

CHAPTER 5 - LIQUIDATION AND LITIGATION

This chapter emphasizes SBA's policy that Lenders **MUST** service and liquidate all loans and summarizes SBA policy and procedures relating to lender liquidation.

Appendix 5-A to this Guide is a quick reference guide to SOP 50 51 2, which governs liquidation activities, and to SOP 50 50 4, which governs servicing activities.

GENERAL LENDER-SERVICED LIQUIDATION

This section covers general lender liquidation guidelines. Additional guidelines for special programs (LowDoc, SBAExpress, or PLP loans) are covered later in this chapter.

SBA'S POLICY ON LENDER LIQUIDATIONS

SOP 50 51 2A, Chapter 8, ¶ 1

The lender must:

1. Notify the SBA office servicing the loan of any adverse event (i.e., foreclosure or other legal action, bankruptcy, abandonment, dissipation of collateral) when the loan is transferred into liquidation status.
2. Liquidate a loan in a prudent and commercially reasonable manner.
3. Execute SBA Form 152, "Participation Certificate," showing SBA's guaranty percentage of the loan when guaranty purchase is complete (see Guaranty Purchase chapter). This form is necessary to effectively service and liquidate the loan when guaranty purchase has been completed and the lender still holds the documents.
4. Submit a liquidation plan when required by program rules or regulations. *Liquidation Plans are discussed further below.*
5. Maximize recovery in the sale of collateral in the minimum amount of time.

EXCEPTIONS TO RULE REQUIRING LENDER'S HANDLING OF LIQUIDATION

SOP 50 51 2A, Ch. 8, ¶ 10

A. Competing Liens

SBA may take over servicing and/or liquidation of the account if: (1) SBA and the Lender have competing liens against any of the Borrower's assets, or (2) the Lender has a non-SBA loan to the same Borrower or its principals.

If either of these circumstances exist, Lender will be allowed to handle the servicing and/or liquidation, but only if:

1. All disputes have been resolved prior to the commencement of recovery actions, and
2. There is a written agreement as to the distribution of funds and expenses expected to be realized.

B. Past Performance

If a lender's liquidation efforts are or previously have been unsatisfactory, SBA may, at its discretion, take over servicing and liquidation of the account. If a lender is deemed to be unable to properly liquidate loans, SBA may terminate its loan guaranty agreement with the lender. Liquidation responsibilities will be assessed during lender reviews.

INSURANCE

SBA considers it to be a commercially reasonable practice for lenders to purchase or maintain hazard insurance on worthwhile collateral after a loan has gone into default, as well as public liability coverage. Lenders may request that SBA share in the premium expense.

SOP 50 51 2A, Ch. 22

WORKOUTS

SBA encourages the lender to consider workouts wherever possible prior to liquidation. Lender must notify SBA in writing when a lender has reached a workout agreement with the borrower and is removing the loan from liquidation status. If Lender is receiving payments under a confirmed bankruptcy plan, Lender must provide a copy of the plan to SBA. *SOP 50 51 2A, Ch. 5*

SITE VISITS

Site visits to inspect collateral after default are required. Lenders must perform site visits within specified timeframes (discussed below) and conduct a meaningful collateral inspection. Lenders should prepare a comprehensive listing/inventory of collateral at default along with an assessment of the collateral condition based upon the site visit. Lenders can substitute third party inspection reports from inspection or appraisal services firms as long as the costs are reasonable and customary and the services are provided within the timeframes specified below.

