

If any interest in the mortgaged property is sold or transferred without the prior written consent of Lender or SBA, Lender or SBA may, if they so choose, require immediate payment in full of all sums secured by the mortgage.”

- b. The *Authorization, Paragraph 3.c.(5)*, provides: “In the event of a default under the Third Party Loan or Third Party Lender Lien, Third Party Lender must give CDC and SBA written notice, referencing the loan number for the 504 Loan, of such default within thirty (30) days of the event of default and at least sixty (60) days prior to Third Party Lender's foreclosure upon the Common Collateral.”
- c. *The Mortgage and Security Agreement*
 - i. The Loan documentation will usually provide under what circumstances, and how, Lender must provide written Notice to Borrower:
 - 1. non-monetary defaults;
 - 2. monetary defaults;
 - 3. Borrower may have opportunity to cure some or all default(s)
 - ii. Lender can't commence an effective foreclosure against Borrower and junior lien holders unless and until Loan's notice requirements have been satisfied.
 - iii. See special required language provided in Section V.B.a.iii. above.

- d. Notice requirements and other restrictions on Third Party Lender under *The Third Party Lender Agreement (SBA Form 2287)* or, for closings prior to August 2007, *The Prior Lienholder's Agreement (SBA Temporary Form 2104)*
 - i. Third Party Lender Agreement, Paragraph 7 of "Terms and Conditions": "In the event of a default under the Third Party Loan or Third Party Lender Lien, Third Party Lender must give CDC and SBA written notice, referencing the loan number for the 504 Loan, of such default within thirty (30) days of the event of default and at least sixty (60) days prior to Third Party Lender's foreclosure upon the Common Collateral."
 - ii. Prior Lienholder's Agreement (Section IV.G.): "Lender will give CDC and SBA written notice of any material default within 30 days after the default. After default, Lender will not sell any of Project Property without giving CDC and SBA at least sixty (60) days prior written notice by certified or registered mail, return receipt requested."
 - iii. Failure to provide the proper notice and to do it timely can have a negative or delaying result in Lender's foreclosure efforts, so make sure to comply. Lender can't commence effective foreclosure against SBA until such notice requirements have been satisfied.
- e. If the default occurs prior to the debenture being sold, then the Lender can proceed to accelerate the liquidation of Loan as it deems necessary as the SBA Loan would not have closed and neither the CDC or SBA would yet be involved.
- f. Lender must visit the Property site to determine:
 - i. What is the status of the Borrower at that location? Is Borrower still in possession?
 - ii. Are there any other parties in possession of any portion of the Property, such as subtenants, whose interests must be foreclosed?
 - iii. What is the condition of the Property? Is a receiver necessary to protect Bank's and SBA's interests).
- g. Lender must promptly contact the CDC and address status of SBA Loan with the CDC's Liquidation Department.
- h. SBA's *Right of Redemption*: This federal right of the SBA may have a chilling effect on the short sale and must be addressed...and resolved...for the buyer to obtain clear title to the subject property at the closing of the short sale.
 - i. Pursuant to 28 U.S.C. 2410 (c), the SBA reserves the right of redemption within one (1) year from the date of the foreclosure sale. Basically, 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, such as an action where the U.S. Small Business Administration is a party, the redemption period is one (1) year from the date of foreclosure sale. SBA must pay out the bid amount, the prior lien holder's advances (i.e., taxes, insurances), and interest); as the outlay is large in relation to SBA's expected recovery it is rarely done. Its potential is more important than the actual process as it usually will hold up deals.

- ii. Where there is no foreclosure sale (such as in states where foreclosures are non-judicial and lenders operate under a "power of sale" clause) there is an issue as to *if and how* the SBA's right of redemption applies. In other words, because 28 U.S.C. 2410 (c), provides that the U.S. has the right of redemption in actions in which the U.S. has a lien and is joined as party...where there is no foreclosure lawsuit, the U.S. is not a party, and there is no right of redemption. Of course, it's not that simple as different circuits and districts interpret 28 U.S.C. 2410 (c) differently, thus some act as if the right of redemption definitely exists, some act as if the right of redemption exists but only if the SBA intervened in the foreclosure action, and others act as if this right does not exist. The bottom line: check your district and circuit if your state is a non-judicial foreclosure state.
- iii. The SBA's one (1) year period of redemption supersedes state law and 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. The SBA may exercise its right of redemption 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. Best practice is to speak with the U.S. Attorney, CDC and local SBA litigation counsel, if any, in advance of the foreclosure sale to determine the SBA's intentions as to the right of redemption.
- iv. Over the last few years (and, it would seem, the foreseeable future), due to the current status of property values, absent a large amount of equity in the property, it is unlikely that the SBA will exercise its redemption right at sale or thereafter. On the other hand, if the SBA did exercise this right of redemption, it would be a benefit to the Lender as the SBA will satisfy the judgment plus the other permitted costs to which Lender is entitled as incurred during the time the Lender held the property.
- v. Where a problem arises is when the Lender has a buyer ready to purchase the property and the SBA's redemption right scares the prospective buyer away. To proceed to close such a sale with a buyer during the one (1) year redemption period, the SBA will need to waive its redemption rights, and such waiver must be in the form of written,

recordable document. My experience is that this can be done in exchange for minimal consideration, depending on the SBA's perception of the value of the property and the likelihood of otherwise collecting on the SBA Loan through other methods.

