Unconventional Wisdom Thomas Wallace

504 Issues: Debenture Sale Conditions and Permanent Financing

"Sweet are the uses of adversity." Obviously, Shakespeare never had to deal with an "unremedied substantial adverse change" in the context of a 504 loan.

Lenders make 504 loans partly based on the perception that at a 50% loan-to-cost-ratio, the permanent financing is extremely secure. But, to get to 'permanent', first the 'interim financing' has to be reduced by the sale and funding of the debenture. Until that point, lenders are potentially 80-90% exposed on a project. In the presence of an "unremedied substantial adverse change", the planned takeout *may* not occur. It can be more than a credit issue since it potentially involves Regulation H compliance issues. This is an outcome to be avoided, if possible.

The 504 Authorization commits the SBA and CDC to bring the debenture to auction, which provides the conversion to the permanent loan by paying down the interim loan—when a series of sale conditions are met. These sale conditions are certified to by the four parties to the loan: the borrower, the interim lender, the permanent third party lender and the CDC. (The interim and permanent third party lenders may be identical; however, the certifications follow the role, not the actual identity *per se*. The CDC counsel also prepares an opinion letter. Citations for the major certifications are provided below on page 6.)

The specifics of what constitutes an 'unremedied substantial adverse change' are broadly written and disclosure requirements are absolute. Per 13 CFR 120.892.a: "The interim lender must certify to the CDC that it has no knowledge of any unremedied substantial adverse change in the condition of the small business since the application to the interim lender". The Authorization is equally broad: "There has been no unremedied substantial adverse change in the financial condition, organization, management, operation, or assets of Borrower and Operating Company". Interim lenders should act with caution.

At a minimum, substantial adverse changes would include the events noted in the SOP that require transferring a loan to liquidation status: closure of the business, abandonment of collateral, significant litigation or an action for protection from creditors. Further obvious issues include collateral impairment: environmental contamination, priming liens (taxes, builders, mechanics, etc.), excessive cost overruns, or title problems. Default under the interim loan itself is equally obvious. The condition of individual principals is self-evident. Please, ask your borrower not to be arrested prior to debenture funding, character does count!

How can a lender protect its interest in these situations? Common sense is a good place to start. Deal with the CDC as you would any other participating lender—with straightforward integrity. The CDC has an economic incentive (within reason and regulatory constraint) to fund the transaction and wants to continue to do business with your institution. Maximize that predisposition by being forthright. The regulations consistently note that the adverse change must be <u>both</u> substantial and unremedied. Therefore, some issues may be determined to be less than substantial or subject to remedy. In the present economic situation, financial issues raise concerns. However, under the new SOP, 504 Authorizations now have a four-year life, so there is a considerable time to remedy adverse financial changes. Work with your borrower and CDC participant to identify, define and pursue remedies.

This implies that you know your CDC. A CDC's willingness to intelligently work through problems is a legitimate criterion for deciding where to place your business. Willingness and intelligence must be matched by documented ability and a bias for action. One easy way to determine this is the delegated authority levels of a CDC: PCLP, ACL, and or ASM status speaks to SBA's opinion of a CDC's abilities.

For situations beyond remedy, the best solution is prevention. Construction loans require management. If as a lender, you are not willing to do so or do not have a trusted outside construction lending source, pass on the opportunity. Equipment loans, particularly for heavy equipment that requires installation and testing, need no less attention. Another option is to require additional collateral during the interim loan. Regulations allow this, but specifically require that the permanent lender not create a preference beyond its rights as a senior lender on the third party loan without the prior written consent of the

Continued on Page 6 >

7(a) Gross Loan Approvals

	FY 2007, 12-12-2007		FY 2008, 12-12-2008		% Change	
	#	$	#	$	#	$
7(a) Loans	17,094	$2,567,023	7,546	$ 1,591,360	-55.9	-38.0
Minority	6,328	872,475	2,071	481,191	-67.3	-44.8
Women	4,204	453,843	1,566	244,555	-62.7	-46.1
SBA Express	10,456	541,359	3,918	238,602	-62.5	-55.9
PLP Loans	3,280	1,580,832	2,012	1,011,243	-38.7	-36.0
$150K & Less	13,357	574,125	5,142	251,892	-61.5	-56.1
504 Loans	1,926	1,143,849	1,121	678,014	-41.8	-40.7

In thousands of dollars.
Approval amount reflects the gross value of the loan at time of initial approval. Does not reflect cancellations or disbursements.