SOP 50 51 2A, Ch. 8, ¶ 8

Timeframes for site visits:

1. Within 60 days of an unremedied default in payment; or

2. As soon as possible after default if there are assets of significant value that could be removed or depleted; or
3. Within 15 days of any of the following events (regardless of delinquency status):
 - a. Business shutdown or abandonment
 - b. Foreclosure or other advance action
 - c. Bankruptcy or receivership
 - d. Any reason to believe the collateral is being lost or its value diminished

PRIVATE NEGOTIATED SALES

A. Lenders liquidating SBA loans may use private/negotiated sales:

1. If it is their usual practice for similar non-SBA assets
13 CFR 120.540 c (1)
2. If the sales were disclosed in their liquidation plan or subsequent amendments to the plan
3. If the lender meets these two requirements:
 - a. Reviews liens on the property to determine that the property is free and clear of all liens, or the lienholders must cooperate in the sale or transfer of title, and
 - b. Has a current appraisal no older than one year to justify the sales price
SOP 50 51 2A, Ch. 8, ¶17-20

B. Some types of sale require a closer review *SOP 50 51 2A, Ch. 8, ¶ 19*

1. Private UCC sales
2. Sales of a "going" business in its entirety
3. Private sales of collateral may not be made to existing owners without prior written SBA approval
4. Term sales – normally apply to real estate. Special compelling needs must exist for a term sale of personal property.
SOP 50 51 2A, Ch. 7, ¶ 6

LENDER'S HANDLING OF LIQUIDATIONS

Liquidation Plans

Prior to initiating recovery procedures lenders are required to prepare a liquidation plan which contains the information referred to in SBA Form 1979, Liquidation Plan Format. For CLP and regular 7(a) lenders, if the principal balance of the loan at the time of default is **\$50,000 or more**, the liquidation plan must be submitted to SBA prior to starting liquidation action. If the balance at default is **less than \$50,000**, the plan is to be retained in the lender's files, and submitted to SBA at guaranty purchase. *SOP 50 51 2A, Ch. 8, ¶11.b* Except for loans with under \$50,000 principal balance at time of default, SBA must give its consent to the general liquidation plan at the outset (including anticipated litigation) and whenever significant modifications to the plan are needed. PLP lenders must submit a liquidation plan at the time of guaranty purchase for loans with a principal balance over \$50,000. *SOP 50 51 2A, Ch. 10, ¶5.f* The plan must also include "Risk Management Database Information," which are required by legislation and used by SBA in its risk management database. *SOP 50 51 2A, Ch. 4, ¶8* The Liquidation Plan Form may be found at Appendix 15 and the "Risk Management Database Information" at Appendix 16 of SOP 50 51 2A.

The lender must follow procedures that:

- a. Are consistent with generally accepted practices used by prudent lenders
- b. Are required by SBA's SOP, regulations, and loan documents
- c. Use the same degree of prudence as when liquidating non-SBA loans

For CLP loans only: If SBA does not approve, deny, or modify a request for approval of a liquidation plan within 10 business days after the lender makes the request, the plan will be deemed approved. If SBA does not respond to a lender's request for approval of a routine liquidation activity under a liquidation plan within 5 business days after receiving the request, it will be deemed approved. *SOP 50 51 2A, Ch. 10, ¶4.*

The CLP and regular 7(a) lender must obtain SBA's prior written consent for the following actions:

SOP 50 51 2A, Ch. 8, ¶22.

1. Sell collateral or real estate owned (REO) to its associates or members of their households.
2. Incur legal expenses if lender anticipates legal expenses for litigation will exceed \$5,000. See litigation section below for more information.
3. Engage in any non-routine (contested) litigation. See litigation section below for more information.
4. Compromise the principal amount of the debt or release an obligor on the loan
5. Sell, assign or transfer the note or related loan instruments

6. Make a protective bid. A protective bid is:
 - a. The amount of lender's bid at sale
 - b. Established based on the current appraisal and expenses related to the foreclosure sale, and should be no higher than the anticipated selling price of the property, less all projected expenses associated with the foreclosure and care and preservation expenses of the property.
7. Accelerate the maturity of the note
8. Make or consent to any substantial alteration in the terms of the note or related loan instruments
9. Approve any release, substitution, or exchanges of collateral, except where the value released does not exceed 20% of the original loan amount
10. Sue upon the note or related loan instruments
11. Waive any claim against a borrower, guarantor, standby creditor, or other obligor
12. Purchase, pay installments on, or pay in full a prior lien
13. When the proposed actions vary from either the lender's or the SBA's usual liquidation procedures. The lender must document the circumstances.

