The Issue of Right of Redemption in SBA 504 Lending

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In this article, the authors review the Right of Redemption under the Small Business Administration's 504 Loan Program and explain steps lenders can take to benefit from the program.

The impact on lending institutions, notably community banks,[1] of the exercise of the Right of Redemption under the U.S. Small Business Administration's 504 Loan Program (the "504 Loan Program") can be profoundly detrimental to both participating financial institutions and to the potential borrower under the loan program.

"Right of Redemption"[2] is the legal principle whereby the SBA, as a federal agency, can redeem a senior creditor's interest in an asset to assert and protect the interest of the federal government, in the case of the SBA, for a period of one year, after the creditor has gone through all normally required legal processes to gain control of the asset. Many states have enacted legislation to eliminate the federal government's Right of Redemption. However, in *United*

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States v. John Hancock Mutual Life Insurance Company,[3] the Supreme Court held that the federal government's Right of Redemption is paramount against state law that conflicts with the one-year redemption period.[4]

The 504 Loan Program of the SBA is a less known financing vehicle; despite having involved the financing of projects with a total cost approaching $6 billion dollars and the creation of up to 50,000 jobs in the past year. The focus of the 504 Loan Program is the purchase or construction of capital assets, while requiring minimal equity from borrowers. The borrower will be required to inject into the project 10 to 20 per cent of project cost. During construction or, as regards equipment, delivery and installation, the bank will fund the entire balance of the project cost. Within approximately 30 to 60 days of completion, an SBA sponsored vehicle will provide takeout financing reducing the bank's exposure to approximately 50 per cent of the project cost, with an upper dollar limit to the takeout of $1 million to $1.3 million depending on specific circumstances. The bank's financing will be in a first security position with the SBA supported financing junior to the bank in security interest. At no time in the process does the bank enjoy a guarantee from the SBA; the program simply commits to reducing the final exposure to a very low loan to cost ratio.[5]

The appeal of the 504 Loan Program to lenders is in its enhancement of the loan to cost ratio, and thus the reduced likelihood of lender loss. However, this enhancement is only as effective as the mechanics that deliver it. A liberal implementation of the Right of Redemption would reduce the perceived value of the enhancement and would lessen the appeal of the program among lenders, particularly community banks. This would limit the distribution and impact of an otherwise extremely successful program. Furthermore, it would work contrary to both the SBA's and the debtor's interest in seeing a maximized sale value of the property, which could benefit both, as outlined below.

DEFINED DOWNSIDE

When the SBA decides not to bid on real property at a courthouse auction, it is implicitly acknowledging the limits to both the potential recovery and the resources required to obtain such. At this point the SBA is making an

economic decision and accepting a loss. The lender, by acquiring the property, is accepting the risk that there is sufficient equity, and the prospect of a ready market for such, to justify the expenses and difficulties, both financial and regulatory, inherent to the situation. Overall, the SBA accepts a defined downside and the lender opts for an attempt at a full financial recovery. It is realistic to consider that at the roughly 50 per cent loan to cost basis of the 504 Loan Program there is every reasonable expectation of such a recovery. There is also the possibility of an additional gain, as the proceeds of a sale in excess of the debt and costs go to the benefit of the lender, as the holder of the foreclosure judgment. The possibility of the lender achieving such a gain is limited by the regulatory pressure that it will encounter in such a situation. It is thus conditioned by the willingness of the lender to endure such regulatory pressure and the ability to bring largely local resources; community knowledge, contacts and local staff to bear in marketing the property.

Under present bank regulatory postures, if a property is taken back and classified as "Other Real Estate Owned" (OREO), it must be appraised and the carrying value on the bank's books adjusted, generally downward, to the current appraised value. Regulatory expectation is that within six to eight months the property will be sold, or if it is not, further write-downs will be mandated, now coming from current period operating earnings as opposed to previously established loan loss reserves. The pressure will be increased by the impact that such a transaction would have on the ratio of criticized assets to capital. Ten per cent is considered a critical performance benchmark by many regulatory bodies, and a bank with a lower ratio would certainly face increased scrutiny of overall loan loss reserve adequacy and portfolio management. This could lead to additional reserving actions, thus further decreasing current period earnings. Given the proportions, the concern is greatest for the literally thousands of community banks participating in the 504 Loan Program. It is estimated that for the most current year's statistics that 30 per cent of the banks participating in the 504 Loan Program meet this definition.

