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Extension of SBA Section 1112 Payments – Lifeline or Rope to Hang?

Recently, the Consolidated Appropriations Act of 2021 (the "Act") became law. The Act, among other things, provides an extension of up to 8 months on the government payment of monthly principal and interest owed on SBA guaranteed loans (the "SBA Payments") set forth in Section 1112 of the CARES Act.

The SBA Payments provide a much-needed lifeline to small businesses struggling through the coronavirus pandemic and the associated lockdowns. In turn, the SBA Payments provide much-needed support for lenders servicing SBA guaranteed loans, which would otherwise very likely go into default. However, the SBA Payments can very easily turn from a lifeline into a rope to hang if lenders are not careful.

The Act, just like Section 1112 of the CARES Act, makes it clear that the SBA Payments are only appropriate for loans that are in "regular servicing status." Under the SBA 7(a) Loan Servicing and Liquidation Guidelines (the "Liquidation Guidelines") a loan is considered in "regular servicing status" when there have been no defaults that would require the loan to be transferred into liquidation status.

There are a wide variety of defaults that would trigger the obligation of a lender to transfer a loan into liquidation status above and beyond simple payment defaults. The SBA Form Promissory Note (SBA Form 147) specifies that a Borrower is in default if the Borrower:

A. Fails to do anything required by the Note and other Loan Documents;

B. Defaults on any other loan with Lender;

C. Does not preserve, or account to Lender's satisfaction for, any of the Collateral or its proceeds;

D. Does not disclose any material fact to Lender or SBA;

E. Makes a materially false or misleading representation to Lender or SBA;

F. Defaults on any loan or agreement with another creditor if Lender believes the default may materially affect Borrower's ability to pay;

G. Fails to pay any taxes when due;

H. Becomes the subject of a proceeding under any bankruptcy or insolvency law;

I. Has a receiver or liquidator appointed for any part of their business or property;

J. Makes an assignment for the benefit of creditors;

K. Has any adverse change in financial condition or business operation that Lender believes may materially affect Borrower's ability to pay;

L. Reorganizes, merges, consolidates, or otherwise changes ownership or business structure without Lender's prior written consent; or

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M. Becomes the subject of a civil or criminal action that Lender believes may materially affect Borrower's ability to pay.

While it is true that lenders do have a bit of discretion as to when a default justifies transferring a loan into liquidation status, the Liquidation Guidelines make clear that lenders need to act as a reasonably prudent lender would act under similar circumstances.

It is also worth noting that the SBA itself has explicitly acknowledged in SBA Procedural Notice 5000-20049 that Coronavirus related deferrals and relief is only appropriate when borrowers are experiencing "temporary cash flow issues." As such, businesses that have been fundamentally destroyed by the Coronavirus and related lockdowns are not experiencing *temporary* cash flow issues and therefore should not remain in regular servicing status.

Putting all of the above together, it is clear that the SBA is still expecting lenders to fully perform their servicing and liquidation obligations notwithstanding the existence of the SBA Payments. While it is true that payment defaults are off the table, there are a wide variety of non-monetary defaults that require liquidation action by the lender. And, if the lender fails to perform this action and a material loss is suffered, the SBA can and will hit the lender with a repair or a full or partial guaranty denial.

Illustrative Hypothetical

A lender has an SBA loan out to a small exercise facility. The primary security for the loan consists of: (1) a first lien on all exercise equipment; and (2) a lien on all receivables (i.e. member payments).

Due to lockdowns and changes in customer consumption patterns, the exercise facility experiences heavy losses in 2020 and is on the cusp of a complete financial meltdown entering 2021. The exercise facility has not paid rent in the last three months and has not paid a number of key venders in the last six months. Notwithstanding being allowed to re-open to the public on December 18, approximately 50% of customers have opted to terminate their membership because they are uncomfortable working out during a pandemic and because they do not like working out while wearing a mask.

Notwithstanding the foregoing, the lender opts not to conduct an investigation into the business, or move the loan into liquidation status because six months' worth of payments were made by the SBA and then the lender subsequently put the loan on a 3-month deferral pursuant to recent SBA guidance without giving the matter much thought.

With the new round of SBA Payments being announced the lender presumes that no action will need to be taken until mid-2021 and it puts this credit on the back burner, with an internal note to re-assess in June of 2021.

Starting in early 2021, a variety of creditors bring collection action against the borrower and its principal. Service providers stop providing key inputs and the business is forced to close in early February. The owner, dealing with intense financial strain, panics into selling all of the exercise equipment online and pocketing the proceeds. Within a month, the proceeds for the equipment are completely gone and the principal declares bankruptcy. The lender receives the bankruptcy notice in early April and moves the loan into liquidation status at that time.

Due to the bankruptcy, the improper liquidation of substantially all collateral for the loan, and the complete loss of all receivables, the loan becomes essentially uncollectable and a near total loss is realized.

The SBA then conducts an analysis of the file and determines that the borrower's dire financial status was readily ascertainable by January of 2021 at the latest and that the lender acted negligently when it opted not to conduct an analysis of the state of the business at that time. The SBA further concludes that the negligence resulted in a direct and substantial loss given that if liquidation was undertaken in January of 2021 the lender could have secured and liquidated all collateral and could have obtained the remaining receivables. Consequently, the SBA opts to completely invalidate the guaranty and the lender experiences a total loss on the loan.

What Should a Lender Do?

To avoid a nightmare scenario like the one described above, lenders simply need to be diligent and proactive in discharging their servicing obligations. Among other things, this includes:

1. Carefully assessing the file as soon as possible to determine whether a non-monetary default has occurred under the loan documents.
2. Conducting an assessment of deposit account records from 2020 to ascertain whether there have been any suspicious checks or deposits.
3. Obtaining and carefully reviewing financials to assess whether there is continued viability with the business and whether the disruptions to cash flow appear to be temporary or permanent.
4. Verifying and monitoring collateral.
5. Running regular bankruptcy and litigation searches regarding the borrower and any guarantors.
6. Monitoring whether taxes have been paid, and contacting taxing authorities as may be appropriate.
7. Requesting proof that rent has been paid and contacting the landlord if there is a legitimate basis to question the information provided.
8. Documenting the rationale for either placing a loan in liquidation status or keeping the loan in performing status.

Lenders should also consider conducting a collateral perfection audit to determine if there are any errors in mortgages, security agreements, or UCC filings. Errors of this nature are the primary issues that give rise to repairs, so they should be identified and corrected as soon as possible.

If the lender determines that a loan should be placed in liquidation status, the lender should proceed as expeditiously as possible given that any delays could result in losses that may open the lender up to a repair or guaranty invalidation. Any liquidation should be conducted in strict conformity with the SBA Liquidation Guidelines and all timelines and requirements specified therein.

-Matthew J. Bialick, Esq.

Replay of Bankruptcy Fundamentals for Bankers in a COVID-19 World

It is undeniable that COVID-19 has fundamentally changed the economic landscape for many companies and even entire industries. While loan deferrals and government payments have masked the problem in the short term, the long-term damage seems inevitable. With economic strain comes an increase in bankruptcy filings. Filings are already on the rise and that trend should strongly intensify in 2021.

To be effective in their roles, bankers need to have at least a basic understanding of bankruptcy and the different Chapters that they may encounter. This webinar seeks to provide bankers with a 10,000-foot overview of the bankruptcy process and a practical guide on how to effectively navigate through each Chapter.

Viewing Link: https://attendee.gotowebinar.com/register/5647331824616680204

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