Liquidation proceeds must be applied to the SBA guaranteed loan as follows:

Prior to Purchase: If the lender liquidates prior to guaranty purchase, the lender can recover liquidation-related expenses and up to 120 days of interest from liquidation proceeds, using the interest rate in effect at payment default. All other proceeds received from liquidation must be applied by the lender to the principal balance of the loan. SBA will then purchase only its portion of the principal balance outstanding with no accrued interest at the time of the guaranty purchase. *SOP 50 51 2A, Ch. 8, ¶24*

Note: The amount of a lender's successful bid at a foreclosure sale must be reflected on the transcript as a credit to the principal balance of the loan.

After Purchase: When the SBA guaranty **has** been purchased, the lender must apply the net proceeds first to expenses, then to principal, then to interest, unless directed otherwise by SBA. The lender must remit SBA's share of the net proceeds to the Denver Finance Center (DFC) within 15 days of receipt, together with an SBA Form 172, "Report of Transactions on Loans Serviced by Lenders." The Form 172 must indicate the nature of the remittance (liquidation recovery or payment) and itemize any expenses deducted. There is no lender servicing fee on liquidation recoveries. All lender expenses must be

customary and reasonable for the services performed and consistent with local practice. Lender must maintain a transcript of account recording all loan payments, liquidation recoveries, fees and expenses properly chargeable to the loan. SBA Form 172 is available at www.sba.gov/library/forms.html#lender. Online submission of the form also is available. *SOP 50 51 2A, Ch. 8, ¶24-25*

Quarterly status reports

Lenders must submit quarterly liquidation status reports to SBA on all loans after guaranty purchase. SBA may request additional reports at any time. *SOP 50 51 2A, Ch. 8, ¶11.d*

Charge off of loan balance and the Wrap Up Report

If the loan will not be fully repaid after all worthwhile collateral has been liquidated and no further recoveries are anticipated within a reasonable period of time, a final wrap-up report that documents the actions taken to liquidate the account and the results of those actions must be submitted to SBA. If collateral remains that is not cost effective to liquidate due to lack of value, prior liens, environmental concerns, or other reasons, lenders must provide justification in the wrap up report to abandon the collateral. All liens must remain in place, and any future recoveries from the collateral must be shared with SBA according to the guaranty percentage on the loan. The final wrap-up report format is contained in Appendix 18 of SOP 50 51 2A. *SOP 50 51 2A, Chapter 18.*

Further Recovery on Charged-off Accounts

If it is not cost-effective to pursue remaining obligors or guarantors for recovery, and collection action against the obligors/guarantors is still legally permissible (i.e., no bankruptcy, compromise or other legal relief from the debt), SBA will refer them to Treasury for collection. *SOP 50 51 2A, Ch. 18, ¶12* **Note:** If the lender begins further collection action after Treasury referral, SBA must be advised in writing so the Agency can coordinate with Treasury.

LIQUIDATION OF LOANS IN SPECIAL SBA PROGRAMS

Unless specifically addressed in this section, all procedures and guidelines discussed above under general lender liquidation guidelines apply to these programs.

LOW DOCUMENTATION LOAN PROGRAM (LowDoc)

SOP 50 51 2A, Ch. 10 ¶ 1

Liquidation Plan: Approval by SBA of a LowDoc liquidation plan is not required for the lender to pursue recovery actions, and **submission of the plan does not necessarily constitute approval by the Agency or acceptance of its terms.**

Liquidation Expenses: SBA shares in reasonable and necessary costs incurred by the participant on a pro-rata basis up to SBA's share of total recoveries. SBA may agree to

pay more on a case-by-case basis in bankruptcy situations. The lender must absorb any excess costs not agreed to by SBA.