CLOUD ON TITLE

By implementing the full authority of the Right of Redemption the SBA provides both a hurdle against and a powerful disincentive to the lender to

Example of Release Calculations

Original Project Cost	$1,000,000			
Entrepreneurial Factor	15.00%			
Project Valuation at Completion	$1,150,000			
Original Loan Structure				
Private Sector Lender First REM	$500,000	*Participation Percentage*	50.00%	
SBA Supported Second REM	$400,000	*Participation Percentage*	40.00%	
Borrower Initial Equity	$100,000	*Participation Percentage*	10.00%	
Range of Probable Recovery				
Loan to Cost	60.00%	75.00%	67.50% (midpoint)	
Loan to Value	50.00%	65.00%	57.50% (midpoint)	
Probable Recovery	$675,000	$661,250		
Midpoint	$668,125			
Recovery Costs				
Legal Foreclosure Costs	$7,500			
Appraisal	$2,500			
Marketing/Brokerage	$66,813			
Maintenance	$5,000			
Taxes	$2,500			
Default Interest (8.00%)	$20,000			
Holding Prd.(Months)	6			
Recovery Costs	$104,313			
Recovery Before SBA Release Fee	$563,813			
Fixed Release Fee				
2.00%of First REM Value	$10,000			
Participation Release Fee				
10.00%of Net Recovery	$56,381	With Ceiling		
Net Recovery to Lender	*Fixed*	*Participation*		
	$553,813	$507,431		
Net (Chargeoff) or Gain				
	Fixed Release	*Participated Release*		
Lender	$53,813	$7,431		
SBA	$(390,000)	$(343,619)		

attempt to maximize the selling price of the property. The SBA creates a cloud on the title,[6] which will limit the marketability of the property. Such limitation reduces both the ability and the incentive to the lender to resist regulatory pressure to dispose of the property as rapidly as possible. Clearly, these actions will limit the possibility of achieving the maximum value.

In sum, it is the perfect incentive to sell the property as rapidly as possible at the most readily "acceptable," "lowest" price. This has no benefit for the SBA, since the SBA would have no incentive to redeem the creditor's position, and could promote the perception among lenders of unfair dealing as the lending institution is asked to bear risks and consequences and reap no rewards. There is no benefit to the lender, as at best it is given the thankless job of managing a foreclosure. Nor do the debtors or guarantors benefit since a reduced asset price, absent debt relief, will create larger deficiency judgments. The particularly insidious aspect of the Right of Redemption implementation as portrayed above is that the promotion of the 504 Loan Program is heavily based on the benefit to the private sector lender of being in a strong senior lien position to a co-operative junior lien-holder. When the mechanics of the program interfere with this premise they go directly contrary to the understanding actively promoted among all product users.

MITIGATION METHODS

These negative results can be mitigated by defining a range of formulas allowing for a release of the Right of Redemption with an equitable sharing of the tradeoffs between upside and downside resources and regulatory burdens. Rather than relying on the potential exercise of the Right of Redemption to occasionally increase its recoveries, the SBA could waive the right for a choice of:

(i) A defined percentage of the existing lien position. This would allow SBA to recover some money for its troubles in a given situation, but would also allow a rapid closure and a minimal commitment of SBA staff resources. A good analogy might be a transaction break-up fee; or

(ii) A defined percentage of the net recovery after the payment of the full

lien position and all expenses associated with the credit and its recovery. This would provide the lender with the incentive to resist regulatory pressures and to bear the significant intangible costs of OREO management while allowing the SBA to participate, with minimal expense or effort, in any recovery generated through the lender's local knowledge, efforts and resources. A good analogy might be an oversized finder's fee.

The chart on page 712 provides an example of the proposed alternatives. The chart lays out an SBA 504 transaction in terms of national averages, from original cost and valuation estimates through funding, and finally derives an estimate of a gross recovery in a liquidation of the property.

The percentages used in the calculation of the "fixed release fee" and the "participatory release fee" are merely examples in specificity to demonstrate the logic of the argument. The "fixed release fee" is a walk-away fee to the SBA and is paid where the SBA determines that while there is some likelihood of recovery the potential does not merit the full commitment of resources to buy through the senior secured position. Such a fee, which could be set as a national standard, should be by its nature minimal and should be easily recovered in the post foreclosure sale, thus posing no issue to the lender. Being a minimal amount it does not act contrary to the interests of guarantors of the debt, as it would have limited impact on the dimensions of a deficiency. The percentage used for this example in the participatory release fee is pure supposition. This fee should be determined on a case by case basis, set by national policy, within a range of approximately ten to thirty percent of recovery after expenses. Decision criteria would have to be defined to determine which of the two courses would be appropriate, though this decision should be left to local SBA district offices, whose specific regional and transactional knowledge should produce superior results. A starting point of the decision would logically be a valuation of the real property and an estimation of likely recovery. Should the valuation incline to a likely gross recovery of less than 10 per cent, the fixed release fee scenario would be pursued. If the likely recovery is greater then 10 per cent, but below an upper limit to be determined, the participatory release fee would be pursued. The specific participatory release fee, would then be negotiated between the lender and the SBA, in the context of a negotiation for an offer

