



**U.S. SMALL BUSINESS ADMINISTRATION  
OFFICE OF INSPECTOR GENERAL**

**ADVISORY MEMORANDUM  
REPORT NO. 12-17**

**DATE:** July 31, 2012

**To:** John A. Miller  
Director, Office of Financial Program Operations

**SUBJECT:** The Small Business Administration Risks Loss of Collateral for Four Disaster Loans  
Totaling \$5.6 Million

This advisory memorandum is to notify you of a finding identified while assessing *the Liquidation of Disaster Loans at the National Disaster Loan Resolution Center (NDLRC)*. Our overall audit objective was to assess the NDLRC's effectiveness in managing disaster loans in liquidation to maximize debt recovery and minimize losses.

During the audit, we reviewed a random statistical sample of 65 disaster loans charged off by the Santa Ana NDLRC. The sample included two defaulted loans the Small Business Administration (SBA or the Agency) approved for a Florida condominium complex. The SBA approved four loans to this condominium complex; two loans are current, while the two in our audit sample are in default. While reviewing the sample, we discovered that the Uniform Commercial Code (UCC) financing statement had lapsed for one loan the SBA approved for this condominium complex. The loan was in servicing at the Birmingham Disaster Loan Servicing Center and had an unpaid principal balance of approximately \$1.3 million. One other loan the SBA granted to this condominium complex also remains in servicing, however, the NDLRC charged off two defaulted loans it granted to the condominium complex. Each of the defaulted disaster loans had an unpaid principal balance of \$1.5 million.

The table below lists the four disaster loans along with the UCC-1 expiration dates:

**Table 1 List of Condominium Association Loans**

<b>LIST OF CONDOMINIUM ASSOCIATION LOANS</b>				
<b>UCC-1 Expiration Date</b>	<b>Borrower Name</b>	<b>SBA Loan Number</b>	<b>Loan Balance (March 30, 2012)</b>	<b>Loan Status</b>
March 15, 2012 (Expired)	[FOIA Ex. 4]	[FOIA Ex. 4]	\$1,296,908	Current
October 3, 2012			\$1,295,326	Current
January 17, 2013			\$1,500,000	Charged-Off
January 17, 2013			\$1,500,000	Charged-Off
		<b>Total</b>	<b>\$5,592,234</b>	

The Birmingham Servicing Center did not renew the UCC financing statement for the collateral on one of the loans in current payment status. This lien lapsed on March 15, 2012; therefore, the government no longer has a secured interest in the collateral for this loan. The UCC financing statement on the other loan in current payment status will lapse on October 3, 2012, unless the Servicing Center takes steps to renew it prior to its expiration. Without prompt action by SBA to renew this expired lien, and the liens on the collateral for the three other loans, we believe the Agency risks the loss of collateral for these four loans with principal balances totaling approximately \$5.6 million. We are recommending that the Center take immediate action to protect the government's security interest in the collateral for these loans.

We conducted this audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. The audit fieldwork necessary to test our other audit objectives is still in progress; however, we conducted the audit work pertinent to the results presented here during the month of March 2012.

## **Background**

The SBA requires disaster loan borrowers to provide collateral for loans above certain thresholds. This collateral may be real estate, personal property or other items with some ascertainable value. The SBA establishes its rights to the collateral other than real estate with a security agreement, which creates a lien and identifies what the SBA may do in the event the borrower fails to pay the disaster loan. Under the security agreement the SBA may, for example, seize and sell collateral after a default. The SBA does not need a court order to take collateral subject to a security agreement after a borrower's default.

The SBA puts other parties on notice of its lien by filing a notice, as controlled by State law, with a centralized repository of non-real estate security interests. When the SBA files its notice of lien properly, the lien is "perfected" and SBA establishes the secured party's rights against third parties. Third parties are on notice of a perfected security interest and will generally need to have collateral released from the lien in order to purchase the collateral. Secured parties will retain a lien against collateral that is not released. Perfecting a lien also establishes priority among lien holders, with junior lien holders paid from collateral only after senior lien holders have received their money.

Unperfected liens are vulnerable to being superseded by junior liens, depriving the senior lien holder of its rights in the collateral against other parties. A perfected lien for security interest gives SBA substantial protection against monetary loss.

Following Hurricane Wilma in 2005, the SBA approved four disaster loans of \$1.5 million each to four individual condominium associations that represented a condominium complex located in Broward County, Florida. The condominium associations were responsible for maintaining the exterior shell of the buildings, as well as community grounds, tennis courts, and a swimming pool. Each of the condominiums had its own condominium association and, therefore, each received a separate disaster loan from the Agency. The source of repayment and the collateral for each of the loans consisted of a special assessment receivable. The special assessment was an additional monthly fee that each of the four condominium associations intended to charge to all of their members in order to repay the SBA

disaster loans. The SBA obtained a first lien on each of these receivables by filing a UCC financing statement with the Florida Secured Transaction Registry<sup>1</sup>.