Liquidate Prior to Guaranty Purchase: Lenders must liquidate all business personal property on LowDoc loans prior to requesting guaranty purchase, and indicate how the lender will pursue real estate collateral and other assets.

PREFERRED LENDER PROGRAM (PLP)

SOP 50 51 2A, Ch. 10, ¶5

SBA policy requires PLP lenders to take all routine liquidation actions without prior SBA approval on all loans in the PLP lender's portfolio regardless of program type. A PLP lender in one district will liquidate its loans as a PLP lender in all districts except where its authority to liquidate has been terminated because of problems with these functions.

Liquidation Plans: The plan is submitted to SBA at the time of a lender's request for guaranty purchase on loans with principal balances of more than \$50,000. SBA approval of the plan is not required, and **submission of the plan does not necessarily constitute approval of the plan by SBA or acceptance of its terms.**

Non-Routine Actions Requiring Prior SBA Approval:

1. Any action that would create a conflict of interest or confer a preference on the lender in collection or lien position with respect to SBA's position or the shared SBA/lender position on the guaranteed loan.
2. Compromise with any obligor of the principal loan balance outstanding for less than the full amount due. The lender can compromise accrued interest if justified without prior SBA approval.

NOTE: If a loan is delinquent or liquidation is contemplated or underway, prior SBA approval is required to release a guarantor for less than the principal balance owed even if actual demand has not yet been made on the guarantor.

3. Acquire property in the Agency's name.
4. Acquire title in the Agency's or lender's name to environmentally impaired property.
5. Transfer of a loan to another lender.
6. Non-routine (contested) litigation or routine litigation with costs anticipated to exceed \$5,000. See *Litigation* section below for more information on lender-serviced litigation.

SBAExpress PROGRAM www.sba.gov/banking/exguide.pdf

Lenders participating in SBAExpress are not required to submit a liquidation plan to SBA, and may use their own documentation and procedures that they use for liquidation of their own loans of similar type/size. Lenders must submit liquidation status reports every 6 months after guaranty purchase on loans with a principal balance over \$50,000.

LITIGATION

Litigation is any matter pending before a judicial or administrative tribunal.

Generally, lenders handling litigation on SBA-guaranteed loans should litigate SBA loans in the same manner as they do their regular commercial loans so long as it is in accordance with **prudent** lending practices. *SOP 50 51 2A, Ch. 10, and SOP 70 50 3, Ch. 6*

The Litigation Plan

A Litigation Plan must be submitted to SBA for prior approval

1. When litigation is not routine (i.e., is contested), or
2. When the cost of litigation activities is expected to exceed \$5000, or
3. Within 15 days of the date of the commencement of any defensive action involving an SBA-guaranteed loan.

Routine litigation is defined as uncontested litigation such as non-adversary matters in bankruptcy and undisputed foreclosure actions. Routine litigation may be handled without prior SBA approval where there are no other outstanding loans made by the lender to the Borrower or any other conflict of interest, as long as fees do not exceed \$5,000.

Contested litigation is defined as litigation in which the facts or legal issues are in dispute. Contested litigation and any litigation in which the lender has another outstanding loan require prior SBA approval.

The Litigation Plan must include certain specified information. *SOP 70 50 3, Ch. 6, ¶ 47.* A proposed Litigation Plan is included as Appendix 5-B. If a Lender fails to submit a litigation plan when required, reimbursement of fees and costs may be limited to those fees and costs that SBA counsel determines were necessary and reasonable.

Lender Reporting after SBA Approval of the Litigation Plan

1. Copies of **legal invoices** must be sent to SBA **when received**. SBA counsel will review the legal invoices to determine whether :
 - a. The fees are customary and reasonable
 - b. The fees do not exceed those charged the lender for non-SBA litigation
 - c. The services do not include non-legal liquidation services
 - d. Outside counsel does not double-bill for unnecessary work or work that only benefits the lender
 - e. Lender's in-house counsel does not bill for legal work
2. Copies of **substantive pleadings** such as dispositive motions or other pleadings containing substantive legal arguments or statements of policy must be submitted to SBA **prior to filing**.
3. An **amended litigation plan** must be submitted to SBA if a modification is necessary or if the costs exceed projections by 5%.