- vi. You will likely need to work with the U.S. Attorney, the CDC and local SBA litigation counsel, as well as the SBA's Commercial Loan Service Center (CLSC) in Little Rock, AR or Fresno, CA. The SBA will commonly require a copy of an executed, valid and enforceable purchase-sale agreement for the property; a breakdown of known equity; a closing statement or other breakdown of the closing expenses and net funds to Lender at closing; 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 delivered to the SBA, it will process it and decide what consideration it requires for waiving its right of redemption. Once such consideration value is agreed upon, the SBA will be able to sign off on the release of its redemption rights. Keep in mind that this process can take some time, so proceed diligently and with urgency.
- vii. **SBA's Protective Bid** – Inquire with SBA (its counsel or CDC) if SBA will be making a protective bid in the foreclosure sale. Pursuant to 28 U.S.C. 2410 (c), where property is sold to satisfy a first lien held by the United States (i.e., the SBA), the SBA may bid at the sale such sum, not exceeding the amount of its claim with expenses of sale, as may be directed by the head (or his delegate) of the SBA. This right is not often exercised by CDC/SBA as the SBA already has the right of redemption.

C. **Deficiency Claims and Judgments; Offer in Compromise**

- a. When a lien holder, particularly a lender, agrees to accept less than the outstanding balance of the lien, the lien holder may seek a deficiency judgment against the debtor and/or guarantors. In a short sale situation, the measure of the deficiency is the difference between the amount of money received by the lien holder from the short sale and the amount of money (including costs of collection) owed to the lien holder. Of course, the debtor and guarantors will fight any such deficiency claim and this will often be a highly negotiated term.
- b. Lender may pursue an action for deficiency on its behalf against borrower and/or guarantors.
- c. CDC and SBA will pursue an Offer in Compromise to recover a deficiency from the Borrower against borrower and/or guarantors and also has the right to proceed to its Administrative Wage Garnishment (AWG) Rights (discussed below).

D. Other Short Sale Considerations in SBA 504 Loans

- a. The SBA and all other lienholders of the property must agree to the short sale for the new owner to get clear title to the property. Prior to agreeing to a short sale, the SBA will require it receive and review the same documentation it requires in the case of a request for the SBA to waive its right of redemption. If there are many lienholders, this can take quite a bit of time. Many CDC's like short sales and are willing to agree to them under deal specific circumstances, so short sales are becoming more and more common.
- b. No Preference. No Third Party Lender shall establish a preference beyond its rights as a senior lender on the Third Party Loan without the prior written consent of CDC/SBA. See 13 C.F.R. §120.10 for a definition of preference. If the Third Party Lender does take additional collateral or otherwise have a preference, in the case of liquidation, any proceeds received as a result of a preference must be applied to the Third Party Lender's debt prior to the proceeds from the liquidation of the common collateral held by the CDC/SBA and the Third Party Lender.
- c. Subordination to 504 Loan and CDC Lien, of Amounts Attributable to Default Provisions.
 - i. The term "Default Charges" used in this paragraph includes, but is not limited to, prepayment penalties, late fees, other default charges, and escalated interest after default due under the Third Party Loan.
 - ii. To the extent the Third Party Lender Lien secures any amounts attributable to Default Charges, which may exist in the Third Party Loan and Third Party Lender Lien, Third Party Lender Lien is and will be subordinate to the 504 Loan and the CDC Lien. This subordination applies only to CDC and SBA and their successors and assigns, and in no event shall be applicable to Borrower or any guarantor of the Third Party Loan.
 - iii. In the event of default under the Third Party Loan, CDC or SBA may bring the Third Party Loan current or may acquire the Third Party Loan secured by the Third Party Lender Lien. Third Party Lender agrees that in either of these circumstances, the amount to bring the Third Party Loan current or the purchase price of that loan will be net of all amounts attributable to the Default Charges so subordinated to the 504 Loan and the CDC Lien. Third Party Lender further agrees that if it receives from CDC/SBA any amounts attributable to such Default Charges, Third Party Lender holds such funds in trust for SBA and will remit such funds to SBA as soon as possible. Should CDC or SBA not purchase the Third Party Loan but rather bring the Third Party Loan current, Default Charges on the Third Party Loan may remain due and owing from the Borrower.