## Results

During our review of a sample of disaster loans charged off by the NDLRC, we discovered that the UCC financing statement lapsed on March 15, 2012 for a current loan serviced by the Birmingham Disaster Loan Servicing Center. We determined that the Birmingham Servicing Center had not renewed the UCC-1 filing in order to maintain the SBA's lien against the special assessment because the servicing center did not believe this special assessment required renewal. The UCC financing statement for the other current loan will expire on October 3, 2012. The combined outstanding principal balance for these two loans is approximately \$2.6 million. However, if the SBA does not renew these UCC financing statements, the Agency runs the risk that another creditor may file a UCC financing statement against the collateral and obtain a priority standing or that a third party will otherwise take the collateral, denying the SBA the opportunity to receive funds from the collateral. Should another creditor file a lien against the collateral for these loans and later liquidate the collateral, there may be no residual value for the SBA to recover. If the borrowers should default on their SBA disaster loans, the SBA may be unable to recover any of the unpaid loan balance because it did not renew these UCC financing statements.

The Santa Ana NDLRC charged off two defaulted disaster loans to the condominium. Under the SBA's procedures for servicing disaster loans, charging off a loan is an accounting procedure, which does not release the underlying debt. A charged off loan is carried on the SBA's books as a loss, but the SBA may still pursue the debtor for all amount still owed (subject to statutes of limitation or other restrictions). The two charged off loans have combined principal balances of \$3 million. The borrowers did not make any payments for these charged off loans. In August 2009, an officer —representing both homeowners' associations for sections one and three of the condominium complex— sent a letter to the Birmingham Disaster Loan Servicing Center. The letter indicated that the condominium owners were not paying their regular association fees, many of the condominiums were in foreclosure, and the association could not pay the loan. According to the condominium association officer, the association was unable to collect regular monthly maintenance fees from the homeowners, let alone the special assessment. Based upon this information, the NDLRC "abandoned collateral" and charged-off the two loans in December 2009.

Although two of the disaster loans to the condominium associations have been charged off, we believe the SBA should renew the financing statements for the special assessments on these two loans. The UCC-1 will automatically expire on January 17, 2013 for both loans, unless the SBA files for their continuation. Since the NDLRC charged off these loans, the Agency is unlikely to renew these liens prior to their expiration. If the UCC financing statement should expire, another creditor may file a UCC financing statement and obtain priority status. In this case, should the first lien holder liquidate the special assessments, there may be no residual value available to pay the SBA. Therefore, the SBA should renew the UCC financing statements to protect its first lien holder position for the collateral of these loans.

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<sup>1</sup> The "Florida Secured Transaction Registry" is a centralized Uniform Commercial Code filing and retrieval system containing initial financing statements, amendments, assignments, and other UCC filings as authorized by Florida Statutes Chapter 679, Section 527.

## **Conclusion**

The SBA risks the loss of \$5.6 million of loan collateral by not renewing the UCC financing statements for these special assessments. The UCC financing statement for one of the condominium association loans with a principal balance of nearly \$1.3 million lapsed on March 15, 2012. Additionally, the SBA risks the lapse of another UCC financing statement on October 3, 2012 for the collateral on a second loan with a principal balance of approximately \$1.3 million. Although the condominium associations are now current on their SBA disaster loan payments, should one or both default on their loans, the SBA might face greater difficulty in recovering these debts by liquidating the loan collateral if it did not renew the financing statements. Since two SBA disaster loans to this condominium complex have already defaulted, we recommend that the SBA renew the UCC financing statements for these loans.

We also recommend that the SBA renew the UCC financing statements that will lapse in January 2013 for the collateral of the two charged-off loans with principal balances totaling \$3 million. Because the SBA has charged off these loans, it is unlikely that it plans to renew these financing statements, despite the validity of the underlying debt. As a result, the SBA risks losing its first lien holder position on the collateral of these four disaster loans totaling approximately \$5.6 million. If the SBA loses its priority lien holder position in the loan collateral, it may be difficult to recover any of the debt by liquidating the loan collateral.

## **Recommendation**

We recommend that the Director of the Office of Financial Program Operations ensure that the Centers renew the financing statements on the collateral for the four disaster loans to the [FOIA Ex. 4]  
[FOIA Ex. 4]

## **AGENCY COMMENTS AND OFFICE OF INSPECTOR GENERAL RESPONSE**

On June 6, 2012, we provided a draft of this report to the Director, Office of Financial Program Operations (OFPO). On July 27, 2012, the Director of OFPO submitted formal comments, which are included in their entirety in Appendix I. The director disagreed with the finding but agreed to implement the recommendation.

A summary of management's comments and our response follows.

### **Agency Comments**

Management relied upon the opinion of legal counsel at the Birmingham Disaster Loan Servicing Center to determine whether it would be necessary to renew the UCC filings in order to protect the government's interests. The Birmingham Center counsel asserted that it was unnecessary to renew the UCC filings because they believed the language in the special assessment would prevent other parties from acquiring an interest in these rights.

OFPO believes that the OIG overstated the situation when it asserts that "SBA risks the loss of \$5.6 Million of loan collateral by not renewing the UCC statements for these special assessments." Any recovery by the Agency from the special assessment payments in these matters, regardless of UCC filing status, is unlikely to yield the full \$5.6 Million.