in compromise with any guarantors between a predetermined range of approximately 10 to 30 per cent of the net recovery. Should the likely recovery exceed the determined upper limit, the SBA would act as a typical junior creditor in a foreclosure environment to protect its interest.

CONCLUSION

The aforesaid analysis begs the question of how to resolve the obligations of guarantors against the deficiency created from the SBA's creditor position. Prior to the finalization of an agreement between the lender and the SBA, an "Offer in Compromise"[7] must be reached with the guarantors. This will preclude any claim of a violation of the covenants of good faith and fair dealing, or that the lender's actions were commercially unreasonable, in disposing of the asset. There are clear benefits to the debtor and third party guarantors by speeding the process, which will allow a discharge of the debt or contingent liability and allow them to move on. The details of the Offer in Compromise will depend, in some degree, on the evaluation of the strength of the guarantors. A decision would be based on a trade-off between the final loss to the SBA as a junior creditor and ability to resolve the obligation with minimal costs, minimal staff resources, and minimal time expended.

Any external factor that increases uncertainty is a threat to commercial lending operations. This is amplified when under the aegis of a risk mitigation program such as the 504 Loan Program, the mechanics of foreclosure and recovery are complicated by the very implementation of the program. To simply continue the policy of subjective use of the Right of Redemption is to discourage the use of the 504 Loan Program, a program the benefits of which are well documented. The proposed resolution allows for an orderly and predictable handling of this issue. By offering a choice of alternative recovery modes in waiving the Right of Redemption, while not precluding the SBA's ability to act as a junior lienholder in foreclosure actions, it allows for maximum flexibility and local decision making. Intuitively this should maximize the overall recovery rate, which further lowers program costs, in a program which is already arguably the lowest delivery cost government based commercial loan programs in existence. As a general policy, and not a pro-

gram revision, it does not require statutory revision or other legislative action. It is thus relatively straightforward to implement and the benefits accrue to all parties. The SBA obtains in the aggregate, a predictable stream of revenue to offset ordinary lending losses and recovery costs while preserving program integrity. The lender obtains a simplified recovery posture, with possible recovery of costs and gains commensurate to risks and burdens. Finally, the debtor and any third party guarantors are allowed to close a painful chapter in their professional and personal lives.

NOTES

[1] The Independent Community Bank Association defines a 'community bank" as one with assets of less than one billion dollars. Fifty-eight per cent of all current bank charters in the United States meet this definition.

[2] The Right of Redemption in favor of the federal government was established on June 25, 1948 and subsequently amended on November 2, 1966 in 28 U.S.C. 2410(c) and provides in relevant part that "Where the sale of real estate is made to satisfy a lien prior to that of the United States, the United States shall have one year from the date of sale within which to redeem, except that with respect to a lien arising under the internal revenue laws the period shall be 120 days or the period allowable for redemption under State law, whichever is longer."

[3] *United States v. John Hancock Mutual Life Insurance Company* 81 S. Ct. 1 (1960).

[4] The Court reasoned that Congress considered the Right of Redemption to be "an important and integral feature of Section 2410" such that the United States would have the opportunity to protect its interest in foreclosed property.

[5] Wallace, Thomas. "SBA 504 Loans: An Underused Product That Helps Community Banks." *RMA Journal* April 2001: 26-31.

[6] The cloud on title will always be present in this event due to the fact that the Right of Redemption vests in the SBA and remains for a period of one year. During the time that the lender is actively marketing the property, any potential purchaser will demand clear title and a title insurance policy insuring the purchaser's fee simple title. A title insurance underwriter, seeing that the property was the subject of a foreclosure of the federal government's interest, will always take exception for the rights of the SBA as an agency of the federal government to exercise its Right of Redemption pursuant to 28 USC 2410. Absent a written, recordable waiver of the SBA's Right of Redemption, the foreclosed property cannot be conveyed with "clear title."

[7] An Offer in Compromise in SBA parlance is an agreement between the lender, borrower and guarantors whereby the parties agree on how to dispose of the asset and minimize loss.