SBA will not reimburse a lender for:

1. Any legal fees and costs incurred by lender in an action brought by lender against SBA or in defense of an action brought against lender by SBA;
2. Any legal fees and costs incurred by lender in joining SBA in the litigation by way of cross-claim or counterclaim;
3. Any legal fees and costs incurred by lender's outside counsel for performing non-legal liquidation services;
4. Actions which solely benefit lender as determined by SBA counsel;
5. Defense of lender liability cases except where the lender's actions were expressly approved by SBA; or
6. Attorney fees and costs not proposed in a Litigation Plan, unless determined by SBA counsel to be necessary, reasonable, and customary in the locality in question.
7. Fees for legal work done by in-house counsel.

SBA may assume litigation responsibilities when:

1. The Lender has an actual or potential conflict of interest;
2. The cost of Lender's counsel is not cost-effective in terms of potential recovery;
3. There is a risk of adverse precedent to SBA;
4. The litigation presents important policy or legal issues;
5. The special remedies available to SBA would produce a greater recovery.

COMPROMISE OF DEBT

GENERAL SETTLEMENT POLICY

SBA approval is required for all compromises of principal. Lenders are expected to evaluate compromise/settlement offers and prepare for SBA's review a recommendation to either approve or decline. *SOP 50 51 2A, Ch. 17*

Lenders should explore the possibility of a compromise prior to:

1. Initiating litigation for judgment
2. Commencing foreclosure against a personal residence

Any settlement amount must bear a reasonable relationship to the present value of the estimated amount of recovery available through foreclosure (using a forced sale equivalent value) and enforced collection. This value, combined with the earning potential of the debtor, will form the basis for the offer. *SOP 50 51 2A, Ch. 17, ¶8-12.*

- a. **Forced sale equivalent and enforced collection:**
The basis for this value is normally the amount recoverable from the sale of assets within a limited period of time (auction type sale). A consideration should also be made as to the time and expense required to gain control of the assets (foreclosure, eviction) and holding costs.
- b. **SBA considers the following factors when evaluating a compromise:**
 - Court costs, filing fees
 - Prior liens, taxes, assessments
 - Costs of sale (auctioneers, advertising, clean up)

- Possibility of contested litigation, bankruptcy and related expenses
- Time mandated by state redemption periods and the resulting costs involved
- Care and protection expenses pending resale
- Extraordinary expenses of eviction, repair, vandalism
- Discount reflecting the present value of future net recovery

Fraud or Misrepresentation

An Offer in Compromise **cannot** be accepted if there is knowledge of fraud, misrepresentation, or financial dishonesty on the part of the offeror. The settlement of claims involving these issues is reserved for the DOJ.

THE COMPROMISE PACKAGE

A. Offer must be in writing from the obligor with specific terms specified (i.e. cash, note, or a combination thereof)

B. Information needed from offerors: SOP 50 51 2A, ¶7

1. SBA Form 1150, Offer in Compromise

SBA Form 1150 must contain the offer and be signed by each person making the offer. Offers submitted in some other format are acceptable if they make reference to 18 U.S. Code 1001 and use the Code language found on the SBA 1150 and are signed by each person making the offer; and,

2. SBA Form 770, Financial Statement of Debtor

A balance sheet and statement of income and expenses which covers each obligor(s) or guarantor for the most current year. SBA Form 770 or the equivalent must be used. Signed copies of federal income tax filings are acceptable for the income and expense requirement.

C. Information lenders need to submit to SBA:

Lender write up recommending acceptance or decline of the offer, presented in a manner consistent with and containing the information specified in Appendix 27 to SOP 50 51 2, "Recommended Compromise Report Format."