- d. Liquidation. In the event that either the Third Party Loan or the 504 Loan is declared in default, Third Party Lender and CDC and SBA agree to cooperate in liquidating and/or selling the Collateral. Third Party Lender agrees to (a) accept a U.S. Treasury check(s) in connection with any purchase of Third Party Lender's note or any foreclosure or liquidation bid by CDC or SBA; (b) to provide CDC and SBA with the loan payment status, loan payment history, and an itemized payoff statement of the Third Party Loan; (c) to provide CDC and SBA with copies of any appraisals, environmental investigations, or title examinations or searches of the Collateral conducted by or for Third Party Lender; and (d) to provide any other information about Borrower or the Third Party Loan requested by CDC and SBA in writing.

NOTE: In the new SOP 50-10(5)(D), new language on preferences in liquidation situations was added, further describing the Lender's obligation to disclose any preferential collateral arrangements to SBA/CDC (Chapter 1, Section IV, A(5); page 260; 13 CFR 120.925). Basically, if the Lender has taken additional collateral or otherwise has a preference, then in the case of liquidation, any proceeds from received by the Lender as a result of the preference must be applied to the Loan before applying proceeds from the liquidation of common collateral also securing the 504 Loan. If the additional collateral or other preference no longer exists at the time of liquidation or has insufficient value to justify the cost of collection, then the Lender is not required to liquidate such collateral or other preference provided it notifies CDC/SBA and obtained CDC/SBA's written consent.

IV. *Solution Alternatives to a Short Sale*

- A. Assumption (with or without rate concession)...this solution is only as good as the strength of the party assuming is to make the business work.
- B. Rent – with or without option to buy (fish plant example).
- C. Partial short sale with restructure – e.g., land condo and lease example
- D. Bankruptcy can be used as a short sale vehicle but this involves paying trustee costs and a “carve out for the unsecureds”. Useful in situations where the sweeping powers of the trustee can be used to resolve problems.

** **Judicial Foreclosure** - The judicial process of foreclosure, which involves filing a lawsuit to obtain a court order to foreclose, is used when no power of sale is present in the mortgage or deed of trust. Generally, after the court declares a foreclosure, the property will be auctioned off to the highest bidder at the Foreclosure Sale.*

** **Non-Judicial Foreclosure** - The non-judicial process of foreclosure is used when a power of sale clause exists in a mortgage or deed of trust. A “power of sale” clause is the clause in a deed of trust or mortgage in which the borrower pre-authorizes the sale of property to pay off the balance on a loan in the event of borrower's default. In deeds of trust or mortgages where a*

power of sale exists, the power given to the lender to sell the property may be executed by the lender or their representative, typically referred to as the trustee. Each state has its own rules and regulations for the non-judicial foreclosure process. For example:

- *If the deed of trust or mortgage contains a “power of sale” clause and specifies the time, place and terms of sale, then the specified procedure must be followed.*
- *Otherwise, the non-judicial power of sale foreclosure is carried out as follows:*
 - *A foreclosure notice must be mailed by certified mail, return receipt requested to the borrower no later than 15 days prior to the date of the foreclosure sale. The time period begins the day the letter is postmarked. The notice must be mailed to the address given to the lender by written notice from the borrower. No waiver or release of the rights to notice is valid if it was signed at the same time as the original documents.*
 - *The notice must be published in a newspaper of general circulation in the county where the sale will be held once a week for four (4) weeks proceeding the date of the foreclosure sale.*
 - *The sale must be made by public auction on the first Tuesday of the month between 10:00 am and 4:00 p.m. at the courthouse.*
 - *Lenders may seek a deficiency judgment (state specific).*

SBA Administrative Wage Garnishment (AWG) Rights. Back in September 2011, NADCO sent a Technical Issues Memo (47-11) to its members that advised that most CDCs had recently received an email from their SBA Commercial Loan Servicing Center with a list of all that CDC’s loans currently in liquidation status. That email also advised that the SBA has a collection tool that it wants to use more extensively: Administrative Wage Garnishment (AWG). SBA can initiate an AWG against non-Federal Government employee Obligor on 504 Loans through an administrative (non-judicial) process. SBA advised that it feels that the AWG can be a very powerful tool in the 504 liquidation process. The following is important information regarding the AWG as provided in Technical Issues Memo (47-11).