## **OIG Response**

The OIG relied upon its own legal counsel to opine whether or not renewing the UCC financing statements was necessary. The OIG legal counsel concluded that it would be prudent for the agency to file a renewed UCC financing statement to protect its interests in the [FOIA Ex. 4] [FOIA Ex. 4] (HOAs) collateral. The OIG's counsel based its opinion upon the lack of clarity in Florida law as to whether it was necessary to file financing statements on the condominium assignments of the special assessments in order to protect SBA's lien priority.

The two defaulted HOA loans were referred to Treasury for cross servicing and collection. Subsequently, Treasury referred the loans to DOJ for litigation to pursue collection of the debts. It is beneficial for the liens to be intact, since the defaulted loans were referred to DOJ for litigation. Should the SBA lose its rights to the loan collateral, it would risk loss of the entire loan balance.

The OIG did not perform an analysis to determine how much of the \$5.6 million loan balances the agency would be likely to recover. The potential recovery amount is not the issue. The OIG has identified that the entire \$5.6 million loan balances are at risk if the agency does not preserve its rights to the loan collateral.

### **Recommendation 1**

#### *Managements Comments*

Management agreed to implement the recommendation.

#### *OIG Response*

Management's comments are responsive to the recommendation.

We appreciate the courtesy and cooperation of the Small Business Administration during this audit. If you have any questions concerning this report, please call me at (202) 205-7390 or Craig Hickok, Director, Disaster Assistance Group at (817) 684-5341.

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/s/

John K. Needham

Assistant Inspector General for Auditing

## Appendix 1



U.S. SMALL BUSINESS ADMINISTRATION  
WASHINGTON, D.C. 20416

MEMORANDUM  
July 26, 2012

To: John Needham  
Assistant Inspector General for Auditing

From: John A. Miller  
Director, Office of Financial Program Operations

Subject: Response to Draft Advisory Memorandum, Project No. 11802

Thank you for the opportunity to review the revised draft Advisory Memorandum and provide you with our comments.

In the course of its ongoing audit of the National Disaster Loan Resolution Center's effectiveness in managing disaster loans in liquidation to maximize debt and minimize losses, the Office of the Inspector General (OIG) separately issued an Advisory Memorandum, Project No. 11802, "The Small Business Administration Risks Loss of Collateral for Four Disaster Loans Totaling \$5.6 Million."

Specifically, this audit advisory memorandum concentrates on the UCC filing status of four loans under the [FOIA Ex. 4]. The OIG asserts that not exercising the renewal of the Uniform Commercial Code (UCC) financing statements puts SBA at risk of collateral loss for these disaster loans.

OFPO relies upon Agency counsel – in this case, counsel with the Birmingham Disaster Loan Servicing Center – to proceed appropriately in matters involving legal determinations. Center Counsel has concluded both that the subject UCC filings were not necessary in the first instance, and that renewals of those filings are equally unnecessary. In April 2012, SBA Center Counsel wrote to the OIG:

I have reviewed the collateral documents for both of these loans. The collateral for each loan consists of "all rights of Debtor to receive and collect proceeds arising pursuant to any and all special assessment and any other assessments, levied by Debtor to amortize and repay Debtor's loan from Secured Party and all accounts and/or general intangibles arising from such assessment(s)." In each case, the special assessment and its assignment to the SBA are created by a specific set of documents unique to that assessment. No other party can acquire an interest in these rights.

Any future special assessment in favor of another party must be created by its own specific set of documents, which will make it separate and distinct from the special assessment created for the repayment of each of the above-referenced loans.

Consequently, a filed UCC Financing Statement is not necessary to protect a lien priority in the special assessment pertaining to ... these loans.

Though having received this explanation from Center Counsel, the OIG makes no mention of that in its own Advisory Memorandum. Furthermore, Center Counsel maintains its conclusion after having reviewed the more detailed explanation of the OIG's legal position recently provided to Center Counsel.

Moreover, as recognized by the OIG in its Advisory Memorandum, a representative from the subject condominium associations has advised that, with respect to the two subject loans which have defaulted, the association was not able to collect from the individual homeowners their regular monthly maintenance fees, let alone the special assessment at issue. Therefore, OFPO believes that the OIG has overstated the situation when it asserts that "SBA risks the loss of \$5.6 Million of loan collateral by not renewing the UCC statements for these special assessments." Any recovery by the Agency from the special assessment payments in these matters, regardless of UCC filing status, is unlikely to yield the full \$5.6 Million.

In light of the above, OFPO responds to the OIG recommendation as follows:

- **OIG RECOMMENDATION #1:**  
**We recommend that the Director of the Financial Program Operations ensure that the Centers renew the financing statements on the collateral for the four disaster loans to the**  
[FOIA Ex. 4]

OFPO is relying on the legal determination of SBA Center Counsel. It is OFPO's understanding, however, that, as an accommodation to the OIG's concerns, Center Counsel will execute the UCC filings referenced by the OIG.

Again, thank you for the opportunity to review the draft Advisory Memorandum and to present our comments.