National Association of Government Guaranteed Lenders

Member Spotlight

New Year, New Board Chair — Term Began January 1

The New Year ushers in a new era as **Greg Clarkson, Compass Bank**, begins his three-year term as NAGGL's Chair.

Clarkson has participated actively in NAGGL since 1993. He served as the chair of the Region VI liaison committee, as well as being involved in the Large Bank and Executive committees.

During the 2008 Annual Conference, Clarkson was awarded NAGGL's highest honor, the Distinguished Service Award, for having a never say "no" attitude to serving on and chairing committees; contributing to the NAGGL PAC, participating on panels and presenting at forums, and acting as a popular instructor.

"I look forward to serving the industry as Chairman of NAGGL," said Clarkson."We are facing unprecedented challenges which will require our focus and commitment to resolve. The new administration should provide us opportunities and initiatives to once again provide meaningful levels of capital to the nation's small businesses."

Clarkson is executive vice president and SBA Division manager at Compass Bank (Dallas). He has 22 years in banking with the last 15 specializing in SBA lending. With Compass Bank for 12 years, Clarkson has grown the SBA program into a leading multi-state PLP lender. ◈

> Continued From Page 4

CDC/SBA. In other words, the additional collateral for the interim loan cannot attach to the permanent loan without prior consent.

Unfortunately, SBA does not maintain statistics on the incidence of unremedied significant adverse changes. However, anecdotally, over the past 10 years, the incidence is small (perhaps a fraction of a single percent). In these economically challenging times, it is likely that there will be an increased incidence of issues that rise to the level of 'significant adverse change'. Prudence in lending and choosing CDC partners will make the issue a manageable risk in the extension of credit. ◈

Interim Lender: Authorization Boilerplate Paragraph B.2.c, as defined by 13 CFR 120.891-2, documented by SBA Form 2288

Permanent Lender: Authorization Boilerplate Paragraph B.4.c.1 & 6, as defined by 13 CFR 120.920-5, documented by SBA Form 2287. Preferences are specifically addressed in 13 CFR 120.925.

Borrower: Authorization Boilerplate Paragraph E.9.a.1, as defined by 13 CFR 120.892 and documented by SBA Form 2289.

CDC: Authorization Boilerplate Paragraph F.3, as defined by 13 CFR 120.960, 13 CFR 120.961, 13 CFR 120.891-2 and documented by SBA Form 2101.

Wallace is president of Independent Development Services Corporation, a Florida-based CDC, and has extensive commercial banking experience. He is NAGGL's lead instructor for 504 Lending: Issues and Opportunities for the 1st Mortgage Lender.

Member Spotlight

Each month, we introduce you to our new members and recognize those celebrating milestone membership anniversaries.

Welcome

- Private Bank of Buckhead, Atlanta, GA
- Banco Buena Ventura, Oxnard, CA
- American Capital Credit Corporation, Las Vegas, NV

3 Years

- Richfield/Bloomington Credit Union, Richfield, MN
- American Continental Bank, Los Angeles, CA
- Sandy Spring Bank, Columbia, MD
- BMI Associates, Kaysville, UT
- Pacific Premier Bank, Costa Mesa, CA
- First Intercontinental Bank, Doraville, GA

5 Years

- Beach Business Bank, Long Beach, CA
- First US Community Credit Union, Sacramento, CA
- Franklin Bank, Southfield, MI
- Merchants Bank, Winona, MN
- Millennium State Bank, Dallas, TX
- K&L Gates, Washington, DC
- SD Cooper Company, Huntington Beach, CA

10 Years

- Florence Savings Bank, Florence, MA
- Pacific Capital Bank, San Diego, CA

15 Years

- **Citibank, Los Angeles, CA***

Anniversary dates may be altered due to mergers and acquisitions.

**** Indicates sustaining member status.***