- *If a 504 Loan is in a workout status, the CDC does not need to supply this information to the CLSC. No individual Obligors in bankruptcy should be included.*
- *Implementation of AWG is appropriate when all the following requirements are met:*
 - *The Obligor is a person as opposed to an entity;*
 - *The Obligor is not a federal civil or military employee or retiree (for current or former federal employees entitled to payments from the Federal Government, there is a separate federal salary offset directly from the Obligor’s paycheck as described below);*
 - *The Obligor is liable on the 504 Loan (as Borrower, Co-Borrower or Guarantor);*
 - *The debt owed on the 504 Loan is legally enforceable (the Obligor has not filed bankruptcy or received a discharge of the debt);*
 - *The Obligor has not been involuntarily unemployed within the last 12 months;*
 - *The Obligor has been employed as an IRS Form W-2 employee for at least 12 months (AWG is not available for individuals who are self-employed); and*

- The Obligor has failed to pay or make satisfactory arrangements to pay the 504 Loan (there has been no successful workout or Offer in Compromise).
- Prior to referring an Obligor for AWG by SBA, your workout attempts should include both a 504 Loan workout/modification and Offer in Compromise. While AWG is not necessarily the “last resort” prior to wrap up and referral to Treasury, SBA expects that the CDC will have made several attempts (through demand letters , site visits, phone calls, etc.) to get the Obligor to arrange for full or partial payment of the 504 Loan.
- The CDC should notify its CLSC of an individual’s eligibility for AWG. Notification can occur at any stage of the liquidation process: in the initial Liquidation Plan, through an amendment to the Liquidation Plan or in the CDC’s Wrap-up Report. The CDC also can simply send an e-mail to the CLSC identifying the Obligor for AWG. AWG of one or more Obligors does not preclude continued collection efforts by the CDC against collateral or other Obligors.
- To initiate AWG, the CLSC needs the following information about the Obligor:
 - The CDCs efforts to work with the individual to facilitate a workout/modification or compromise; and
 - Specific information about where the individual works, including the workplace address, workplace phone number(s) and, if possible, a copy of the Obligor’s IRS Form W-2 (although the CDC probably will not have the IRS Form W-2 unless the individual had outside employment at 504 Loan origination and continued that employment or has attempted a compromise with the CDC) ; and
 - The individual’s Social Security Number and last known address.
- SBA initiates AWG by sending a Pre-Garnishment Notice to the Obligor’s last known address via first-class mail. If the individual fails to respond to the Notice within 30 days, SBA then sends the garnishment papers to the individual’s employer and begins collecting a percentage of the individual’s disposable pay. The garnishment can continue indefinitely until the 504 Loan is paid in full as long as the individual continues to work.
- Not surprisingly, AWG often results in the Obligor now wanting to enter into a workout or compromise of the 504 Loan rather than garnishment. When the Obligor contacts SBA, SBA will notify the CDC and the CDC then works with the individual to achieve either a workout or compromise.
- After referring an Obligor to SBA for AWG, the CDC should discontinue any collection efforts against that individual, but should still pursue any other individual Obligors and any entity Obligors (corporations, partnerships, LLCs, etc.).
- If the CDC obtains information prohibiting collection against an Obligor referred to AWG, such as the individual filing bankruptcy or no longer being employed, the CDC should notify the CLSC immediately.
- As noted above, AWG is not available against individuals who are self-employed, unless the individual draws regular pay from his/her company. AWG also is not available for an individual whose only employment is/was the 504 Loan small business unless the business closed more than one year ago and the CDC can verify that the individual has been employed elsewhere for more than one year.
- SBA has identified an outside contractor, which is a subsidiary of Equifax, called “The Work Number” (www.talx.com). For a small fee (\$15.00 per individual), this company provides employment verifications for individuals. CDCs are encouraged to use this source to obtain business addresses for Obligors. The cost is a recoverable liquidation

expense reimbursable by SBA. Since this is a newer service, not all employers may be listed.

- SBA has issued a new SOP for 504 Loan Servicing and Liquidation, which contains more information concerning AWG when it is released.
- SBA has been using AWG for its disaster loan program with success.
- If the Obligor is a current or former civilian federal employee, an employee of the U.S. Postal Service or Postal Rate Commission, or a member of the Uniformed Services or Reserve of the Uniformed Services and is receiving or entitled to receive funds from the Federal government such as a salary, retirement benefits, training expenses or a lump sum payment, SBA can initiate a “federal salary offset” against payments of those funds.
- Even though an obligor is referred under AWG or federal salary offset, the CDC should still prepare the Wrap-up report within 90 days of completing all liquidation activities (per SOP 50 51 3). However, in that Wrap-up report, the CDC should state that the Obligor(s) has/have been referred under AWG or federal salary offset and those Obligor(s) will be coded “do not refer” to Treasury in SBA’s computer system.

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